HAS DODD–FRANK ENDED TOO BIG TO FAIL?

HEARING

BEFORE THE

SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

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HAS DODD–FRANK ENDED TOO BIG TO FAIL?

WEDNESDAY, MARCH 30, 2011

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND
BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2154, Rayburn House Office Building, Hon. Patrick T. McHenry (chairman of the subcommittee) presiding.

Present: Representatives McHenry, Buerkle, Meehan, Ross, Quigley, and Welch.

Also present: Representatives Issa and Cummings.

Staff present: Michael R. Bebeau and Gwen D'Luzansky, assistant clerks; Robert Borden, general counsel; Lawrence J. Brady, staff director; Katelyn E. Christ, research analyst; Benjamin Stroud Cole, policy advisor and investigative analyst; Drew Colliatie, staff assistant; John Cuaderes, deputy staff director; Adam P. Fromm, director of Member liaison and floor operations; Linda Good, chief clerk; Tyler Grimm and Ryan M. Hambleton, professional staff members; Peter Haller, senior counsel; Christopher Hixon, deputy chief counsel, oversight; Hudson T. Hollister, counsel; Justin LoFranco, press assistant; Laura L. Rush, deputy chief clerk; Becca Watkins, deputy press secretary; Kevin Corbin, minority clerk; Ashley Etienne, minority director of communications; Carla Hultberg, minority chief clerk; Lucinda Lessley, minority policy director; Jason Powell, minority senior counsel; and Suzanne Sachsman Grooms, minority chief counsel.

Mr. MCHENRY. The committee will come to order. Today's hearing is entitled "Has Dodd-Frank Ended Too Big to Fail?" This is the Special Inspector General for TARP, Mr. Barofsky's last day on the job, and he has had an eventful 2½ years. It has probably felt like a lifetime. We certainly appreciate your service and we appreciate you being here on your final day on the job.

But as has been tradition for our subcommittee, we begin by reading the Oversight and Government Reform Committee's mission statement: We exist to secure two fundamental principles: first, America has a right to know that the money Washington takes from them is well spent and, second, Americans deserve an efficient, effective government that works for them. Our duty on the Oversight and Government Reform Committee is to protect these rights. Our solemn responsibility is to hold government accountable to taxpayers because taxpayers have a right to know what they get from their government. We will work tirelessly in partnership with citizen watchdogs to deliver the facts to the American people and bring genuine reform to the Federal bureaucracy.

This is the mission statement of the Oversight and Government Reform Committee. It is also very similar to the mission statement of inspector generals across our government.

Today's hearing will explore whether our largest financial institutions—I will start by giving an opening statement, so we will start the time now. Today's hearing will explore whether our largest financial institutions are still too big to fail. Despite passage of the Dodd-Frank Act and subsequent financial regulations, specifically, we are concerned about the ongoing perception that government bailouts remain an option for poorly managed financial firms. The bottom line is that 2,300 pages, or over that, Dodd-Frank was supposed to end too big to fail. As it turns out, Dodd-Frank has only reinforced the bailout culture, perpetuated the moral hazard of government intervention, and tipped the economic scales for a few at the expense of growth and competition.

In his January 2011 quarterly report to Congress, the Special Inspector General for TARP, Mr. Barofsky, outlined his concerns with the lasting legacy of too big to fail. This report detailed the unfair competitive advantage of certain financial institutions with implicit government support. Through inflated credit ratings and greater access to cheap credit, these institutions receive benefits that crowd out their smaller competitors.

Those findings were backed up by data from the FDIC, which found the large financial institutions paid 78 basis points less to borrow funds than their smaller rivals. This point was not lost on credit rating agencies, who now take implicit government backing into account when rating credit worthiness. This funding advantage is the result of the market perception that certain institutions are just simply too big to fail.

Dodd-Frank codifies open-ended ad hoc deal making like we saw in the financial crisis of 2008. And if that was not enough, Secretary Geithner stated to the Special Inspector General in December 2010 that in the future we may have to do exceptional things again. And he said this well after the passage of Dodd-Frank.

The combination of an implicit government guarantee and cheap money only reinforces the moral hazard that Dodd-Frank failed to eliminate. Instead of taking bailouts off the table, the Federal Government has given large institutions a special preferred status. Last November voters delivered a very loud message to Washington: they don't want their hard-earned tax dollars going to any more bailouts. The American taxpayer does not want their government in the business of picking winners and losers.

We need to create a competitive lending environment where small businesses can gain access to capital and thrive; where they can feel confident in the credit markets and start creating jobs again. By recognizing our Government's ongoing willingness to bail out large institutions, we can begin to have an honest conversation about ending too big to fail.

I am interested to hear what our first panel and second panel have to say about this matter. On the first panel we are going to have the Special Inspector General for TARP; on the second panel we will have a representative from Treasury, Mr. Massad, who is the Acting Under Secretary for Financial Stability.

With that, I would like to yield the balance of my time to the chairman of the full committee, Mr. Issa.

[The prepared statement of Hon. Patrick T. McHenry follows:]

CHAIRMAN McHenry:

<Opening Statement>

Today's hearing will explore whether our largest financial institutions are still "Too Big To Fail" despite passage of the Dodd-Frank Act and subsequent financial regulations. Specifically, we are concerned about the ongoing perception that government bailouts remain an option for poorly-managed financial firms.

The bottom line is, at over 2,300 pages, Dodd-Frank was supposed to end "Too Big To Fail." As it turns out, Dodd-Frank has only reinforced the bailout culture, perpetuated the moral hazard of government intervention, and tipped the economic scales for a few at the expense of growth and competition.

In his January 2011 Quarterly Report to Congress, the Special Inspector General for TARP, Neil Barofsky, outlined his concerns with the lasting legacy of "Too Big To Fail." This report detailed the unfair competitive advantage of certain financial institutions with implicit government support. Through inflated credit ratings and greater access to cheap credit, these institutions receive benefits that crowd out their smaller competitors.

Those findings were backed by data from the FDIC which found that large financial institutions paid 78 basis points less to borrow funds than their smaller rivals. This point was not lost on credit ratings agencies, who now take implicit government backing in to account when rating credit worthiness.

This funding advantage is the result of the market perception that certain institutions are just "too big to fail." Dodd-Frank codifies open-ended, ad-hoc deal making. And if that was not enough, Secretary Geithner stated in December 2010 that "in the future we may have to do exceptional things again." And he said this well after the passage of Dodd-Frank.

The combination of an implicit government guarantee and cheap money only reinforces the moral hazard that Dodd-Frank failed to eliminate. Instead of taking bailouts off the table, the Federal government has given large institutions a special, preferred status.

Last November voters delivered a message loud and clear to Washington: They do not want their hard-earned dollars financing another bailout.

The American taxpayer does not want their government in the business of picking winners and losers.

We need to create a competitive lending environment where small businesses can gain access to capital and thrive, where they can feel confident in the credit markets and start creating jobs again.

By recognizing our government's ongoing willingness to bailout large institutions, we can begin to have an honest conversation about ending "Too Big To Fail."

I am interested to hear what our witnesses have to say on this matter and what can be done to end "Too Big To Fail" once and for all.

Mr. ISSA. I thank the chairman for holding this hearing and I thank the chairman for yielding his time.

I really just wanted to thank a unique individual. If there is a wall of fame for IGs, Neil, you are going to be on it. You have done an amazingly good job. I looked at your op ed this morning and said, darn, he got the title we should have had. It is entitled "Where the Bailout Went Wrong." So I look forward to hearing your thoughts on, regardless of good intentions of Dodd-Frank and of the TARP bill, where we should learn from the mistakes that probably were inevitable, but, due to your hard work, they are very public, and we intend to address them one by one. So as you go off to academia to teach and to write, I hope you will consider an invitation to come back here exactly that, an invitation, one, where we want your counsel in whatever form it can be provided.

Again, Mr. Chairman, thank you for holding this hearing, one of many in your series, and taking seriously the special committee responsibilities for oversight. And again, nobody is more a hero here than a great IG, and we have a great IG in front of us.

I yield back.

Mr. MCHENRY. I thank the chairman.

At this time I yield 5 minutes to the ranking member, Mr. Quigley, and, by prior agreement, he will share his time with the full committee ranking member as well.

Mr. QUIGLEY. Thank you, Mr. Chairman, for convening this meeting.

Again, I would like to thank our guest today, Mr. Barofsky, for his work at SIGTARP. We appreciate all you have done for us.

One of the lessons of the financial crisis is that the government bears too much risk and taxpayers are left vulnerable to huge losses. More importantly, if firms perceive that taxpayers will cover their losses, then those firms have an incentive to take even bigger risk. And as these over-leverage firms grow in size, they can become too big to fail, in effect passing all their risk on the taxpayers, who would not allow a financial collapse.

TARP, which was passed by Congress and signed by President Bush, averted a catastrophe, and while TARP will likely end up as a net profit for taxpayers, we should not minimize the fact that it exposed taxpayers to unacceptable losses.

Today we must continue to safeguard our financial system against collapse. TARP did not create too big to fail, but it did reinforce it. The Dodd-Frank law is an attempt to roll back those perverse incentives that caused firms to become too big to fail; it establishes stronger prudential regulation, closing many of the loopholes that allowed excessive risk-taking; it created a systemic risk regulator to oversee all financial firms that are systemically important; most importantly, it creates a special resolution authority for failing firms to end bailouts and impose losses on shareholders.

Resolution authority's successive failure will be judged on whether the market perceives it is a credible alternative to bailouts. For me, this is the key question: Does the market view resolution authority as a credible alternative to bailouts? It is my understanding that implementation of Dodd-Frank is still in its early stages. I am hopeful that the result will be a predictable, credible, and orderly process for unwinding failing financial firms.

Addressing the too big to fail problem is even more important today than before the financial crisis. In 1999, the five largest U.S. banking institutions controlled 38 percent of all banking industry assets. Today they control 52 percent of banking assets. To fix this problem, we need to ensure that Dodd-Frank is successfully implemented.

I look forward to hearing testimony from our witnesses and I yield the balance of my time to the ranking member of the full committee.

[The prepared statement of Hon. Mike Quigley follows:]

Opening Statement, March 30, 2011, Subcommittee on TARP and Financial Services
Rep. Mike Quigley, Ranking Member

Mr. Chairman, I'd like to thank you for convening today's hearing on the Dodd-Frank law and "too big to fail".

I'd also like to thank our two witnesses for contributing their time and expertise.

In particular, I'd like to recognize Mr. Barofsky on his last day at SIG-TARP, for the incredibly valuable work he has done over the past couple years.

One of the lessons of the financial crisis is that if the government bears too much risk, then taxpayers are left vulnerable to huge losses.

More importantly, if firms *perceive* that taxpayers will cover their losses, then those firms have an incentive to take even bigger risks.

And as these overleveraged firms grow in size, they can become too big to fail, in effect passing all of their risk onto taxpayers, who would not allow a financial collapse.

TARP, which was passed by Congress and signed by President Bush, averted a catastrophe.

And although TARP will likely end up as a net profit for taxpayers, we should not minimize the fact that it exposed taxpayers to unacceptable losses.

Today, we must continue to safeguard our financial system against collapse, but we have to do so in a way that taxpayers are not exposed to intolerable risks.

TARP did not create "too big to fail", but it did reinforce it.

The Dodd-Frank law is an attempt to roll back those perverse incentives that caused firms to become too big to fail.

It establishes stronger prudential regulation, closing many of the loopholes that allowed excessive risk-taking.

It creates a systemic risk regulator, to oversee all financial firms that are systemically important.

Most importantly, it creates a special resolution authority for failing firms, to end bailouts and impose losses on shareholders.

Resolution authority's success or failure will be judged on whether the market perceives it as a credible alternative to bailouts.

For me, this is the key question: Does the market view resolution authority as a credible alternative to bailouts?

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I am hopeful that the result will be a predictable, credible, and orderly process for unwinding failing financial firms.

Addressing the "too big to fail" problem is even more important today than before the financial crisis.

In 1999, the five largest U.S. banking institutions controlled 38 percent of all banking industry assets—today, they control 52 percent of banking assets.

To fix this problem, we need to ensure that Dodd-Frank is successfully implemented.

Now I would like to yield my remaining time to my colleague Mr. Cummings.

Mr. CUMMINGS. I thank the gentleman for yielding and I thank the chairman for calling the hearing this morning. Unfortunately, today's hearing represents a tragically missed opportunity in the majority's refusal to grant the request to invite Representative Barney Frank to testify before the subcommittee. As the chairman of the House Financial Services Committee throughout the drafting of the financial regulatory reform legislation and as the current ranking member monitoring the implementation of that legislation, Representative Frank's expertise on the matters before us today is unparalleled. We would have benefited greatly if we were able to hear from him.

But despite the disappointment in this subcommittee's process, I thank our witnesses for appearing before us today. I particularly recognize our Special Inspector General Barofsky and I too commend you for a job well done. I want to thank you for working with me the many times I bugged you to do reports and look into things; I really do appreciate it. Your tireless work has enabled us to better fulfill our role in ensuring efficient and effective government oversight of the TARP program and again I thank you.

In the wake of the 2008 financial crisis, we enacted Dodd-Frank in order to set into place a robust regulatory structure to end too big to fail. According to FDIC Chairwoman Sheila Bair, the new requirements under Dodd-Frank will ensure that the largest financial companies can be wound down in an orderly fashion without taxpayer cost. Under Title 2 of the Dodd-Frank Act, there are no more bailouts.

However, as Chairwoman Bair has said, and Mr. Barofsky and others have acknowledged, Dodd-Frank will not work unless we provide our regulators with the resources they need to make full use of these new regulatory authorities.

Frighteningly, the budget proposed by the new majority would effectively cripple the regulators. If we drastically cut the budget of our agencies charged with carrying out this important regulation, we will be paving the way for the next financial collapse and we will never be rid of entities that are in fact too big to fail, and I trust that Mr. Barofsky will comment on that, the whole issue of the need to make sure that these agencies are properly funded.

I am looking forward to the hearing from today's witnesses and again, Mr. Barofsky, I want to thank you for all that you have done. I know you are moving on to academia, but I know that many students will benefit from what you have to say and what you have learned, and we hope you will return to government soon. May God bless you, and I yield back.

Mr. MCHENRY. I thank the full committee ranking member. In response to requests to have Mr. Frank testify before the committee, I also serve on the Financial Services Committee. He is an ex officio member of five subcommittees on that committee; he has been chairman of the Financial Services for the previous 4 years; he is the ranking member of Financial Services. He has every venue to speak about his law that he passed.

Today is about the implementation of Dodd-Frank and whether or not that has ended the culture of too big to fail or whether or not it has propagated it. So we have two panels today. One is the Special Inspector General who oversees the program; the second panel is the Treasury Department, and they can, in essence, have a full panel to themselves. In essence, we are giving the minority a full panel. So usually that is praised, but I certainly understand, in this atmosphere, it may not be.

But our first witness today is Mr. Neil Barofsky. He is the outgoing Special Inspector General for the Troubled Asset Relief Program. Prior to assuming his position at the U.S. Treasury, Mr. Barofsky was a Federal prosecutor in the U.S. Attorney's Office for the Southern District of New York for more than 8 years.

Mr. Barofsky's last day is today. I know his staff is sitting behind him. They are not smiling. I think they are sad to see you go, Mr. Barofsky. We certainly appreciate your service to your Government that you have rendered in the last 2½ years; we know it has been busy, it has been challenging, and you have put more hours into government service than you will ever be paid for, so we appreciate your service to your Government, and in the interest of openness.

So, with that, it is the policy of the committee that all witnesses be sworn in to testify. If you would please rise and raise your right hand.

[Witness sworn.]

Mr. MCHENRY. Thank you. Let the record reflect that the witness answered in the affirmative. Thank you, Mr. Barofsky. So now we will give you an opportunity for your opening statement. Your written testimony will be entered into the record, but we would like to give you an opportunity to say what is on your mind.

STATEMENT OF NEIL BAROFSKY, SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM

Mr. BAROFSKY. Thank you, Chairman McHenry, Ranking Member Quigley, Chairman Issa, Ranking Member Cummings. Thank you for your kind comments and thank you for the opportunity to appear before you today. It is a privilege and an honor to testify before this subcommittee on this, my final day as Special Inspector General.

It is hard to believe that 2½ years ago there was no such thing as TARP, no such thing as SIGTARP, certainly no such thing as a TARP Subcommittee, and since that time we have seen an historic outpouring and outlaying of Government funds to a financial industry that was teetering on the brink of collapse, accompanied by historic oversight.

The Emergency Economic Stabilization Act [EESA], which, of course, created TARP, also created SIGTARP at Congress's insistence, and I am proud to say that, since our inception in December 2008, we have made great progress fulfilling the goals set forth for us by Congress. By the numbers alone, we have issued nine quarterly reports, 13 audits, secured civil or criminal charges against more than 50 individuals, 18 different defendants have been convicted of TARP-related fraud, and our investigations have helped assist in the recovery of or prevention to loss from fraud from more than $700 million, making sure that SIGTARP as an agency will more than pay for itself. As importantly, we have helped bring transparency and accountability to a program desperately in need of them.

Treasury, through TARP, made a series of promises both to Wall Street and to Main Street. Unfortunately, its track record has been mixed. It has fulfilled its promises to Wall Street, as reflected in the returns of record profitability of the Nation's largest banks, but, unfortunately, it has failed to live up to some of its promises to Main Street.

First, with respect to the promise to restore lending, such an important part of any economic recovery, has gone unfulfilled. When Treasury gave out hundreds of billions of dollars to banks, it did so without any policy in place to accomplish that goal, without any strings to require lending or even provide incentives for it. Not surprisingly, credit continued to contract throughout the financial crisis and well into the recovery.

Second, the promise to preserve home ownership, such an important part of the legislative bargain that Treasury struck with Congress in order to get TARP passed, lies in tatters. The original promise to modify up to $700 billion in mortgages that Treasury was to purchase under TARP cast aside within weeks after EESA was passed. That was replaced months later by a promise by this administration to modify up to four million mortgages for struggling homeowners. That promise too has essentially been cast aside, replaced with the cold, stark reality of a failed program that was poorly designed, poorly managed, poorly executed, and will come nowhere close to living up to that original promise.

Finally, after Secretary Paulson and then Secretary Geithner told the world that they would stand by and not let our largest banks fail, and demonstrated that they were ready, willing and able to use the TARP funds to accomplish that, we are left with a financial system with the largest banks that are bigger, more concentrated, and even more dangerous to the system than before the crisis.

We were then promised that through regulatory reform, the era of bank bailouts would end, a promise that looks like it too may very well go unmet because, notwithstanding the passage of Dodd-Frank, the financial markets still perceive that the U.S. Government will bail out the largest banks, with credit rating agencies explicitly giving higher ratings to those banks based on the assumption that, should they hit the rocks again, the U.S. Government will come to their rescue.

As to the execution of Dodd-Frank, it still remains theoretically possible that it will address the problems of too big to fail. Treasury and the regulators were certain we would give them the broad powers and authorities to take on the largest banks. But these are the same regulators whose incompetence and lack of foresight was described by the Financial Crisis Inquiry Commission as one of the causes of the financial crisis.

And while Chairman Sheila Bair stands out as a strong advocate for using the tools of Dodd-Frank to either shrink or simplify the most complex financial institutions as necessary, she also appears to stand alone as her term quickly winds down. Without dramatic and quick action, I am afraid that this promise too will be broken, with potentially devastating consequences.

Mr. Chairman, ranking member, I thank you for the opportunity to be here today. I also want to thank you and the chairman of the full committee and the ranking member of the full committee for your strong support over the years. At SIGTARP, we would not have been able to accomplish nearly any of our goals or our accomplishments if it wasn't for the strong, continuous and, above all, bipartisan support from Congress.

If we had received only support from one side or the other, it would not have had nearly the impact that your uniform support has been for our office, so I thank you. I also want to thank the incredible men and women who work at SIGTARP for their sacrifices, their commitment. They demonstrate all the good that is in Federal workers, and it has truly been my privilege and honor to get to work with them for the last two-plus years.

So I thank you and I look forward to answering any questions you may have.

[The prepared statement of Mr. Barofsky follows:]

SIGTARP OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM

ADVANCING ECONOMIC STABILITY THROUGH TRANSPARENCY, COORDINATED OVERSIGHT AND ROBUST ENFORCEMENT

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OF PUBLIC AND PRIVATE PROGRAMS

STATEMENT OF NEIL BAROFSKY

SPECIAL INSPECTOR GENERAL
TROUBLED ASSET RELIEF PROGRAM

BEFORE THE
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
SUBCOMMITTEE ON TARP, FINANCIAL SERVICES, AND BAILOUTS
OF PUBLIC AND PRIVATE PROGRAMS

MARCH 30, 2011

Chairman McHenry, Ranking Member Quigley, and members of the Committee, I am honored to appear before you today to discuss the impact to date of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act") and subsequent financial regulations on market perceptions surrounding the "too big to fail" financial institutions.

Today marks my last day as the head of the Office of the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP"), and before I address the subject of today's hearing I would like to briefly review the status of SIGTARP. Thanks in no small part to the tremendous support SIGTARP has enjoyed from Congress generally, and members of this Committee specifically, in the time since its inception in December 2008, SIGTARP has had notable success in fulfilling its goals of transparency, oversight, and enforcement. To date, through nine quarterly reports and 13 completed audits, SIGTARP has brought light to some of the darkest areas of the financial crisis and the Government's response to it, and has offered Treasury 68 recommendations to help program effectiveness and protect the taxpayer from losses due to fraud. When Congress created us, it assigned SIGTARP the responsibility for policing the program to minimize losses to fraud to bring those who attempt to steal from the program to justice. I am proud to report that where fraud has managed to slip in, our Investigations Division has already produced outstanding results. To date, 54 individuals and 18 entities have already been subject to criminal or civil actions related to SIGTARP investigations, with 18 individuals criminally convicted. SIGTARP's investigative efforts have helped prevent $555.2 million in taxpayer funds from being lost to fraud, and have assisted in the recovery of over $151 million, already assuring that as an agency SIGTARP will more than pay for itself. Thanks in part to SIGTARP, and to Treasury's adoption of many of SIGTARP's anti-fraud recommendations, it appears that TARP will experience losses from fraud at a substantially lesser rate than what is typically expected for comparable Government programs. And with 158 ongoing investigations, including 77 into executives and senior officers at financial institutions that applied for and/or received Troubled Asset Relief Program ("TARP") funding through TARP's Capital Purchase Program ("CPP"), much more remains to be done.

While the reduction in the anticipated direct financial costs of TARP from hundreds of billions of dollars to potentially $19 billion is certainly good news, the total cost of TARP necessarily involves far more than just dollars and cents. In other words, the good financial news should not distract from the careful and necessary assessment of TARP's considerable, non-financial costs that, while more difficult to measure, may be even more significant. Those costs include what is essentially at the heart of this hearing, the increased moral hazard and potentially disastrous consequences associated with the continued existence of financial institutions that are "too big to fail."

In January, SIGTARP published the audit report "Extraordinary Financial Assistance Provided to Citigroup, Inc.," which details how the Government assured the world that it would use TARP to prevent the failure of any major domestic financial institution. Indeed, public statements by then-Secretary of the Treasury Henry Paulson in late 2008 and Treasury Secretary Timothy Geithner in early 2009 made clear that they were ready, willing, and able to use TARP funds to ensure that none of the nation's largest banks would be permitted to fail, and then stood behind Citigroup Inc. ("Citigroup"), along with others such as American International Group, Inc. ("AIG") and Bank of America Corp. In the darkest days of the financial crisis, 18 very large financial institutions received $208.6 billion in TARP funding almost overnight, and most did not have to meaningfully "apply" for funding or even have to demonstrate an ability to repay taxpayers. Three especially vulnerable institutions with large systemic footprints – Citigroup, Bank of America, and AIG – received additional assistance under programs that were not made available to smaller, less significant institutions. While these actions and statements succeeded in reassuring troubled markets, they also did much more. By putting the United States Government behind these institutions and explicitly guaranteeing them against failure, Treasury encouraged future high-risk behavior by insulating from the consequences of failure the risk-takers who had profited so greatly in the run-up to the crisis (and indeed, in many cases, continue to reap large profits and rich executive compensation packages), and gave an unwarranted competitive advantage, in the form of enhanced credit ratings and access to cheaper credit and capital, to institutions perceived by the market as having an implicit Government guarantee.

Financial institutions now operate in an environment where size matters because the Government guarantee that naturally flowed from the mid-crisis statements by Secretaries Paulson and Geithner that they will not be allowed to fail grossly distorts normally functioning markets, in which an institution's creditors, shareholders, and executives bear the brunt of poor decisions, rather than the taxpayers. As Federal Reserve Chairman Ben Bernanke stated just last week, "[t]he too-big-to-fail problem is a pernicious one that has a number of substantial harmful effects." The prospect of a Government bailout reduces market discipline, giving creditors, investors, and counterparties less incentive to monitor vigilantly those institutions that they perceive will not be allowed to fail. For executives at such institutions, the Government safety net provides the motivation to take greater risks than they otherwise would in search of ever-greater profits. This "heads I win, tails the Government bails me out" mentality promotes behavior that, while it may benefit shareholders and executives in the short term if the risks pay off, increases the likelihood of failure and, therefore, the possibility of another taxpayer-funded bailout. Ratings agencies continue to give such "too big to fail" institutions higher credit ratings based on the existence of an implicit Government backstop. Creditors, in turn, give those institutions access to debt at a price that does not fully account for the risks created by their behavior. Cheaper credit is effectively a Government-granted subsidy, which translates into ever increasing profits, and which allows the largest institutions to become even larger relative to the economy while materially disadvantaging smaller banks. According to Chairman Bernanke, "[t]his competitive distortion is not only unfair to smaller firms and damaging to competition today, but it also spurs further growth by the largest firms and more consolidation and concentration in the financial industry." In short, these institutions and their leaders are incentivized to engage in precisely the sort of behavior that could trigger the next financial crisis, thus perpetuating a doomsday cycle of booms, busts, and bailouts.

The "too big to fail" problem pre-dated TARP, and to the extent that bailouts were necessary, a temporary worsening of the problem to some degree was probably unavoidable. Nevertheless, TARP's most significant legacy may be the exacerbation of the problems posed by "too big to fail," particularly given the manner in which Treasury executed the bailout, largely sparing executives, shareholders, creditors and counterparties, reinforcing that not only would the Government bail out the largest institutions, but would do so in a manner that would do little harm to the responsible stakeholders. Further, to the extent that huge, interconnected "too big to fail" institutions contributed to the crisis, the Government's management of the crisis, including TARP, has left those institutions larger than ever, fueled by Government support and taxpayer-assisted mergers and acquisitions. According to retiring Kansas City Federal Reserve Bank President Thomas Hoenig, "after this round of bailouts, the five largest financial institutions are 20 percent larger than they were before the crisis. They control $8.6 trillion in financial assets – the equivalent of nearly 60 percent of gross domestic product." A total of 334 small and medium-sized banks, however, have failed since the TARP's inception. In other words, for all its help in rescuing the financial system from the brink of collapse, TARP may have left a truly alarming bequest: It has increased the potential need for future Government bailouts by encouraging the "too big to fail" financial institutions to become even bigger and more interconnected than before, therefore *increasing* their ultimate danger to the financial system.

The Dodd-Frank Act, signed into law by President Obama last July, was intended, in part, "to end 'too big to fail'" and "to protect the American taxpayer by ending bailouts." Secretary Geithner, testifying before the Congressional Oversight Panel ("COP") in June 2010, shortly before the Act's passage, proclaimed that "the reforms will end 'too big to fail.'" The Act's proponents cite several provisions as particularly important components of this effort. These include creation of the Financial Stability Oversight Council ("FSOC"), charged with, among other things, the responsibility for developing the specific criteria and analytic framework for assessing systemic significance; granting the Federal Reserve new power to supervise institutions that FSOC deems systemically significant; granting the Federal Deposit Insurance Corporation ("FDIC") new resolution authority for financial companies deemed systemically significant; requiring the development of "living wills" designed to assist in the orderly liquidation of such companies; and granting regulatory authority to set more stringent capital, liquidity, and leverage requirements and to limit certain activities that might increase systemic risk.

Whether these provisions will ultimately be successful remains to be seen. They rely heavily on many of the very same financial regulators whose "widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets," according to the Financial Crisis Inquiry Commission ("FCIC"). Many commentators, from Government officials to finance academics to legislators, have expressed concern that the Act does not solve the problem. Kansas City Federal Reserve Bank President Thomas Hoenig remains unconvinced "that our too-big-to-fail problem has been solved," noting just last month that "[m]arket participants and large financial institutions have little reason to doubt that they will be bailed out again" and that "the existence of too big to fail financial institutions poses the greatest risk to the U.S. economy." Massachusetts Institute of Technology Professor Simon Johnson agrees, stating in September 2010 that "there is nothing [in the Act] that ensures our biggest banks will be safe enough or small enough or simple enough so that in the future they cannot demand bailout — the bailout potential exists as long as the government reasonably fears global financial panic if such banks are allowed to default on their debts." In his recent testimony before COP, Nobel laureate and Columbia University Professor Joseph E. Stiglitz stated that "too-big-to-fail institutions, whether they be mortgage companies, insurance houses or commercial investment banks, pose an ongoing risk to our economy and the solidness of government finances," and emphasized that the Act's "[r]esolution authority has made little difference, because few believe that the government will ever use the authority at its disposal with these too-big-to-fail banks." Professor Stiglitz thus concluded that the Act "did not go far enough; it was riddled with exceptions and exemptions. It did not adequately deal with the too-big-to-fail banks. . . ."

Senators Sherrod Brown and Ted Kaufman, now the chairman of COP, have argued that the Dodd-Frank Act could not and did not by itself provide the *global* regulatory framework required to resolve incredibly complex megabanks operating around the world. Chairman Bernanke has noted that "[r]esolving a large, multinational financial firm safely will likely always be a difficult challenge." Professor Johnson, less optimistically, recently testified before COP that without a cross-border resolution authority, we "cannot handle in orderly fashion the failure of a bank like Goldman Sachs or JPMorgan Chase or Citigroup, which operate in 50, 100, 120 countries." Other critics of the Dodd-Frank Act, including Congressman Spencer Bachus, Speaker of the House John Boehner, and Chairman Patrick McHenry of this Committee, have expressed concern that the Act's provisions, particularly those relating to designation and resolution, will not only fail to solve "too big to fail" but actually make it worse by institutionalizing Government bailouts.

As even its proponents now concede, the new authorities in the Dodd-Frank Act are a work in progress — a tremendous amount of research and rule making by FSOC, FDIC, and a host of other regulators remains to be done. Their tasks will not be easy. Secretary Geithner told SIGTARP in December 2010, for example, that identifying non-bank financial institutions as systemically significant, one of the Act's premier mandates, "depends too much on the state of the world at the time," and that he believes "you won't be able to make a judgment about what's systemic and what's not until you know the nature of the shock." If the Secretary is correct, and regulators have difficulty properly identifying non-banks as systemically significant and therefore subject to the Dodd-Frank Act's restrictions, then the Act's effectiveness will undoubtedly be undermined.

While it is too early to tell whether the Dodd-Frank Act will eventually rein in the moral hazard problem, the path regulators choose to take will make all the difference. Federal Reserve Chairman Ben Bernanke recently discussed how the regulators are working to implement the Dodd-Frank Act by developing more stringent prudential standards (including enhanced capital and leverage requirements, liquidity requirements, single-counterparty credit limits, and requirements to produce resolution plans and conduct stress tests on a routine basis) for banking firms with assets greater than $50 billion and all nonbank financial firms designated as systemically important by the FSOC. According to Chairman Bernanke, the goal is to "force these firms to take into account the costs that they impose on the broader financial system, soak up the implicit subsidy these firms enjoy due to market perceptions of their systemic importance, and give the firms regulatory incentives to shrink their systemic footprint."

FDIC Chairman Sheila Bair has argued repeatedly that regulators should take a more proactive role, and use the Dodd-Frank Act's "living will" provisions as a tool to force companies to simplify their operations and shrink their size if necessary to ensure that orderly liquidation is possible:

> Under Dodd-Frank, the FDIC and the Federal Reserve wield considerable authority to shape the content of these [living will] plans. If the plans are not found to be credible, the FDIC and the Fed can even compel the divestiture of activities that would unduly interfere with the orderly liquidation of these companies. The success or failure of the new regulatory regime will hinge in large part on how credible those resolution plans are as guides to resolving those companies. And let us be clear: we will require these institutions to make substantial changes to their structure and activities if necessary to ensure orderly resolution. *If we fail to follow through, and don't ensure that these institutions can be unwound in an orderly fashion during a crisis, we will have fallen short of our goal of ending Too Big to Fail.* (Emphasis added.)

If Chairman Bair prevails in ensuring that the Dodd-Frank Act is used to simplify and shrink large institutions as necessary, if Chairman Bernanke's incentive structure proves to be effective in compelling meaningful change, or if some other effective regime is adopted, along with similar provisions being implemented internationally, then perhaps in the long run the Dodd-Frank Act will have a chance to end "too big to fail." But as Secretary Geithner acknowledged to SIGTARP in December 2010, "In the future we may have to do exceptional things again if we face a shock that large," even though "[w]e have better tools now thanks to Dodd-Frank."[1] His acknowledgement of the reality of potential future bailouts under the current regime serves as an important reminder that TARP's price tag goes far beyond dollars and cents, and that the ultimate cost of the moral hazard that accompanied TARP will remain unknown until the next financial crisis occurs.

Regardless of whether all the required regulations are properly calibrated and fully implemented, the ultimate success of the Dodd-Frank Act depends on market perception. As long as the relevant actors (executives, ratings agencies, creditors and counterparties) believe there will be a bailout, the problems of "too big to fail" will almost certainly persist. Federal Reserve Chairman Ben Bernanke, in a speech to community bankers in March 2010, summed up the problem this way:

> The costs to all of us of having firms deemed too big to fail were stunningly evident during the days in which the financial system teetered near collapse. But the existence of too-big-to-fail firms also imposes heavy costs on our financial system even in more placid times. Perhaps most important, if a firm is *publicly perceived* as too big, or interconnected, or systemically critical for the authorities to permit its failure, its creditors and counterparties have less incentive to evaluate the quality of the firm's business model, its management, and its risk-taking behavior. As a result, such firms face limited market discipline, allowing them to obtain funding on better terms than the quality or riskiness of their business would merit and giving them incentives to take on excessive risks.

As to Dodd-Frank's impact on this ultimately determinative issue – market perception – thus far the Act has clearly not worked. Reflecting Secretary Geithner's candid assessment of the likely limits of Dodd-Frank in the event of a full blown financial crisis, the largest institutions continue to enjoy access to cheaper credit based on the existence of the implicit Government guarantee against failure. Standard & Poor's ("S&P") and Moody's Investors Service ("Moody's"), two of the world's most influential credit rating agencies, recently reinforced this significant advantage for those institutions. In January of this year, S&P announced its intention to make permanent the prospect of Government support as a factor in determining a bank's credit rating, a radical change from pre-TARP practice, stating that it expected "this pattern of banking sector boom and bust and government support to repeat itself in some fashion, *regardless of governments' recent and emerging policy response*." (Emphasis added.) Similarly, also in January, Moody's stated its belief that the proposed resolution regime "will not work as planned, posing a contagion risk and most likely forcing the government to provide support in order to avoid a systemic crisis." Because of this belief, Moody's also intends to continue assuming government support for the eight largest banking organizations. In short, S&P and Moody's are telling the market that they do not believe that the Dodd-Frank Act has yet ended the problems of "too big to fail," and given the discounts that such institutions continue to receive, the market seems to be listening. In fact,

[1]It was apparent to SIGTARP from the context of the interview, including the reference to doing something exceptional "again" in the face of a future financial crisis, that Secretary Geithner was referring to the possibility of future bailouts. While Treasury has not disputed the quotation attributed to Secretary Geithner or the context in which it was presented in SIGTARP's audit report, "Extraordinary Financial Assistance to Citigroup, Inc.," at least one Treasury official has suggested that Secretary Geithner was actually referring to using the tools of the Dodd-Frank Act.

some recent reports suggest that the largest banks' funding advantage over their smaller competitors has actually *increased* since the passage of the Dodd-Frank Act.[2]

As former Treasury Secretary and National Economic Council Director Lawrence Summers said more than a decade ago, "a healthy financial system cannot be built on the expectation of bailouts." Federal Reserve Chairman Ben Bernanke reiterated this sentiment just last week, stating that "[a] financial system dominated by too-big-to-fail firms cannot be a healthy financial system." The continued existence of institutions that are "too big to fail" — an undeniable byproduct of former Secretary Paulson and Secretary Geithner's use of TARP to assure the markets that during a time of crisis that they would not let such institutions fail — is a recipe for disaster. Unless and until institutions viewed by the market as "too big to fail" are either broken up, so that they are no longer a threat to the financial system, or a structure is put in place to assure the market that they will be left to suffer the full consequences of their wanton risk-taking, the prospect of more bailouts will potentially fuel more bad behavior with potentially disastrous results.

As Chairman Bernanke stated last week, "[a] clear lesson of the past few years is that the government must not be forced to choose between bailing out a systemically important firm and having it fail in a disorderly and disruptive manner." For several decades, our nation has had a framework in place to resolve failing banks in a manner that preserves market discipline. While the Dodd-Frank Act sought to establish a comparable framework for resolving systemically important non-bank financial firms, including bank holding companies, in a manner that insulates the broader financial system from the possibly destabilizing effects of the firm's collapse, much work remains before these new authorities become fully effective. Indeed, based on the market's reaction to date, the early results have been far from encouraging. Nevertheless, bold regulatory action, as embodied in the forceful advocacy of Chairman Bair, is still at least possible. Unfortunately, the status quo has powerful defenders, and only time will tell whether the agents of meaningful change will prevail. The stakes – the future integrity of our financial system – could not be higher.

Finally, on a personal note, today is my last day, and my last time testifying before Congress, as the Special Inspector General before stepping down to join New York University's School of Law as an adjunct professor and senior fellow for its Center on the Administration of Criminal Law and the Mitchell Jacobson Leadership Program on Law and Business. I have been blessed with the opportunity to serve our country as it has struggled through this financial crisis, and I would like to thank the members of this Committee for their unwavering and bipartisan support of our office. Without that support, it is unlikely that SIGTARP would have ever been able to achieve our goals of bringing transparency to TARP, holding its participants accountable, and

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[2] In a recent editorial, the *Wall Street Journal* cited an analysis conducted by Mike Mayo of Credit Agricole Securities (USA) that shows that the "10 largest bank holding companies, on average, paid 29 basis points less on interest-bearing liabilities than the next 40 bank holding companies" over the course of 2010. Furthermore, according to the editorial, FDIC and Federal Reserve data illustrate that the funding advantage enjoyed by the largest financial institutions has increased since the passage of Dodd-Frank. For example, the FDIC's data on non-deposit, interest-bearing liabilities demonstrates that "the funding advantage enjoyed by banks with more than $100 billion in assets over those in the $10 - $100 billion range rose from 71 basis points in the first quarter [of 2010] to 78 basis points in the third quarter . . . to 81 [basis points] in the fourth quarter." "Still Too Big, Still Can't Fail," *Wall Street Journal* (Mar. 5-6, 2011) (online at online.wsj.com/article/SB10001424052748703530504576164880968752682.html). *See also* Harry Terris, "Measuring 'Too Big to Fail' Subsidies," *American Banker* (Mar. 11, 2011) (discussing how large banks continue to enjoy an overall funding advantage in the wake of Dodd-Frank).

deterring and prosecuting those who have sought to take criminal advantage of this national crisis.

Chairman McHenry, Ranking Member Quigley, and members of the Committee, thank you again for this opportunity to appear before you, and I would be pleased to respond to any questions that you may have.

If you are aware of fraud, waste, abuse, mismanagement or misrepresentations affiliated with the troubled asset relief program, please contact the SIGTARP Hotline.

Via Online: WWW.SIGTARP.GOV
Via Toll Free Phone: 877-SIG-2009
Via Fax: 202-622-4559

Via Mail: Hotline, Office of the SIGTARP
1801 L St., N.W.
Washington, D.C. 20220

Mr. McHENRY. Thank you for your testimony. I recognize myself for 5 minutes.

To initially start this questioning, you have mentioned in your reports, you mention in your editorial today in the New York Times that the objectives of TARP have been shifted dramatically in the 2½ years since the creation of the program. It is not evolving, but it seems like if they fail to meet metrics they have set for themselves, that they change the metrics. Can you elaborate on this?

Mr. BAROFSKY. It has happened far too often with this program that when a goal wasn't met, rather than do what you would expect in a good government program, which is you have a goal, you set forth a plan or policy to achieve that goal, you measure performance against that goal, and if you are not performing you change the program, so make the necessary changes to accomplish that goal.

Far too often in TARP it has been set a goal, adopt no policy to achieve that goal, basically ignore it, try not to be incredibly transparent about the progress toward that goal; when you don't meet that goal, rather than change the program, change the goal and then declare mission accomplished, program a success, and move on. That has happened with the housing program, certainly, and it has happened with a lot of the Main Street goals, which have basically been written out.

Recently, in testifying in front of congressional oversight panel, a Treasury official talked about these goals, these incredibly important Main Street goals that were part of the bargain, is why TARP got passed, and dismissed them essentially a window dressing, just things to be taken into account. Well, they were intended to be more than that, and those are some of the broken promises that I discussed in the op ed and that we discussed in our reports.

Mr. McHENRY. Now, to go further on this, there has been a discussion in recent days that TARP has been a success for the taxpayers, that in dollars and cents terms it hasn't been a huge negative. What are the negatives? What is the legacy of TARP and our unprecedented intervention in the market?

Mr. BAROFSKY. Well, I think that there are a number of areas where TARP fell short. First, of course, are the goals not met, the goals that were part of the bargaining we just discussed that were not met, and there is a cost to not meeting your Main Street goals. One of those costs has been on the impact of government credibility, and the bottom line is that people don't trust their government, and part of the reason why they don't trust their government today is because of the bailout, because of the failure to meet its goals and, frankly, because of the mismanagement of the program.

Second, one of TARP's greatest legacies is the two big to fail problem. As I noted before, when the secretaries told the markets we are not going to let these banks fail, this was instrumental in one of the other positive aspects of TARP, which is helping to prevent a financial collapse, but it really exacerbated the problem of too big to fail; it was no longer implicit, it was as explicit as it could be.

The whole reason why TARP helped contribute to avoiding the economic collapse was because of the promise we are not going to let these institutions fail, and that has had the unintended consequences of the problem of getting bigger and bigger, more concentrated. You mentioned now the statistical data that backs up what we all know, that they are able to borrow money more cheaply, they are able to access the credit markets, access the capital markets, and right now they are more systemically significant than they were before, if for no other reason that there are fewer of them and they are bigger than ever, and that is a real legacy.

Mr. MCHENRY. Now, has Dodd-Frank prevented that from continuing?

Mr. BAROFSKY. Dodd-Frank was not a magic wand. Passing a piece of legislation that gave Treasury and the regulators certain powers and authorities didn't actually change the status quo; it gave one possible path that the regulators could choose to use to potentially accomplish that goal, but the bill itself is just that, a bill, and, unfortunately, based on the market's perception, they are very, very much unconvinced that it will be used in the effective way that it would need to be used in order to really address too big to fail.

Mr. MCHENRY. Even in the design of the bill does it leave wide openings for bailouts to continue?

Mr. BAROFSKY. Well, technically, under the letter of the law, and there is some dispute about what the meaning of all this is, it does state in certain language that bailouts won't happen. But that sort of ignores reality, and the reality is when we talk about too big to fail, I think far too often we lose sight of the fact what those words mean and that it means really what they say, that whether there is a law on the books or not a law on the books, if these institutions, if we have a repeat of the financial crisis, it is not going to matter what the law on the books is because its failure is not an option.

You can't let those banks fail if that happens. It doesn't matter your political ideology, it doesn't matter your personal ideology; the country will go down the tube, there will be a systemic crash that will have devastating consequences, Great Depression, Armageddon, no cash coming out of the ATMs. And the point is that, much like with TARP, the White House, whoever happens to be president at the time and whoever happens to be controlling Congress at that time, for the best of the country has to go in and rescue the banks. It is not a moral question; that is what too big to fails means.

So while I think people can argue whether certain interpretations and portions of Dodd-Frank which gives a certain degree of discretion as to which creditors possibly get paid 100 cents on the dollar and which don't, which I know is a subject of the debate, or other provisions that you can point to and say, OK, this doesn't mean an orderly bankruptcy, this gives a suggestion that these banks can continue in the form of a bailout, whether funded by the industry or elsewhere, it is almost all besides the point because, if you have too big to fail banks, it is all going to be put to the side and we are going to be right back where we were in late 2008.

Mr. MCHENRY. So, in essence, it codifies the status quo.

Mr. BAROFSKY. Unless and until Treasury and the regulators use the powers that they have under Dodd-Frank—and a lot of these powers, frankly, they had before Dodd-Frank and went unused. But unless and until they use those authorities, we are actually in the status quo or slightly worse than the status quo because this, with nothing. Maybe you have a chance of convincing the markets, but right now the markets are looking at Dodd-Frank and they are rejecting it.

Now, that is not to say that Dodd-Frank doesn't do some good things that help limit the banks. Increasing capital requirements is important around the edges, the Volcker rule, although I think a lot of exceptions may defeat it, are all helpful to help limit, in certain areas, potential risks, but the big ticket question that we are talking about today, does it solve too big to fail, the answer is certainly not yet. And by all indications of what has been happening and what the direction has been, I am not entirely optimistic that it will.

Mr. MCHENRY. Thank you. Thank you for testifying.

I recognize Mr. Quigley.

Mr. QUIGLEY. Thank you, Mr. Chairman.

It is not that I disagree with you on the point; I want to understand it a little bit better. As you advocate in your testimony today and editorial discussing Ms. Bair's recommendation to simplify or shrink, can you react to, I guess, the response to that about too big to fail, Mr. Zandi's remark? And if I can quote, "There is no reasonable way of sufficiently reducing their size and complexity without jeopardizing their independence. Large European and Asian banks will gobble them up, pushing the too big to fail risk overseas and outside of our control. Cutting our banks down in size won't mean there will be any less risk taking in the financial system; it will mean that the risk taking will shift elsewhere in the financial system where it is harder to monitor and to regulate. Think hedge funds."

What would your response to that be?

Mr. BAROFSKY. Well, that seems almost to me like an embracing of too big to fail.

Mr. QUIGLEY. But is he correct?

Mr. BAROFSKY. I don't think he is correct. I mean, I think that if you—this is very similar to a different argument that has been advanced that our largest banks, if they are not of the size and scope that they are, they are not going to be able to compete with their larger European banks.

Essentially what that means, if we break that down, what it really means is that, OK, so other countries guarantee their banks and those banks have an advantage, and unless we guarantee our banks, our banks are not going to be able to compete with those other banks. That is essentially what it comes down to.

So really the question becomes do you believe that the Government should subsidize and guarantee and backstop our largest financial institutions or do you believe that we should be true to our capitalist ideals and let these banks compete without an economic subsidy, a very significant subsidy that they receive? And, sure, there are a number of doomsday scenarios that one could posit, that if we actually use the tools of Dodd-Frank and were true to the idea of ending too big to fail, it may actually result in banks that are not as profitable as they are today.

Mr. QUIGLEY. But there are all sorts of instances in which unfair trade practices, for example, by other countries do put our capitalistic ideals at risk. I am just asking, you don't see that as a possibility in the banking industry?

Mr. BAROFSKY. I think it is a possibility, but I think there are other ways to deal with those policy concerns rather than embracing the idea that we should be effectively granting our largest banks a subsidy and essentially putting them on the books. I mean, there is very little difference when you compare where we were in the lead up to the financial crisis with Fannie Mae and Freddie Mac than we are right now with some of our largest banks.

It is the same type of implicit guarantee; it is the same type of distortions on the market. And in many ways we could very well end up in that exact same situation. So, sure, maybe our banks are able to reap short-term profits because they are able to compete with other banks that have subsidies, but I am going to take the other side. I am going to say if we remove these subsidies, if we remove this implicit guarantee, over time we are going to have a healthier and better banking system. This is what Chairman Ben Bernanke said recently, this is what Larry Summers said recently, that our system would be stronger without it.

Mr. QUIGLEY. How do you protect our banks in the meantime from unfair practices or unfair competition as it might exist?

Mr. BAROFSKY. Well again I think there is constant interaction——

Mr. QUIGLEY. I don't think you need to like too big to fail or embrace it to be concerned about that potential risk, right?

Mr. BAROFSKY. Right. And we shouldn't ignore it. But the Treasury Department has whole offices that are dedicated to dealing with foreign countries and dealing with foreign regulators through the G–20. There are mechanisms to deal with unfair practices internationally, and that is the right place to deal with them, I think, not throwing your hands up and saying we are going to subsidize our largest banks; we are going to take money out of one pocket and put it into the pockets of the shareholders and executives at these largest banks, and I think that is what is happening.

One study I saw recently was $34 billion was one of the dollar subsidies that we give to our largest banks as an implicit guarantee, and I say take that money and let's put it elsewhere, and I think we will be better off.

Mr. QUIGLEY. And I appreciate that. I guess the second point would be what is implied here is that this encourages banks to engage in risky behavior. Could you detail the risky behavior you see today?

Mr. BAROFSKY. Sure. The idea of risky behavior is that banks sort of have—anyone who runs a bank, especially when they are large and interconnected in so many different businesses, they are going to make decisions on how they invest their money, how they manage their portfolio, and the question comes what is the level of risk that they are going to attach to each of those decisions.

And the problem with too big to fail is that it impacts that decisionmaking process. Senator Kaufman, when he was Chair of the congressional oversight panel, described it as being the rational decision of an executive when you take out the sine curve, what you call the bottom of the sine curve in the decisionmaking process of profit and loss from a particular design, and that what too big to fail does is takes out the bottom of that because it is the rational assumption that if the risk doesn't work out, you are not going to have the negative consequences of that risk. And that is what happens with too big to fail, is you actually rationalize risky behavior because it is in the best interest not only of the bank, but of the shareholders and its executives.

Mr. QUIGLEY. Thank you. I yield back.

Mr. MCHENRY. Mr. Meehan for 5 minutes.

Mr. MEEHAN. Thank you, Mr. Chairman.

And thank you, Mr. Barofsky, for once again coming before our committee. But let me thank you, as well, for the service that you have given in looking at this issue in such scope, a tremendous challenge to our country when it happened but the healthy capacity to then look back at what happened and ask the kinds of difficult questions that allow us to consider the implications of all that happened so quickly with such remarkable significance at the height of the challenge to our financial system.

So I appreciate your service to our Nation and I thank you for it and wish you the best of luck as you move into the next part, but thank you for your contribution. And I know that you would say, as well, that is something that has been a great part of it, has been the work that you have done, but you have been supported by some other fine people as well, some of whom I have known from prior existence, and I want to compliment them too on the great work that they have done with you for your work.

But you have studied this. You have spent time really looking at the big picture and have had the chance to sit back maybe more than many of the people here in Congress have, and you made a comment talking about unless there is dramatic and quick action, we are going to head down a path, and that is a very concerning observation to me. Can you identify what you mean by dramatic and quick action, and what you think we ought to be doing here in Congress to protect against the kind of concern that you have identified in your testimony?

Mr. BAROFSKY. First of all, thank you for your kind comments, and it is certainly true, I am the one who gets to sit at the table and I am the one who gets to take the credit for our successes and the blame for our failures, but it doesn't happen without the people at SIGTARP and the senior staff, and, yes, we have both benefited from one individual, you as a U.S. attorney, of course, that is my Chief of Staff, Geoff Moulton, who has been wonderful for our organization and I am deeply appreciative.

As to your question, what I was referring to is I think we have to stay here within the realm of the possible, and I could go back and say that there are certain things that could have been done with Dodd-Frank, things that were suggested in the Senate by Senators Brown and Kaufman that could have made this a better protecting against too big to fail, but here in the realm of where we are today there is a path that has a better chance than most of succeeding, and that is the one that is being advocated by Sheila Bair, outgoing chair of the FDIC, and it is ultimately not a very dramatic departure, it is really just fulfilling the mandate of Dodd-Frank.

And what she has said is that part of the proposal is these living wills, where the banks are required to come up with plans of how they would be resolved in the event of a financial crisis, and she came out with something and has been saying this over and over again, which on its face does not appear to be very controversial. She says in order for us to carry out the mandate of Dodd-Frank, in order for us to really address too big to fail, we need to use these provisions, and if banks come up with things that are not sufficiently credible not just to us but to the markets, so that they can be resolved in a meaningful way, then we need to use the powers of Dodd-Frank to simplify and shrink those institutions. And she has had stronger language than that on other occasions.

What is remarkable about this is the deafening silence with which it has been met by the other regulators, the other members of the Financial Stability Oversight Council, including its chairman, Secretary Tim Geithner. This is a path that at least has a chance of working because ultimately they are too complex, they are too large, and I think Chairman Greenspan said, famously, in the beginning of this crisis, too big to fail starts with too big. And it is not always too big; that would be an oversimplification. It is interconnectedness, it is a number of other things. But it is a really, really good place to start.

But it really does appear that is what is happening with Chairman Bair's suggestion is that the others are playing the equivalent of a regulatory game of running out the clock; they say nothing, they do nothing, and the bottom line is that she is not going to be able to institute those changes before she steps down over the course of this summer, and even those plans aren't going to be coming in a matter of 6 months. It could be a year before anything happens.

So what would be an example of dramatic change? How about a strong endorsement from the Secretary of the Treasury, from the chairman of the Federal Reserve and others that Chairman Bair's suggestion is going to be adopted? Perhaps this could help chip away at the market's perception that resolution authority is somewhat of a joke. I mean, if you look at the language that Moody's used in rejecting the idea that Dodd-Frank is going to work, going to somehow end too big to fail, that this resolution authority is going to work, it is striking language. It is not just a passive rejection, it is a complete rejection.

Mr. MEEHAN. Well, Moody's is one of the groups that has actually included within their analysis the idea that the government is actually going to bail out the banks. I mean, this is part of the problem that we are looking at.

Mr. BAROFSKY. Absolutely. They reject that this is really going to happen. So it is a minor first step. But I think if we start by the government officials who are in charge of implementing Dodd-Frank, instead of issuing what are basically, I am sorry, empty statements that this is going to end too big to fail as we know it, we are never going to have to bail out anyone again, citing to different provisions in the law, which I have heard and I am sure you will hear again, that, oh, this law says we can't bail out, so therefore there will never be a bailout, let's start with an articulated plan, similar to the one advocated by Chairman Bair, saying, OK, this is how we are going to do this; we are going to simplify and shrink these institutions so we can have a credible response to the market that we are not going to bail them out, because right now the empty rhetoric we are not going to bail these banks out, the market is not buying it.

And you can actually measure whether or not your statements are effective or not; all you have to do is look at what the credit rating agencies say, look at what the spread is, how much cheaper the benefit is, how much cheaper it is for the big banks to raise capital. I mean, there are things you can actually look to.

And while it is unfortunate that credit rating agencies still have so much power and so much influence, that is the sad reality of where we are today, and I think that it has to start with an increase in rhetoric and then it has to be backed up by demonstrated action to fulfill those rhetorical promises. But right now we don't really have any of that; what we have is a lot of discussion about endless rulemaking that will accomplish some goal; a real sense of incrementalism, we will do a little bit here and a little bit there, and maybe eventually the incentives will be in place that these banks may reduce in size. I personally believe that Chairman Bair's approach is the better one.

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

Mr. MEEHAN. Thank you, Mr. Chairman.

Mr. MCHENRY. Thank you.

The ranking member of the full committee, Mr. Cummings.

Mr. CUMMINGS. Mr. Barofsky, thank you so much. As you were testifying, I could not help but think about the fact that come June 25th, in my district, 40 miles from here, people will march into a room to a conference, someone preventing foreclosure, they will march in, Mr. Barofsky, with tears, literally, about 1,000 of them—that is what happened at the other five—and they will face some very difficult situations, and finally they will get a chance to sit down with some lenders and try to come to some resolve with regard to modifications. Many of them will be lied to. Many of them have been lied to. They have been playing games with them, a lot of these servicers, as if they were fools.

When I read your editorial piece at 4:25 this morning, I was very impressed and I am just wondering. You know, we just voted yesterday to end the HAMP program, and I know how you feel about it; many of us feel the same way. But when you end the program, if we end the program and there is nothing to substitute, nothing, I am just wondering is that a good idea? I am just curious.

Mr. BAROFSKY. I mean, as Special Inspector General it has always been my position and continues to be my position that TARP made a promise and, Congressman, I don't want to presume anything about you or your decision to make your vote, but for a lot of progressives that I have spoken to, Members of Congress, the reason why they voted for TARP, one of the really things that convinced them to vote for what was essentially a bank bailout was this promise to preserve home ownership.

Mr. CUMMINGS. Well, you are right, that was one of the reasons why I voted for it.

Mr. BAROFSKY. So this is as part and parcel of TARP, in my view, as was the need to save the financial system. I don't rank them, but I put them side by side. It was just as important a goal of TARP to preserve home ownership in dealing with the foreclosure crisis as it was to save the large banks.

Now, the second panelist today disagrees with that conception and talks about that as being something to be taken into account, but I believe that is on par. So I look at the disappointment, the broken promise of the HAMP program and I do agree with you that we can't just abandon that goal of TARP.

I also can't defend, for those who voted for termination of HAMP, I can't defend this program because ultimately Treasury has had opportunity after opportunity to make meaningful change. Why on earth have those servicers that you just described, what they have done to those homeowners in this program, which has been so well documented, how come Treasury has not lived up to a different promise it made, the promise it made in November 2009 to impose financial penalties on those servicers for not performing? Why are we here, 2 years into the program, without a single financial penalty for nonperformance under the program?

Mr. CUMMINGS. And I agree with you. Before they shut me down, I need to get to one other thing, though. You know, the reason why I started out the way I did is because we can have all the discussions we want, but when I go back to my district, and I know Members on both sides of the aisle, when they go back to their district, some of them may not see these folks, but there are a lot of Americans suffering, and you are talking about too big to fail and Dodd-Frank. If we basically cut the money for carrying out Dodd-Frank, do you have an opinion on that? Because that is what is happening.

Mr. BAROFSKY. I come from a law enforcement background; I spent 8 years at the U.S. Attorney's Office, and I have seen, during budget freezes, and hiring freezes. At SIGTARP we have been blessed, and I thank all the members of this committee on both sides of the aisle for your generous support through resources for our agency; we couldn't do what we could otherwise. But those types of budget cuts and freezes have a direct impact on the ability of those offices to put people in jail, to lock people up, to hold people accountable.

Mr. CUMMINGS. But does it also have an impact, you said you know how the market is viewing Dodd-Frank. You talked about the possibilities that Dodd-Frank could operate, but you also said they look at it and say, you know what, we are not so worried about it because you said too big to fail. But also could it be that they see that there is an effort to kind of take the money from out of these agencies so that they can properly enforce and carry out Dodd-Frank? That is what I am trying to get at.

Mr. BAROFSKY. It may be part of that perception issue. Look, the bottom line is if the regulatory agencies that are charged with, again, they are not just charged with implementing Dodd-Frank, they are implementing other things, including law enforcement goals and enforcement goals. I am thinking specifically of the SEC. When you take away funding, it may be that they reallocate resources to Dodd-Frank, but overall, as an agency, they are going to be able to accomplish less as far as enforcement is concerned and accomplish less, perhaps, in implementing Dodd-Frank. And I am not here to wade into the politics of a budget battle.

Mr. CUMMINGS. No, I understand.

Mr. BAROFSKY. But, look, it is just simple; I have seen it over and over again. When budget cuts hit, when spending freezes hit, it has a direct impact on enforcement. That is a reality.

Mr. CUMMINGS. Just one last thing, Mr. Chairman.

A Wall Street Journal article recently noted that Republicans appear to be drafting bills aimed at dismantling the financial reform piece by piece at a time. What impact do you think that these repeated news reports about the funding or dismantling Dodd-Frank have on the market's perception of whether Dodd-Frank is working?

Mr. BAROFSKY. To be honest with you, I am not really sure of what the impact is, in part because of the political realities of divided government. It is a question of how much success one side may have versus the other side. I haven't really traced anything or seen anything or heard anything that directly links that but, of course, if the agencies are cut so deeply to the bone that they are unable to implement provisions of regulatory reform, that is going to have an impact.

But I think the far greater impact, frankly, is the lack of political and regulatory will in staking out how they are going to use those authorities, even if they have all the resources, to really take on the issue of too big to fail. And unless and until we see that shift, I think that is going to have the far greater impact on market perception.

Mr. CUMMINGS. Thank you, Mr. Chairman.

Mr. MCHENRY. I thank the ranking member.

Ms. Buerkle is recognized.

Ms. BUERKLE. Thank you, Mr. Chairman, and thank you, Mr. Barofsky, for being here this morning. To echo my colleagues' comments to you and your staff, thank you for all the fine work that you do. I have one general question and then I would like to just ask a couple questions about some of the comments you have made already.

Would you agree that TARP picked winners, perhaps letting weaker entities survive? And, if so, do you think that maybe was a misallocation of funds?

Mr. BAROFSKY. Well, when you look at TARP as a whole, I think that the lack of transparency in the program in certain aspects have led to the very fair criticism that at times TARP may have picked winners and losers. Generally speaking, when we are talking about the different TARP programs and, of course, there were 13 different TARP subprograms. We often think of TARP as a monolith, and usually then we think of TARP as one of those programs, the capital purchase programs, which, by very definition, picked winners and losers because banks applied for TARP funds, and some received TARP funds and others didn't. And those who received TARP funds essentially got the benefit of government capital and those that did not.

But there was in fact a process in place that was dependent mostly on the banks' regulatory ratings or CAMEL's ratings, that type of thing, and on certain occasions there were exceptions and we have done audit work on this. So certainly there were winners and losers picked. TARP certainly didn't have a perfect record; there have been a number of banks that were supposedly healthy, deemed healthy and viable that failed; others that were deemed healthy and viable and, months later, had to get tremendous amount of additional support, like Bank of America and Citigroup. So I certainly understand that concern.

On the flip side, it would have probably been inappropriate for TARP to give money to all financial institutions that came to the window. Part of the importance of protecting taxpayer money was making sure that it went into banks that were healthy and viable, but they didn't have a perfect track record. But I don't blame them for not having a perfect track record. Based on our audit work and our reporting, it was an incredibly difficult time, to say the least; there was a real sense of panic. They made mistakes, for sure, but I don't think those were mistakes that were intentional in any way. Overall, I think they tried to get it right; they just didn't sometimes.

Ms. BUERKLE. Thank you. I just want to go back to a comment when you were responding to our chairman. You mentioned that unless Treasury and the regulators use their authorities, and you mentioned that some of those authorities they already have, that we will experience a status quo or worse. Could you expand on that for me, the authorities that you are referring to, and whether or not they exist outside of Dodd-Frank, prior to Dodd-Frank, actually?

Mr. BAROFSKY. I think the concept of, for example, caps on leverage, capital floors are sort of examples of things that have been around for a while. I think what Dodd-Frank does, and this is sort of one of the positive things it does, it really forces an entry point for using those types of mechanisms anticipatorily.

In other words, again, I am going to go back to the discussion earlier about using living wills. This gives us an entry to evaluate the largest banks, those deemed systemically significant, and evaluate whether or not they really could survive or whether the system could survive their failure; and that is the key to any resolution plan, is to take whatever it is and, as Chairman Bair suggests, putting it through a reality check.

And if it doesn't meet that reality check, using those tools to either spin off certain businesses, to shrink the company, to simplify the organizational structure. If you look at some of the stuff that came out of the Lehman bankruptcy and the 3,200-something different entities that were comprised there, hopelessly complex, it makes resolution very difficult. I mean, I think that is a good start.

Of course, we also have to remember that one of the limitations if we wait too long, in other words, we don't use the authorities when we get these resolution plans, prescriptively, before the next financial crisis, even our best intentions may not really work because in an era of a financial crisis, that is when all these institutions are suffering similar threats at the same time. It is going to be very difficult to execute some of these resolution plans.

How do you sell off a large business or a large business chunk as part of a resolution if there is no one to buy it because the other entities are also going through the same stress of a financial system collapse? And I think that is what Secretary Geithner meant when he said to us that Dodd-Frank helps, but in the event of another financial crisis the size and the scope of the one that we just went through, there may be a need to do exceptional things again, because even with the best intentions the reality of that type of shock to the system is going to require, as long as the banks are too big, it is going to require, again, extraordinary intervention.

Ms. BUERKLE. Thank you very much.

Mr. MCHENRY. Mr. Welch, 5 minutes.

Mr. WELCH. Thank you very much, Mr. Chairman.

Mr. Barofsky, I want to thank you for the tremendous work that you have done. We are really in your debt.

Mr. BAROFSKY. Thank you.

Mr. WELCH. As I understand it, what you are saying is that Dodd-Frank has not succeeded in making the market believe that it has addressed this question too big to fail.

Mr. BAROFSKY. In essence, the implementation of Dodd-Frank has not succeeded in convincing the market.

Mr. WELCH. And when you say the implementation, is that because of the regulatory provisions that had to be part of the follow-up of Dodd-Frank?

Mr. BAROFSKY. Right. So much of Dodd-Frank put the responsibility on the regulators and, frankly, on the Treasury Department as the chair of the Financial Stability Oversight Council to implement the necessary changes and send the right messages to the market.

Mr. WELCH. So we would have been better off with Congress specifying what were the guidelines and what were the parameters within which these large financial institutions could operate, is that what would have been a better approach?

Mr. BAROFSKY. Well, I don't know whether I can say it would have been a better approach; it would have been a more effective approach if ideas like Senator Browns and Senator Kaufman's amendment in the Senate to Dodd-Frank, which would have put leverage caps and size caps on the largest institutions. If that had passed, that would have sent a very large and very clear message to the markets that the largest banks are not going to be too big to fail.

Mr. WELCH. And that is simple.

Mr. BAROFSKY. And much simpler. You would have relied a lot less on the regulators if that were included.

Mr. WELCH. And when we get into the regulators, we are, of course, having a budget challenge in this country and in this Congress, and if we are cutting the budget for, for instance, the SEC by $25 million, what kind of signal does that send and how does that affect the ability to actually supervise the regulations that would apply?

Mr. BAROFSKY. Well, according to the SEC, it would have a very direct result; it would inhibit their ability, according to Chairman Shapiro, of being able to implement the requirements that they need to do under Dodd-Frank.

Mr. WELCH. Right. And in your independent capacity, that conclusion that they are offering makes sense to you; that is a threat to their ability to carry out their responsibilities?

Mr. BAROFSKY. There is no question. When you are a regulatory agency, a law enforcement agency, and you have fewer resources, you have to make cuts. Frankly, you have to make cuts across the board; everything suffers. So that will suffer; I think enforcement will suffer.

Mr. WELCH. The same thing with the Consumer Financial Protection Board. Dodd-Frank called for an independent watchdog and that would be independent, it wouldn't be their advocating for the interest of the large financial institutions, it would be advocating for the interest of consumers, and the CR provision, continuing resolution provision, would cut that budget by 40 percent, from about $143 million to $80 billion. So would you have the same response to that budgetary cut and its impact on being able to provide those protections?

Mr. BAROFSKY. I would imagine so. I am not really familiar with the budget of the Consumer Protection Bureau and what the requirements are, but, again, having been fortunate enough to work with Elizabeth Warren as she was the chair of the congressional oversight panel, I would certainly take her at her word that if this would impact the ability of that bureau to go forward, then it would be accurate.

Mr. WELCH. Let me ask you this. One of the points of this hearing is there are some legitimate questions about how TARP is being implemented and whether too big to fail is going to work, and it is not clear what the consensus would be on this committee as to whether we would want to be tougher on the too big to fail policy or not; that is not part of what the hearing is.

But let's assume that we did have a view that was shared across the aisle, both sides, where we did want to protect the taxpayer from a future bailout. What would be your recommendation that Congress should do in order to provide us with protection against another bailout?

Mr. BAROFSKY. I think, again, step one is working within the realm of the possible of the bill that has already been passed, and that is to exert as much pressure as you can on the Financial Stability Oversight Council, on Secretary Geithner to fulfill the promise and to not take an incrementalist approach, but to take a strong, hard look at the recommendations and the advocacy of Chairman Bair and use those tools. The goal should be nothing short of getting rid of that subsidy, getting rid of that economic advantage that the largest banks have over their smaller counterparts, whether it is the 78 basis points referenced in the chairman's opening statement, whether it is the implicit guarantee, the increased credit rating.

That has to be a goal because this is the remarkable thing about too big to fail: perception matters. Perception is as important as anything else, and it is unfortunate. It is unfortunate that credit rating agencies still have so much influence over things, but that is the reality, and we need to take that perception head-on and we need to figure out how to use the tools that we currently have to try to deal with that perception and not just, I am sorry, essentially ignore the advocacy of Chairman Bair and others who have strong ideas about trying to get us to a point where these banks no longer enjoy that subsidy.

Mr. MCHENRY. If the gentleman would yield, I would be happy to, I think we agree that we want to end too big to fail, and I know that has been your advocacy in your time as Congress, as well as mine. The bill of goods that some of us saw coming out of Dodd-Frank is that it would prevent too big to fail.

Mr. WELCH. Well, I appreciate that and, as the chairman knows, I voted, really in significant part because of the testimony of Mr. Barofsky, in favor of the committee bill on HAMP. And to the extent that we can find ways to solve the problem, we have to do it together. So I really appreciate your statement.

Mr. MCHENRY. Well, thank you. And I appreciate the gentleman's advocacy. We don't always agree, but you certainly had a great way of reaching out and trying to find consensus, and I appreciate that.

With that, I yield 5 minutes to Mr. Issa, the chairman of the full committee.

Mr. ISSA. Thank you, Mr. Chairman. I would join in saying that as we start looking at the particulars of the continuing resolution, if we can get to some bipartisan discussion where we agree to the number and then begin saying if we need to add to SEC or as Mr. Barofsky, I am sure, would agree, some of the sunlight Web sites and so on that are also seeing cuts plus those back up because they actually save us money, then I think we could find those offsets.

I think as the chairman worked so hard to recognize that HAMP was a large amount of money that did not need to be spent to ruin people's credit ratings, it still, at the same time, I would join with the gentleman in saying I am concerned about where we make the cuts, and I would hope that in the very near future we begin talking about the need to make austerity moves and then begin to say where can we find multiple votes for something by putting things back in.

You mentioned the SEC. I am very concerned that many of the sunlight activities that we have, on a bipartisan basis, been investing in are also on the block there, and it is my intention to work with leadership on whatever the final resolution is, once we get with the Senate, to plus those back up. I think we need to have the access that, quite frankly, Dodd-Frank, with bipartisan support of this committee, almost got in the way of data transparency; and we still have to get back as a committee to getting that transparency into what was Dodd-Frank.

Mr. Barofsky, if I can throw a slide up, I want to just go through a couple of these, because it illustrates probably the most important point you are making today, which is the two to dash three step credit rating increase.

Go to the next slide.

Real examples. Wells Fargo. If their cost of money is 4.81 versus Comerica at 5.26.

Next slide.

If Goldman Sachs, vilified often here, but if their cost of money is just under 5 percent while National City is over 6 percent, that is not the three-quarters of a point you were talking about, it is even greater.

Next slide.

Barclay's Bank at 4.39 versus BB&T, certainly important in this region, a little less than three-quarters of a point, 5.07 higher.

Last, Citicorp, 5.64, not earned in any way except that they are big; Huntington National Bank, 6.54.

Let me ask it to you in a different way, as a former businessman. If I am among the most credit-worthy companies, the Fortune 500 down to small companies that simply have healthy balance sheets, is there any reason in the world that they are not going to migrate to the largest banks when the largest bank can make a profit nearly a point cheaper than its competition? Pure cost of money. Isn't this going to move the most creditworthy onto the big banks, while leaving the little banks with higher rates and being forced to take whatever is left behind?

Mr. BAROFSKY. No, absolutely, because, again, let's say you are depositing money at one of these banks and you go beyond the FDIC's limit. Don't you want to have the implicit government guarantee of too big to fail behind your deposits? I mean, you may, from an ethical and moral point of view, not want to support these institutions because of this implicit government guarantee, but, as a businessman, how could you not take advantage of the fact that you are getting what is essentially free deposit insurance based on the implicit guarantee that the government is going to bail them out? And what does that do? Makes them bigger; makes them even more systemically important. It is a downward spiral. It also takes those smaller banks, it gives them an incentive as well. We need to get bigger; we need to get into this gravy train; we need to get on this subsidy level so that we can also out-price our competition and raise money more cheaply just because of this implicit guarantee. It is a complete perversion of the system.

Mr. ISSA. And I think that brings up a point that I want to make sure the committee focuses on. If we do not change where we are today, the five banks that represent 50 percent will be seven banks that represent 80 percent. Basically, through mergers the little banks will get this rate by getting big enough to be not too big to fail, right? That would be the business approach in order to get my business away from the big five.

Mr. BAROFSKY. It is a real danger. I mean, there are some provisions in Dodd-Frank that limit concentration above 10 percent of all deposits, but it is a real concern and a real problem. One of the things that we talk about is Lehman, and wasn't Lehman a good example of the government not stepping in, but so much of the incentive of allowing Lehman to fail was the lesson that we need to get bigger than Lehman because we need to make sure that we are big enough that we don't have to go through a bankruptcy because of the implicit guarantee of too big to fail.

Mr. ISSA. Well, thank you and thank you for your service and your testimony here today. I look forward to reading your work as an academic.

Yield back.

Mr. MCHENRY. Thank you, Mr. Chairman.

Now I recognize Mr. Ross of Florida.

Mr. ROSS. Thank you, Mr. Chairman.

Mr. Barofsky, a pleasure to have you here. You know, as I was a kid growing up, I remember commercials and the Avis commercial: We try harder because we are No. 2. All of a sudden No. 1 seems to now be, in the financial markets, a guarantee by the Federal Government, and that whoever is No. 2, good luck to them, because you can try as hard as you want, as long as you are too big to fail, you will always be No. 1.

So my question and followup with the chairman here, with community banks, if we see what happens, where you have seven banks take 80 percent of the market, it seems to me that there is an incentive only for community banks to merge with or to be acquired by the too big to fail banks. Is that what we are seeing a precedent with the TARP package?

Mr. BAROFSKY. Well, again, there are some limits on, there potentially could be some limits in Dodd-Frank and from the regulators that could help to prevent the largest banks from just gobbling up all the smaller community banks over a certain cap, but certainly consolidation and continued consolidation certainly could occur and might be a likely bi-product of where we are.

Mr. ROSS. Which really wouldn't be that healthy for the consumer or, in this state of economy that we have today, where the community banks are the ones that are serving most of our businesses in terms of loans, it could give them what I think would be an opportunity for the too big to fail banks to dictate more policy and restrictions that would make it even more prohibitive to have a recovering economy.

Mr. BAROFSKY. Less competition is never good for the consumer. And I have to say although the notion of the too big to fail banks of having even more political power almost seems unfathomable at this point, but it certainly could happen.

Mr. ROSS. Systemically, as a result of the TARP package, and I may have missed this because I came in late, but has there been anything to change the way we do business to avoid ever having to have another TARP package passed by this Congress?

Mr. BAROFSKY. In many ways, the way the TARP has been executed, and its legacy of increased moral hazard has made future bailouts, if anything, more likely, and unless and until we deal with this too big to fail problem, the increased concentration, the increased size, the increased interconnectiveness, the fewer number of large institutions all will contribute and lead us to a point where the too big to fail banks have become even bigger and their failure even less conceivable or possible.

Mr. ROSS. And would it not be just as likely, then, because of the precedent set there, that such packages, TARP packages would now be considered for nonfinancial institutions; insurance companies? We saw that with AIG, but I guess my question is does this not set a precedent that goes well beyond assisting the too big to fail financial institutions and to any entity that may be deemed to be too big to fail, regardless of what their commercial purpose is?

Mr. BAROFSKY. The moral hazard generated by TARP wasn't just limited to banks, it was, as you said, to insurance companies like AIG, to the automobile industry like GM and Chrysler. So, no, I think that is part of TARP's legacy, is the expanding moral hazard.

Mr. ROSS. And as a professor, would it be wise now in any of your classes that you would consider the opportunity of changing your business plan to include a path to where you can now be acquired or be guaranteed by Federal Government because of the precedent that has been set over the last 2 years?

Mr. BAROFSKY. It certainly is a possibility. Again, unless we take the steps to make that so painful and really address it through our regulation, again, right now it is a pretty good place to be, to be too big to fail.

Mr. ROSS. So much for entrepreneurship.

I yield back. Thank you.

Mr. MCHENRY. I thank the gentleman.

With that, I ask unanimous consent that I have two additional minutes, and I will grant the full committee ranking member or the gentleman from Vermont, Mr. Welch, 2 minutes. OK, thank you.

Mr. Barofsky, I have spoken to you about the Small Business Lending Fund, this legislative creation that doesn't have oversight from your office, from the SIGTARP's office. Can you talk about the Small Business Lending Fund and the impact this has, especially on these TARP banks, these small TARP banks that are still within the program?

Mr. BAROFSKY. Sure. Part of the Small Business Lending Fund Congress enabled Treasury to refinance, if you will, really move banks off of the TARP ledger and onto the SBLF ledger. And, when doing so, Congress gave Treasury the authority and direction to adopt certain procedures that were different for the TARP banks than other banks that come in and apply for this program.

And we made a series of recommendations to Treasury, which have been rejected, to help protect the American taxpayer as those banks move from the TARP ledger to the SBLF ledger. Look, there is less oversight in the SBLF program; there are less protections, capital protections for the taxpayer, and we have made a couple recommendations and they have been rejected.

It is not entirely within our jurisdiction; on this issue it very much is within our jurisdiction because we have jurisdiction over the sale of troubled assets, and here the sale of the preferred shares of stock, which essentially are being sold from one government entity and purchased by another government entity is very much, in our view, within the confines of our jurisdiction, which is why we have announced an audit specifically on this issue.

Unfortunately, Treasury is dithering on whether or not they think we have this jurisdiction. We have tried to schedule an entrance conference and we were told to hold off for a little bit because the Treasury general counsel has to decide whether or not we have the right to conduct an audit of the exit of banks from TARP.

Now, I haven't written a letter, I haven't made a big deal about this because, frankly, I can't even conceive that they are going to come out and suggest that the very clear intent of Congress that we have jurisdiction over the exit of TARP banks isn't going to be there, and because the money hasn't funded into this program yet, we don't have this great sense of immediacy of getting this entrance scheduled.

But if there is some bizarre legal construct that they adopt and suggest that we can't do this work, I certainly hope that my successor will immediately bring that to this committee's attention because this is a really important area because of the potential for the taxpayer really to get a raw deal as TARP banks exit TARP and go into SBLF, and we need very close oversight.

Mr. MCHENRY. Thank you. Thank you for testifying.

I yield 2 minutes to the full committee ranking member, Mr. Cummings.

Mr. CUMMINGS. Mr. Barofsky, back on February 25th I requested that your office conduct an audit and analyze the homeowner complaints. Can you tell me what is going on with that and when we can expect to have some results?

Mr. BAROFSKY. I just got an email that has the preliminary numbers. We are going through I think it is more than 25,000 hits to our hotline, and part of what this has been helpful is helping us to organize and categorize our hotline hits. Since we have gotten your letter our staff has been going through our hotline literally entry by entry and pulling together, and I got notice just last night that we have some preliminary results.

So I expect that we will have it to you before too long. I don't want to give you an exact date because when you are walking out you shouldn't dump on the people behind you with a commitment that you can't deliver, but I will definitely have staff get in touch with your staff today to give you an estimate of the timeframe.

Mr. CUMMINGS. Thank you. That may be one of your last duties?

Mr. BAROFSKY. Probably, yes. I think so.

Mr. CUMMINGS. Let me ask you this. One of the things that concerns me is that we are going to—as you move on, the question becomes—and Mr. Massad is going to testify in a few minutes. I remember when I was practicing law, one of the things I would say if one witness wasn't side by side with the other, which is never, I would say what would your response be to what they are going to say in some way or another. It sounds like you made some reasonable recommendations and Mr. Massad, who will testify in a few minutes, has said, Mr. Chairman, that he is going to come in, he told us a month or so ago that he was going to be retooling.

Have you seen any evidence of that? And why wouldn't the administration accept some of your recommendations? Why do you think? I am just curious because there is a lot of frustration on both sides of the aisle, and I am just curious as to what you think.

Mr. BAROFSKY. There has been no retooling. The announcement yesterday, which I think, non-coincidentally, was on the date of the vote in the House to terminate HAMP. There was an announcement, it was an op ed in Politico that Mr. Massad authored, and essentially it said that they are going to now, finally, 2 years later, almost 18 months after the promise to impose financial penalties on nonperforming servicers, there is going to be a plan.

So I read the op ed, it was brought to my attention, and, frankly, it sounded initially like a little bit of a gimmick. The idea is they are going to give servicers grades and then withhold payments based on that grade. But, OK, at least it is some movement in that direction, although, again, I don't put a lot of faith in words at this point, given the words that we had almost 18 months ago; it is action that matters.

So I did what I would normally do in that situation, I reached out to the Treasury and said, OK, give us the backup for this. Let's give us so we can evaluate, so if I am asked a question today in front of this committee, I can give an opinion about whether this is going to be effective, what the construct is, and the response back I get, first, I got no response, and then eventually we got a response that, no, no, no, we can't tell you because we don't have any other policy or plan other than what was outlined in the op ed.

This is ready, fire, aim all over again with respect to this program. So this has been the one incidence of potential retooling of finally meeting our recommendation? And not just our recommendation, almost everyone's recommendation to start holding servicers accountable financially? And I am hopeful. I am hoping that this is better late than never, as opposed to too little too late, but ultimately words, at this point, are just words. And after all of the broken promises we need to see some action on this front if we are ever going to get the servicers to be held accountable for their terrible and abysmal performance that even Treasury acknowledges.

Mr. CUMMINGS. Thank you, Mr. Chairman. Thank you very much.

Mr. MCHENRY. I thank the ranking member.

Mr. Barofsky, we certainly appreciate your testimony, your candor, your ability to actually react to a whole variety of questions. Too often in Congress we see the person on the other side of the panel as more sport. It is quite interesting to have someone who is on the other side of the panel who is of sporting mood, that you are willing to react and answer the question posed to you.

Too often in this place and around Washington it is not about answering the question posed to you, it is about what you want to answer; and you have been very frank, very forthcoming, very open in answering the questions posed to you, even when they are not convenient, and we certainly appreciate your service to your government and to your country. Thank you for your time today, thank you for your testimony, and, most of all, thank you for your hard work.

Mr. BAROFSKY. Thank you, sir.

Mr. MCHENRY. Good luck to you in your future endeavors. God bless.

Mr. BAROFSKY. Thank you so much.

Mr. MCHENRY. This committee will now be in recess for 5 minutes until we set for the second panel.

[Recess.]

Mr. MCHENRY. The committee will come back to order. We will now recognize our second panel. Mr. Timothy Massad is the Acting Assistant Secretary for Financial Stability at the U.S. Treasury. In his capacity, Mr. Massad heads the Office of Financial Stability which administers TARP. Prior to joining Treasury, Mr. Massad was a partner with a New York law firm which has a diverse corporate practice.

Thank you for being here today. It is the policy of this committee that all witnesses be sworn in before they testify. If you would please stand and raise your right hand.

[Witness sworn.]

Mr. MCHENRY. Thank you. You may be seated. Let the record reflect that the witness answered in the affirmative.

So, with that, Mr. Massad, we will recognize you for 5 minutes. Your written testimony will be entered into the record. We will then have some questions from the panel.

STATEMENT OF TIM MASSAD, ACTING ASSISTANT SECRETARY FOR FINANCIAL STABILITY AND CHIEF COUNSEL

Mr. MASSAD. Thank you. Thank you, Chairman McHenry, Ranking Member Quigley, and distinguished members of the subcommittee for the opportunity to testify today. You have invited me here to address whether the perception that some institutions are too big to fail persists despite the passage of Dodd-Frank, and I am happy to do so. I am also pleased to be following Special Inspector General for TARP Neil Barofsky on his last day in office.

SIGTARP's recent quarterly report suggests that TARP's most significant legacy may be the moral hazard associated with too big to fail institutions, and I am happy to address that statement as well.

Moral hazard is a real and significant concern, but to suggest that this is TARP's main legacy confuses a response to a crisis with the need to fix the flaws in our regulatory system that helped trigger the crisis. TARP was necessary and it did what it was supposed to do. Its most significant legacy is that it, combined with other government actions, helped save our economy from a catastrophic collapse and may have helped prevent a second Great Depression.

The lesson we learned from having to take these actions was that, to better protect ourselves against future crises and to deal with the moral hazard issue, our regulatory system needed to be fixed. Today, while more work remains, we have taken significant action to do just that. In particular, we have taken steps to address the moral hazard associated with the fact that TARP and other government interventions were necessary and to address the too big to fail problem.

Just 19 months after TARP was enacted, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, the most comprehensive reform of our financial regulatory system since the 1930's. Dodd-Frank contains three main elements that work together to address the too big to fail problem in particular.

First, and most important, Dodd-Frank gives the government authority to shut down and break apart large non-bank financial firms whose imminent failure might threaten the broader system. It does so in a way that protects the economy, while ensuring that large financial firms, and not taxpayers, bear the costs. Dodd-Frank provides us with the tools to ensure that no firm will be insulated from the consequences of its actions or protected from failure. Dodd-Frank makes clear that taxpayers must not be asked to bear the costs of a financial firm's failure.

Second, Dodd-Frank creates a framework for identifying and responding to risk in the financial system; it creates the Financial Stability Oversight Council, FSOC, and the Office of Financial Research, the OFR. FSOC is charged with identifying risks to financial stability, responding to any emerging systemic threats, and promoting market discipline. OFR supports this task by addressing the critical need for more standardized, more useful, and more reliable data.

Third, Dodd-Frank requires regulators to impose substantially stronger prudential standards. Risk-based capital, leverage and liquidity standards will be tougher. Bigger and more complex firms will have to hold more capital than smaller and less complex firms. Dodd-Frank also requires that certain large firms undergo regular stress tests, and requires living wills. It also restricts risky activities by banks such a proprietary trading, as well as the excessive growth by acquisition of the very largest firms.

Dodd-Frank sets a clear path forward. We have made important progress since enactment to implement its provisions, but there is a lot more work to do. The financial markets are closely watching this progress, which underscores the importance of the implementation.

Let me turn briefly back to TARP, because another piece of restoring a strong financial system is unwinding the extraordinary assistance that had to be provided during the crisis. Since I last appeared before the full committee, TARP has continued to make good progress. We have moved quickly to reduce the dependence of the financial system on the emergency support provided.

I am happy to note that as this hearing is taking place, we expect to receive an additional $7.4 billion in repayments from banks. This means the taxpayers will have recovered more than 100 percent of the funds invested in the banking system, that is $251 billion compared to the $245 billion invested. Every additional dollar we recover from now on will be a net gain to the taxpayer. And with today's repayments, over 70 percent of the total amount disbursed under TARP has been recovered. The ultimate cost of TARP will be far less than anyone expected. Earlier this month, the CBO estimated the overall cost to be approximately $19 billion.

Of course, TARP is only one part of the actions taken by the government to respond to this crisis, which also included support for Fannie Mae, Freddie Mac, the Federal Reserve's actions to provide credit and guarantees of money market funds and bank debt. And it is important to look also to the cost of all of these measures. Our latest estimate of the direct fiscal cost of these interventions, which will be made available shortly, will show that there actually should be a small profit when we look at all those actions combined.

Now, this estimate does not include the stimulus measures and it doesn't include the significant costs to our economy of this crisis. Jobs were lost, businesses failed, household wealth declined, and tax revenues fell. But that damage would have been far worse without the government's emergency response.

Thank you again for the opportunity to testify. I welcome your questions. And let me just say I am also happy to respond to any of the matters that Mr. Barofsky raised, whether it is pertaining to Dodd-Frank or other issues.

[The prepared statement of Mr. Massad follows:]

Embargoed until delivery

Acting Assistant Secretary Timothy G. Massad
U.S. Department of the Treasury
Written Testimony Before the
House Committee on Oversight and Government Reform
Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs
March 30, 2011

Chairman McHenry, Ranking Member Quigley, and distinguished members of the Subcommittee, thank you for inviting me to testify today. Your invitation letter asks that I address whether there is a perception that our nation's largest financial institutions are "too big to fail" despite the passage of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("*Dodd-Frank*"). In its most recent quarterly report, the Special Inspector General for the Troubled Asset Relief Program ("TARP") raised that concern and suggested that TARP's most significant legacy may be the moral hazard associated with institutions that are "too big to fail." As the Acting Assistant Secretary responsible for implementation of TARP, I am happy to address SIGTARP's statement and the Subcommittee's question.

We recognize that moral hazard is a real and significant concern. But to suggest that it is TARP's main legacy is to ignore the facts, and to confuse the response to a crisis with the need to address the causes of the crisis. TARP was necessary to respond to the worst financial crisis we faced in decades. Its most significant legacy is that it, combined with a variety of other government actions, helped save our economy from a catastrophic collapse, and may have helped prevent a second Great Depression. And while more work remains to be done, we have since taken significant action to address the moral hazard that comes with any government assistance and specifically the "too big to fail" problem.

Circumstances That Led to TARP

In discussing the "too big to fail" problem, we must remember the situation we faced in the fall of 2008, and why TARP was needed. Over the two decades preceding the crisis, the financial system had grown rapidly in an environment of economic growth and stability. In particular, we saw significant growth of large, short-funded, and substantially interconnected financial firms. Huge amounts of risk moved outside the regulated parts of the banking system to where it was easier to increase leverage. Creditors and investors became hardened in their belief that large firms could grow larger, take on more leverage, engage in riskier activity—and avoid paying the consequences should those risks turn bad.

Legal loopholes and regulatory gaps allowed large parts of the financial industry to operate without oversight, transparency, or restraint; allowed unchecked predatory and abusive lending; and failed to require sufficient responsibility from those who, for example, made loans, sold loans, or packaged loans into complex instruments to be sold to investors.

Derivatives were traded in the shadows, and entities performing the same market functions as banks escaped meaningful regulation on the basis of their corporate form. The financial sector, under the guise of innovation, piled ill-considered risk upon risk. The lack of transparency hid the growing wedge in incentives facing different players in the system.

Ample credit and accommodative monetary policy around the world had also fueled an unsustainable housing boom in the first half of the last decade, and when the housing market inevitably turned down starting in early 2006, the pace of mortgage defaults accelerated at an unprecedented rate. By mid-2007, rising mortgage defaults were undermining the performance of many investments held by major financial institutions.

These forces continued to build and in the fall of 2008, events accelerated. Credit markets froze. And the over-reliance on short-term financing, opaque markets and excessive-risk taking that had been the source of significant profit on Wall Street and in financial capitals globally, fed a panic that was producing the classic signs of a generalized run. For the first time in 80 years, we faced the risk of a complete collapse of our financial system.

These events remind us why TARP was needed. The government simply did not have sufficient resources to address the worst financial crisis in decades. And the actions taken by both the Bush and Obama Administrations under TARP, along with the government's other emergency programs, worked: they broke the back of the panic and prevented a catastrophic collapse of our financial system. This in turn helped pave the way for an economic recovery. Today, banks are better capitalized, and the weakest parts of the financial system no longer exist. The credit markets on which small businesses and consumers depend—for auto loans, for credit cards, and other financing—have reopened. Businesses can raise capital, and mortgage rates are at historic lows. And, all this was done at a fraction of the initially anticipated cost. There is no doubt that much work remains, but overall TARP has been remarkably effective.

While that record is the most significant legacy of TARP, anytime the government provides emergency assistance to private firms, it raises a moral hazard concern—that is one of the reasons why we needed to take further action. Lehman and AIG highlight many of the key deficiencies of the old regulatory system and underline the necessity of the recent financial regulatory reforms. Our regulatory regime was simply not equipped to effectively monitor, constrain or respond to risks in our financial system, and we did not have the tools to liquidate failing firms that threaten the overall stability of the system in an orderly manner. Those were central lessons of this crisis, and ones on which we needed to act.

Just 19 months after TARP was enacted into law, President Obama signed the *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("*Dodd-Frank*"). This Act represents an historic overhaul of our financial regulatory system—the most comprehensive since the 1930s. It is a testament to those Members of Congress who supported this legislation that we were able to adopt such sweeping measures so quickly. Although I am not personally involved in Treasury's day-to-day work to implement *Dodd-Frank*, I am happy to summarize the general status of the Department's efforts, which have been discussed publicly by other senior officials.

Important Dodd-Frank Reforms

Dodd-Frank addresses the failures that led to the crisis and builds a stronger financial system by closing major gaps and shoring up weaknesses in regulation. It puts in place buffers and safeguards to reduce the chance that another generation will go through a crisis of similar magnitude. The main elements of *Dodd-Frank* that work together to address the "too big to fail" problem include: the establishment of an orderly liquidation framework for certain large firms; the creation of a system to better identify and address systemic risk; and the imposition of heightened prudential standards.

First, and most importantly, *Dodd-Frank* gives the government the authority to shut down and break apart large nonbank financial firms whose imminent failure might threaten the broader system. It does this in a way that protects the economy while ensuring that large financial firms, not taxpayers, bear any costs. Modelled on pre-existing authority to wind down failed banks, this liquidation authority closes a gap, with respect to nonbank financial firms, that severely limited the federal government's options during the crisis—for example with AIG and Lehman. *Dodd-Frank*'s liquidation authority provision allows the government to wind down a failing financial firm—wiping out shareholders, firing culpable management, and allowing creditors to take losses, while stabilizing the financial system. Any losses that cannot be covered through sales of the firm's assets will be recouped from the largest financial institutions through an ex-post assessment. In short, *Dodd-Frank* provides us with the tools to ensure that no firm will be insulated from the consequences of its actions. No firm will be protected from failure. No firm will benefit from the perception that taxpayers will be there to break their fall. *Dodd-Frank* makes clear that taxpayers must not be asked to bear the costs of a financial firm's failure.

Second, *Dodd-Frank* creates a new framework for identifying and responding to risk in the financial system. In the lead up to the crisis, gaps and inconsistencies led to regulatory arbitrage, and some of the largest, most interconnected firms were able to escape meaningful supervision. *Dodd-Frank* creates the Financial Stability Oversight Council ("FSOC"), chaired by the Secretary of the Treasury, and composed of the heads of the financial regulatory agencies. FSOC is charged with identifying risks to financial stability, responding to any emerging threats in the system and promoting market discipline. FSOC also is responsible for deciding which nonbank financial companies and financial market utilities will be designated for heightened prudential standards and for making recommendations regarding those standards—with a view not only to the safety of specific institutions, but, critically, to the stability of the entire system.

In order to respond to risk in the financial system, FSOC must be able to monitor that risk more effectively, which requires improvements in financial reporting and analytical capacity in the regulatory community. To that end, *Dodd-Frank* establishes the Office of Financial Research ("OFR"). The OFR was created to address the critical need of regulators, policymakers, and industry for data that are more standardized, more useful, and more reliable. The OFR's capacity to organize and analyze data will help FSOC make more informed decisions about potential threats to the financial system.

Third, *Dodd-Frank* requires regulators to impose substantially stronger prudential standards. Risk-based capital, leverage, and liquidity standards will be tougher, providing a more reliable buffer against both firm-specific failures and systemic shocks. And, firms that are bigger and more complex will have to hold more capital than smaller and less complex firms, requiring them to internalize risks they impose on the system by virtue of their size and complexity. *Dodd-Frank* also imposes a new mandatory stress-testing regime on the largest bank holding companies and designated nonbank firms. It requires them to establish "living wills," laying out a credible plan for breakup and wind-down in the event of severe financial distress. Regulators are now able to require all financial firms, including holding companies, to take swift action to remedy declines in capital levels and other critical measures of financial health. And there will be restrictions on certain risky activities by banks and their affiliates, such as investing in hedge funds and proprietary trading, as well as on the excessive growth by acquisition of the very largest financial firms.

Finally, *Dodd-Frank* provides comprehensive reform of the financial system. These are beyond the scope of this hearing, but they are important to creating a stronger financial system and helping prevent future crises. These include regulation of the derivatives markets, the establishment of the Consumer Financial Protection Bureau, federal monitoring of the insurance sector, and other tools.

Dodd-Frank sets a clear path forward, and we have made important progress since enactment to implement its provisions. But much work remains to be done. The financial markets are closely watching this progress, which underscores the importance of efforts to implement these authorities.

The Role of TARP

Let me now turn back briefly to TARP, because another important part of what we need to do to restore a strong financial system is to unwind the extraordinary assistance that had to be provided during the crisis. Since I last appeared before the full Committee two short months ago, TARP has continued to make good progress in this task.

Quickly Exiting Investments in Larger Firms

Treasury has moved quickly to reduce the dependence of the financial system on emergency support and to return our financial institutions to private hands as quickly as possible. When President Obama took office, the government had made investments in financial institutions representing 75 percent of the entire banking system by assets. Today, the government's remaining investments in banks represent only about 10 percent of the banking system. Moreover, taxpayers have now recovered more than 99 percent (approximately $244 billion) of the approximately $245 billion in total funds disbursed for TARP investments in banks (inclusive of dividends, interest and other income). In this month alone, taxpayers have recovered $690 million from investments made in the TARP Capital Purchase Program. This means that nearly every dollar recovered from banks from now on will constitute a positive return to taxpayers. Indeed, Treasury currently estimates that bank programs within TARP will ultimately provide a lifetime positive return of nearly $20 billion.

We have also made enormous progress in recovering our investment in AIG—two and a half years after the government was faced with the terrible choice of either assisting AIG or facing a failure that would have brought down our financial system. Today, AIG has been restructured—it has new management, a new board of directors, it has wound down some of the riskiest, unregulated parts of its business, and it is much more focused on its core business. This past January, AIG, the Treasury, and the Federal Reserve Bank of New York closed a major restructuring plan that will accelerate the repayment of taxpayer funds and that put the government in a position to recover its entire investment. AIG has already repaid the Federal Reserve $47 billion and repaid Treasury $9.1 billion. Because market prices fluctuate, there is no guarantee of what the ultimate returns will be. However, if Treasury sells its investments in AIG at current market values, including the AIG shares that Treasury received from the trust established by the Federal Reserve, taxpayers will get back every dollar put into AIG and will realize a positive return. This is a dramatic turnaround, and a result that stands in sharp contrast to what most observers expected in the fall of 2008.

Treasury, under the Bush and Obama Administrations, invested $80 billion in the domestic automotive industry. These actions saved jobs across the country—as many as one million, by one estimate—and created many new ones. Treasury's strategy is helping to restore the domestic auto industry to profitability, and we have already begun to recoup our investments. Recently, General Motors reported net income of $4.7 billion for 2010—old GM had not reported an annual profit since 2004. Chrysler reported four consecutive quarters of operating profit in 2010 totaling $763 million. Ford's 2010 net income reached $6.6 billion, its best level in more than 10 years.

Moving forward, Treasury has set a pathway for exiting its remaining GM investment, and is working to exit investments in Chrysler and Ally Financial. To date, Treasury has recovered almost 40 percent, approximately $30 billion, of its total investment in the domestic auto industry. Through a highly successful initial public offering of General Motors in November of last year, Treasury recovered almost half of its $50 billion GM investment and has reduced its stake in the company from 60.8 percent to 33.3 percent. And, earlier this month, taxpayers received a $2.7 billion TARP repayment from the sale of Treasury's trust preferred securities in Ally Financial, Inc.

Helping Responsible but Struggling Homeowners

Housing is an area where there is still much work to be done. It should be remembered that the forces that created this housing crisis had been building for nearly a decade. When the Obama Administration took office in January 2009, millions of American families could not make their monthly mortgage payments—having lost jobs or income—and were unable to sell, refinance, or find meaningful modification assistance. The Administration took aggressive steps to address the crisis facing many American homeowners. The strategy focused on providing stability to housing markets and giving Americans who are struggling, but with a little help could afford to stay in their homes, a chance to do so. By reducing mortgage rates and providing sensible incentives to prevent avoidable foreclosures, our programs and policies have helped hundreds of thousands of families stay in their homes, and they have helped to change the mortgage servicing industry generally. They are vital to the recovery of the overall housing market.

Recently, however, some in Congress have been working hard to eliminate the Home Affordable Modification Program, or HAMP, and other housing programs. In addition to ending much needed help to tens of thousands of new families each month, terminating HAMP would relax the pressure on mortgage companies to offer better assistance to struggling homeowners, and damage the prospects of recovery in our still-fragile housing market. There is no easy or quick way to repair all the damage that the housing crisis has caused—it will take hard work, sustained effort, and bipartisan cooperation. But ending HAMP and other housing programs will make the situation worse.

Efficiently Managing Taxpayer Funds

TARP will use far fewer funds than were originally authorized, and Treasury is unwinding TARP faster than anyone thought possible. Congress originally authorized $700 billion under TARP. To date, $411 billion have been disbursed under the program, and nearly 70 percent of that amount has been repaid. Earlier this month, the Congressional Budget Office estimated the overall cost of TARP to be approximately $19 billion—just a fraction of their initial estimate of $356 billion. We expect the cost of TARP to be roughly equal to what we spend on the housing programs. The TARP investment programs taken as a whole—including financial support for banks, AIG, the domestic auto industry, and targeted initiatives to restart the credit markets—are expected to result in very little or no cost to the taxpayer.

Furthermore, the direct fiscal cost of TARP and all the other interventions by the government to stabilize the financial system—exclusive of the costs and benefits of broader stimulus measures such as the American Recovery and Reinvestment Act—is quite low when compared to past systemic crises. An International Monetary Fund study found that the average net fiscal cost of resolving roughly 40 banking crises since 1970 was 13 percent of GDP. The Government Accountability Office estimated that the cost of the U.S. Savings and Loan Crisis was 2.4 percent of GDP. In contrast, last year Treasury estimated that the direct cost of all our interventions, including TARP, the actions of the Federal Reserve, the Federal Deposit Insurance Corporation, and our efforts to support the Government-Sponsored Enterprises—would be less than 1% of GDP. We must remember that the financial crisis has resulted in significant costs to our economy that are not included in that estimate. Jobs were lost, businesses failed, wealth was destroyed, and tax revenues fell because our economy suffered. But that damage would have been far worse without the government's emergency response.

Conclusion

TARP was necessary because we did not have the tools to confront the worst financial crisis since the Great Depression. The crisis had many causes, one of which was the fact that our regulatory system was in need of an overhaul. We did not have the tools to monitor or constrain the buildup of risks in the financial system or liquidate firms that could threaten the stability of the system in an orderly manner.

To suggest that TARP's "most significant legacy" is "too big to fail," is to fundamentally misunderstand the history of the crisis. It confuses what was needed to put out the fire from the reforms needed to prevent a future fire. TARP and the other actions taken by the government were necessary because the consequences of not acting would have been catastrophic. The legacy of TARP is that it worked: it helped bring stability to the financial system and laid the foundation for economic recovery. And, it did so at a fraction of the expected cost.

The passage of *Dodd-Frank*—just 19 months after TARP—was the vital next chapter in this history. *Dodd-Frank* gives the government the critical tools it needs to address the fundamental failures that led to this crisis. We must now implement these tools swiftly and effectively, and use them wisely.

Thank you again for the opportunity to testify. I look forward to your questions.

Mr. MCHENRY. Thank you, Mr. Massad. I recognize myself for 5 minutes.

There are a number of questions that Dodd-Frank raises. Now, I certainly read your editorial against my legislation ending the HAMP program. We don't have to relitigate that; we won the vote last night, so I am fine with that, obviously, and we had a bipartisan vote as well.

And I hope that sends a strong message to the overseer of that program, you, Mr. Massad, and your staff that the status quo there is simply not acceptable. Destroying 800,000 people's credit scores, taking their savings is not a responsible program in order to help a half a million people. And the people that are brought into the program, given verbal modifications of their mortgages, and yet are kicked out at the program at the end of the day, in your recent report, that number was 740,240. And we appreciate your releasing those numbers, but it is simply not acceptable. But we don't have to relitigate that because I was happy to win the vote.

Now, I want to raise a question that I think is interesting. You said the taxpayers won't be on the hook for future bailouts. Can you explain how you justify that under Dodd-Frank?

Mr. MASSAD. Dodd-Frank provides that taxpayers will not fund any bailout. What it provides is it gives the authority——

Mr. MCHENRY. How does it provide that?

Mr. MASSAD. It gives the authority to the FDIC to liquidate a non-bank financial firm that is threatening the system and to impose those costs on creditors and shareholders, including the ability to clawback those costs. And to the extent those costs can't be imposed on creditors and shareholders, then there is an assessment after the fact on large financial institutions.

Mr. MCHENRY. OK. So you disagree with Mr. Barofsky's assertion that Dodd-Frank and your boss, the Treasury Secretary's comment in the event of a next crisis, we would have to do extraordinary things beyond the scope of the Dodd-Frank legislation?

Mr. MASSAD. As I have testified before, Mr. Chairman, the Secretary's statement referred to the fact that it is difficult to predict the shape, the nature of a crisis, and you may have to take extraordinary actions, but he was referring to using the tools of Dodd-Frank.

Mr. MCHENRY. Interesting. Interesting. OK, so another question I have is, is Treasury, in terms of looking at financial stability, are you looking at the interconnectedness of our financial markets across regulatory regimes, meaning foreign regulations and how they are moving forward? Speaking to market participants, I think they see an opportunity for regulatory arbitrage and to make money based on the fact that other European countries, for instance, are behind us in terms of changing their financial regulations. Is this a concern to you?

Mr. MASSAD. Oh, absolutely, Mr. Chairman. It is a very good question; thank you for raising it. One of the important things we have to do is to work with foreign regulators to try to——

Mr. MCHENRY. Are you doing that?

Mr. MASSAD. Yes. There is a lot of work going on by Treasury, by the Fed, by others to do that. The Dodd-Frank law provides for that.

Mr. MCHENRY. Well, I know it provides for that. I am asking you the question of how that is going. Is that progressing? And how is it progressing? What are you doing?

Mr. MASSAD. There is a lot of work going on by each agency, Mr. Chairman.

Mr. MCHENRY. I know that there is a lot of work going on by each agency. I mean, you are stating some very obvious things. I understand part of the Treasury tact here, and I have seen you in committees before, is not to answer questions. Well, I am the chairman of this committee; I call my own time, so you need to answer the question.

Mr. MASSAD. Mr. Chairman, I will be happy to provide you with details about that. I do not have them at my fingertips. It is not my responsibility to coordinate with our international friends on those regulatory regimes; it is my responsibility to implement the TARP program. But I would be very happy to get you a detailed response on that.

Mr. MCHENRY. OK. So financial stability doesn't entail looking at international regulatory regimes is what I am trying to understand from you. I will move on. I will move on. It is fine.

So the Financial Stability Oversight Council, which is a creation of Dodd-Frank, entails a number of regulators sitting on a council together, and I understand that. Now, each regulator has their own staff. Is it your view, in terms of preparing for this and how this council will actually operate, how their meetings will occur, where they will occur, is this largely being driven by the Treasury Department?

Mr. MASSAD. Mr. Chairman, the FSOC is chaired by the Secretary of the Treasury; it has a number of members, as you know, 10 voting members as well as non-voting members. It meets periodically. It is developing staff. It is promulgating rules. So there is a lot of activity there and it requires the coordination across all agencies, as you know.

If I may also, though, respond, I don't believe I said that financial stability doesn't entail looking at international regimes; I think I said the contrary, sir. And, again, I would be happy to get you details on what is going on in that regard.

Mr. MCHENRY. Well, you said it wasn't your responsibility.

Mr. MASSAD. That is correct, it is not. My responsibility is the TARP program.

Mr. MCHENRY. Right. OK, fantastic. Great.

So, with that, I recognize Mr. Quigley for 5 minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman.

Good morning.

Mr. MASSAD. Good morning.

Mr. QUIGLEY. Questions this morning were brought up earlier about community banks and their relative disadvantage. Are you in a position to talk about the comparative disadvantage many of those banks, many of them in my State, are at at this point and what can be done?

Mr. MASSAD. Congressman, that is a very important question. I would be happy to talk about that. We obviously have to have a thriving community bank sector in this country. We have taken a number of actions under the TARP program to do that. The Obama administration did not provide any funds to large banks; we provided funds to about 400 small banks, and about 650 small banks were funded under the program.

The Treasury also pushed for the implementation of the Small Business Lending Fund to provide additional assistance to those banks. The differential you have referred to is important, and I think, once again, Dodd-Frank provides us with some tools to address that. It allows us to impose tougher standards on the largest banks; capital standards, leverage standards, liquidity standards. Now, again, there is a lot of work to be done to implement that, but I think it does give us some tools to address that very problem.

Mr. QUIGLEY. If you could mention at least some of the differences that still exist that need to be addressed. Could you detail some of those?

Mr. MASSAD. Sure. Well, a basic problem, of course, is a lot of our small banks don't have access to the capital markets. That is why, of course, we have been able to see that a lot of the larger banks have repaid TARP funds; many of the smaller banks have not because it is more difficult for them to raise money to do so. But we are continuing to work with them. The capital under TARP is not required to be repaid at any time. And I think, again, the fact that we funded a lot of those banks has helped them weather this storm.

Mr. QUIGLEY. The perception in my State is that, as simplistic as it sounds, you have bailed out the big banks and shut down the small ones. If you were in my position, how do you respond to those banks?

Mr. MASSAD. Very good question, Congressman. I think what we say is that, in fact, under TARP, particularly under President Obama, we provided capital to any small bank that was viable, and we ended up providing that to, as I say, overall in the TARP program, about 650 banks, and we are continuing to work with them. Now, the issues you have raised, as to whether big banks have an advantage, again, I think the Dodd-Frank Act is meant to provide us with tools to level the playing field. It needs to be fully implemented.

Mr. QUIGLEY. Longer discussion at some other point.

Let me shift gears just for a few minutes. March 21st of this year Forbes reports that Goldman Sachs and others are skirting the Volcker Rule by saying that it doesn't apply to long-term principal investments. What has Treasury's reaction to that been?

Mr. MASSAD. Congressman, I am not familiar with the particulars of implementing the Volcker Rule. I would be happy to get you a response on that.

Mr. QUIGLEY. Thank you. I yield back.

Mr. MEEHAN [presiding].

[Remarks made off mic.]

Mr. MEEHAN [continuing]. Time to be before our committee, and you had identified at the outset of your comments that one of the things that you would do is to try to be responsive to any comments that were made by the gentleman who testified before you. He raised an issue, which was a question that I think your general counsel was looking at, the right to conduct an audit of the exit of banks from TARP. Is there any reason why that should be a question? And what is your position as to the authority of the Inspector General to audit that particular process?

Mr. MASSAD. Thank you, Congressman, that is a very good question. I believe that issue goes to whether SIGTARP or the Treasury Inspector General has jurisdiction or what each of their jurisdiction is. That is the issue. In my capacity, I respect that both are entitled to their opinions, and I defer to the judgment of the General Counsel as to the proper jurisdiction between them, and that is what is going on.

Mr. MEEHAN. OK. Well, you have a willingness on the part of SIGTARP to engage in this particular activity. If it is determined that the Inspector General from Treasury is the entity by you, are we assured that the Inspector General from Treasury would conduct that same audit?

Mr. MASSAD. Well, again, it is not my determination; it is a question of interpreting what the law requires and provides for, both as to the Small Business Lending Fund law as well as TARP, and I would say that I think both the Special Inspector General's Office and the Inspector General's Office are very, very excellent operations that have conducted thorough audits, and I would be happy to work with both of them as we have.

Mr. MEEHAN. Well, thank you. Well, then I understand that is a little issue that will have to be resolved, but it will give us a chance to follow that, and I thank you for your observation because I didn't understand why there would have been any reluctance.

As we look at the larger question of not just where we have been with TARP, because there is a lot of analysis and information on both sides, much of it credible, about the successes of TARP, but there is a real issue about where we are going, and part of the problem has been, I think, in some ways, the unintended consequences, or presumably unintended consequences, with the bigger banks getting bigger; as my colleague, Mr. Quigley said, a lot of the oversight going toward the institutions that perhaps were not really the target of this initial effort.

And what I am concerned about is the perception that now we have rating agencies that are factoring in the likelihood that somebody is going to step in to cover these banks in shoring up their position. So I am dramatically concerned about the consequences, as Mr. Bernanke said, sort of it creates almost limited market, it limits the market discipline in this kind of a context.

So how do we check the ability to be assured that we aren't going to see this again? And one of the factors that I see that you have been looking at has been the idea of the living will. Now, what is going to happen in practice with that living will? Are we enforcing this and are we requiring that a real effort be made to compel these organizations to explain how they are going to get out of it?

Mr. MASSAD. Absolutely, Congressman. It is a very good question, and I was rather surprised by Mr. Barofsky's comment that somehow Treasury was opposed to this. It is a requirement of Dodd-Frank. Implementation of living wills is left to the FDIC and the Federal Reserve. They are working on it; they have until January 2012. But it was part of the original proposal that Treasury made, and we have backed the concept the entire time. But you are absolutely right that is a critical tool, and how thoroughly that is enforced, I think, and how thorough those plans are will make a critical difference.

Let me just add, also, in terms of the rating agencies, they are obviously watching this very closely, as well they should, but I think, again, they have made it clear that what they are doing is monitoring it. They are seeing how we develop——

Mr. MEEHAN. They are not just monitoring, they are making calculations, and the calculations they are making is that we are rating these banks, giving them a preferential position with respect to the rest of the market based on their confidence that effectively somebody else is going to step in.

Mr. MASSAD. That is correct, and they are doing that worldwide. But they have also said we are closely monitoring the situation to see how these resolution regimes are implemented and to see if there is the political will to ensure that there aren't bailouts in the future.

Mr. MEEHAN. What would that political will take? What should be requiring of them in order for them to be able to pass the scrutiny of that living will analysis?

Mr. MASSAD. Well, again, I think we are at the early stage of the implementation. This law was passed 8 months ago, and to sort of say it is not going to work is a bit like saying, when we passed the Securities and Exchange Act in 1933, that, well, because they didn't fix our markets within 6 months, they didn't work. In fact, we set up the SEC, we took a lot of actions.

We now have the most vibrant, robust capital markets in the world. It is the same thing as saying, well, we passed the Civil Rights Act and it didn't end discrimination overnight. There is some time needed to implement these things. We are busy working on it; it involves many, many agencies, not just Treasury. And I welcome Mr. Barofsky's suggestions, if he has suggestions on how to implement it, but I haven't heard any specifics.

Mr. MEEHAN. Thank you, Mr. Massad.

At this point in time I turn to the gentleman from Maryland, Mr. Cummings.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

Let me ask you this, Mr. Massad. You heard the testimony of Mr. Barofsky, did you not?

Mr. MASSAD. Yes, I did.

Mr. CUMMINGS. And when you were here before us before, you said that there was going to be some retooling with regard to the HAMP program. Basically, if I were to sum up what Mr. Barofsky said with regard to the HAMP program and your retooling is that it is a little late, but at least it seems like you are aiming in the right direction, but he doesn't seem to have a lot of confidence, based on the past, that your department is going to do very much of anything, even under the threat of demise of the program. And I am just wondering what is your reaction to that?

Mr. MASSAD. Certainly, Congressman. Thank you for the question. I guess my reaction was once again to be a little puzzled. I felt like there was strong criticism, but I didn't hear a whole lot of specifics. SIGTARP has made about 18 recommendations to us on the HAMP program. We have implemented 14 of those. The ones we didn't implement basically would have made it harder for people to get assistance; it would have required us to thumb print anyone, it would have required more documentation about income, comparing their income today to when they got their mortgage, and other things like that. And the last specific recommendation we got was in April of last year.

Now, lately he said the program is a failure, but, again, we haven't seen anything specific. We made an announcement yesterday that we are expanding our compliance reporting and we will withhold incentives. Again, on that, what we did from the outset was we had a very strong compliance program to try to get servicers to fix the problem. There wasn't, frankly, we only pay money when they actually enter into the permanent modification. They weren't entering into the permanent modification, which is why we focused on remedial actions initially.

Mr. CUMMINGS. But you understand there is a lot of frustration on both sides of the aisle, and the question is what can we do passed the conversation to really effect more people. Is there something that we need to do differently? I, for one, and I know many of my colleagues voted against the bill yesterday to end the HAMP program, but most of us said to ourselves and to each other that Treasury has to do better. I mean, that is just real.

So I am just wondering what is going to happen. We can't keep going down this road the way we are going, because there a lot of people suffering. And with all of that money out there, I think it just gives the opposition more ammunition to not only destroy the program, but also not replace it with anything. And that goes against everything that we are trying to accomplish. So I just want to know what your reaction is to that.

Mr. MASSAD. Well, you are absolutely right that those people who want to end the program have not offered any alternatives. We continue to look at ways that we can improve it, but it is a very difficult issue. We have a lot of people who have spent a lot of time on this and, believe me, if there was a silver bullet, if Mr. Barofsky knows of a silver bullet, he certainly hasn't told us. It is not easy. At the same time, the program is continuing to help tens of thousands; it is affecting people indirectly through the standards that we are setting.

Mr. CUMMINGS. Do we need to raise the standards?

Mr. MASSAD. Yes, absolutely. We need national servicing standards, and there is a lot of activity going on in that regard, as you know, both through the discussions on the foreclosure problems and otherwise, and I think we will see that coming. We are very committed to that. And we have also met with Members of Congress about the specific things that need to be in those national servicing standards.

Mr. CUMMINGS. One of the things that Mr. Barofsky said, too, with regard to too big to fail, he said that in Dodd-Frank there are the tools there, and I think you agree with that. But he said that he does not believe that the administration has the will to really carry it out, and I want you to comment on that. But I also want you to comment on this other issue that I brought is, which is that if we take substantial funds away from your budget, how would that affect and that market perception that he talked about so much?

Mr. MASSAD. Congressman, I agree 100 percent that taking away funds from implementation at this time, whether it is Treasury, SEC, FDIC, CFTC, because they all have responsibilities here, would not be a good thing. We need to make sure we vigorously enforce this.

As to Mr. Barofsky's comment, again, I don't know what specifics he is referring to. The implementation process is an open one. There are a number of rulemaking proceedings going on. If he has comments on those, he can make them. If he thinks that certain things aren't happening fast enough, he should point that out.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

Mr. MEEHAN. Thank you, Mr. Cummings.

At this point the gentlelady from New York, Ms. Buerkle.

Ms. BUERKLE. Thank you, Mr. Chairman.

And thank you, Mr. Massad, for being here this morning and your willingness to testify. I am looking at your opening statement and I just wondered if we could flesh out a couple of items that are in your comments here this morning. In reference to Dodd-Frank you listed three points for us. The first one is Dodd-Frank gives the government the authority to shut down and break apart large non-bank financial firms. To what extent, what is the scope of that, and should we be concerned that the government has that kind of power that they can just shut down a private entity?

Mr. MASSAD. It is a good question, Congresswoman. There is a process that has to go on. There is a determination that has to be made by the Treasury, with also the vote of the FDIC and the Federal Reserve, and in consultation with the President, and there are criteria that have to be met in order to do that in terms of when you can use that authority. Those criteria include that there is not another way to deal with the situation, that the firm in fact does pose a threat to our financial stability, and there are others. And, again, there is rulemaking going on to further explicate that because it is important for there to be clarity as to those rules.

Ms. BUERKLE. Thank you. And I guess the second point for identifying and responding to risk, I think that would tie back to the first point. Are there certain benchmarks that you are going to look for that will identify that someone is in trouble that then the government needs to take this aggressive action?

Mr. MASSAD. Sure. And again there are standards in the law that now have to be implemented and flushed out more. But I think the key thing to remember here is that prior to the passage of Dodd-Frank we regulated entities based on the type of entity, and we didn't have a comprehensive way of looking at risk to the system, and that is what we have now and that is why this law is so important and that is why implementation of it is so important.

And we can take proactive measures to impose prudential standards, whether it be capital, leverage, liquidity. We can limit risky activities, and there is a whole process where even before you exercise the liquidation authority you can impose restraints on firms. So it gives us a lot of tools but, again, they need to be implemented.

Ms. BUERKLE. I guess going along with that gives you the tools, at what point what is the concern that the government—many feel

Dodd-Frank is an overreach, and while we want to prevent what happened in the meltdown, we want to still maintain free market. So what point does the government step back and say we are not going to get involved?

Mr. MASSAD. Sure. Well, obviously, there is a balance there. I think Congress struck the right balance in the Dodd-Frank Act in giving us those tools, but the answer to your question really gets into the details of how it is implemented, and that is why, again, it has to be implemented thoughtfully over time, and that may change over time. As our financial industry changes, we are going to have to change how we look at it and how we think about risk.

Ms. BUERKLE. Then just one more question regarding your testimony. You talk about Dodd-Frank, you say but much work remains to be done. Can you just expand on that briefly?

Mr. MASSAD. Certainly. There are about 250 rulemakings that have to happen; there are about 70 studies, one-time studies that have to happen; it involves efforts of many agencies, not just the Treasury, not just the FDIC, but also the Federal Reserve, the SEC, the CFTC and others. So that is the work I am referring to. A number of those things have already been done or are in process; a number of proposed rules are out there, but there is a lot more work to be done.

Ms. BUERKLE. Thank you. In my few seconds that are remaining here, I just have one last question. The government now is a player and a referee. Do you see a conflict in all of this?

Mr. MASSAD. Well, I don't think we want the government to be a player in the sense of having interest in firms; that is why we are trying to unwind the TARP program so quickly, for example, and get out of the business of owning stakes in private companies. And, as I said, we have been very, very successful in doing that quickly. I think the government needs to stick to its role of regulating risk and monitoring risk and taking action when firms pose risks to the system. But clearly we have to have a system where there is no firm that is too big to fail and that firms fail as a result of the actions they take.

Ms. BUERKLE. Thank you very much.

I yield back.

Mr. MEEHAN. Thank you, Ms. Buerkle.

The Chair now recognizes the gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you and welcome to the committee again.

Mr. MASSAD. Thank you.

Mrs. MALONEY. During the financial crisis some firms became so risky, they were so risky and so interconnected that their failure was a threat to the broader economy, and I know Congress tried to address that and Treasury in Dodd-Frank. Can you describe the progress being made under the authority granted under Dodd-Frank to prevent companies from becoming so interconnected and so risky that they could be a danger to the broader economy?

Mr. MASSAD. Well, yes. Thank you for the question. There are a number of efforts going on in that regard looking at the riskiness of activities. For example, the FSOC will make determinations about which firms pose those sorts of risks based on not just their size, but also their interconnectedness, their leverage, the nature of their activities; and that work is ongoing. Those determinations haven't been made yet; they will be made by the FSOC, which, as I noted earlier, is comprised of all these various agencies.

Mrs. MALONEY. Thank you. One of the factors that led to the financial crisis was the evolution of what we call the shadow banking system, where the purchase, sale, and trading of derivatives had grown to a trillion dollar business, but it became very evident during the crisis that people, Treasury, even the companies did not understand the scope, location of the risk, the size of it. I can recall AIG coming before this committee, saying the threat was only $50 million, and then later it became billions and billions and billions. There was no control, no understanding of even the location, the size. Can you comment on what advances you have made on the derivative market and bringing them to the light of day to ensure that it can exist without posing a threat to financial stability?

Mr. MASSAD. Certainly, Congresswoman. As you know, Dodd-Frank does provide provisions for greater transparency and regulation of the derivatives market, and we did not have those previously, and there is a lot of work going on in that regard.

Mrs. MALONEY. Can you specify?

Mr. MASSAD. Congresswoman, I am not directly involved in that work. Again, I would be happy to get back to you. That involves Treasury, but also the SEC, the CFTC. But I would be happy to arrange that for you.

Mrs. MALONEY. And the growth of the shadow banking system also illustrates the fact that Federal regulators had in many ways failed to keep up with market innovation and development. Regulation couldn't keep up with the innovation and dynamic action taking place in the markets. Can you ensure us that Dodd-Frank and the regulations that you put in place are going to be able to keep pace with innovations in the financial markets?

Mr. MASSAD. That is a very good question, and, again, what Dodd-Frank does is gives us the tools to do that. We have to implement them. But previously we didn't have a system where we could look at risk across our entire system; we regulated banks, we had certain regulation of other type of entities. But as you have noted, the had an entire shadow banking system developed; we had all this risk being taken on by firms that weren't subject to regulation.

AIG is a classic example. There was no Federal regulation, effectively, of AIG, and it did engage in these derivatives that were terribly destructive. Now, as to AIG, for example, we have now wound that down. That is part of the reason why they are going to be able to repay the government every dollar that we gave them.

Mrs. MALONEY. That is good news. Earlier, we heard testimony from Special Inspector General Barofsky, and one of the points that he raised and has raised is that the act does not reach far enough to fully address international firms that operate globally, and we are in a global economy, a global market. Are U.S. regulators working with their foreign counterparts to address the issue of cross-border resolution authority and are our financial institutions at a competitive disadvantage because we have regulation, yet many of these other areas in the financial global market do not? They don't have the capital requirements; they don't have the risk restraints; they don't have the oversight that American firms will be having.

Mr. MASSAD. Congresswoman, thank you for that. The international coordination piece of this is very critical. We are dealing in a global world; we have these large institutions who aren't just national institutions, they operate worldwide, and that is why that coordination is important. It is going on; I know the Federal Reserve is involved in that, the Treasury is involved in that. I would be happy to get you more details on what is taking place in that regard, but obviously Congress couldn't legislate something that mandates what our foreign counterparties do; it requires us to engage in cooperation and coordination with them.

Mrs. MALONEY. Well, the Basel talks, where do they stand? They are going to have international capital requirements.

Mr. MASSAD. They will.

Mrs. MALONEY. Where does that stand now?

Mr. MASSAD. That is right, and that will result in higher capital requirements that will be phased in over time that are badly needed. Fortunately, many of our institutions are better capitalized today than their foreign counterparts, but we need to phase in those tougher standards.

Mrs. MALONEY. Well, my time has expired. Thank you for your service.

Mr. MASSAD. Thank you.

Mr. MEEHAN. Thank you, Mrs. Maloney.

Let me turn now to the gentleman from Illinois.

Mr. WALSH. Thank you, Mr. Chairman.

And, Mr. Massad, thank you for your testimony today. Let me ask you just a brief question or two related to the insurance industry. I have heard from a number of people of late who have expressed concerns with how Dodd-Frank has and will affect the insurance industry. You know that insurers are already heavily regulated at the State level, including an industry-funded State guarantee system that helps secure policyholders in the event of an insurance company failure.

Most insurers are not engaged in significant unregulated, interconnected off-balance sheet, highly leveraged activities, and so designations such as systemically important would appear to be unwarranted in this industry. Overlapping and conflicting rules between State and Federal regulators adds an additional costly layer of regulation that would significantly disadvantage these insurers and their customers.

As you know, in the event of another large financial company failure, companies with assets over $50 billion could be on the hook to pay for the resolution of these failed firms, even though they exhibited no bad behavior of their own. Insurance companies who, according to the Dodd-Frank Act, will continue to be resolved in the existing State system, are never resolved by the orderly liquidation process, and yet have to pay to resolve banks and other bad actors in the financial industry. These costs will inevitably be borne by the consumer.

So if insurance companies are already regulated at the State level and if it is clear that they don't participate in systemically risky behavior, why do they have to bail out other failing financial service companies that do participate in this risky behavior?

Mr. MASSAD. Congressman, your question raises a number of very, very important issues. Let me try my best. I guess where I would start is that we have come out of a period where in fact we did have a very large insurance company that was regulated at the State level, but which posed huge risks to our system because it wasn't regulated beyond that, and that was AIG. And we didn't have the tools to deal with it and its potential failure could have brought down our entire system. So obviously that has animated the provisions of Dodd-Frank that in part address the insurance industry.

But I recognize your point, that we have to make sure that these provisions are implemented in a way that which is fair to those companies that don't pose those risks and that don't engage in those activities. I think that is a process that we have to focus on as we go forward. The FSOC is very focused on those sorts of issues because we, again, need to do this in a way that imposes standards and restrictions on those firms that pose the significant risk to the system, while at the same time level the playing field for the others.

Mr. WALSH. You would acknowledge, though, that with regard to AIG, it wasn't their insurance business that in effect got them in trouble or brought them down.

Mr. MASSAD. Well, it is a complicated question. There were things going on with their insurance business that did pose some risks, but you are correct that AIG was involved in a number of activities that went outside of the traditional insurance area.

Mr. WALSH. And outside of the traditional insurance activities, which really didn't get them in trouble. What activities did get AIG in trouble?

Mr. MASSAD. Well, again, I think it is a complicated question. They had, obviously, a derivatives business that posed a lot of risks, but they were also engaged in some activities with the capital through their insurance business that posed liquidity challenges, and that was one of the reasons why they had liquidity problems and the Fed had to step in.

Mr. WALSH. But even using AIG as an example, is there a part of you that thinks, again, it is a bit of a stretch to want to lump the insurance industry into Dodd-Frank as well?

Mr. MASSAD. Well, again, I think the regulation of large firms that pose a risk to the system is designed to recognize that we can't achieve our goal by doing that by type of entity or by particular business line today. We have to have the ability to look across the entire financial industry and determine where are the risk coming from and take appropriate action. At the same time, as you have pointed out, we have to make sure that those regulations don't impose unfair burdens on other companies that aren't engaged in those activities.

Mr. WALSH. Right. And I would second that point and just reiterate that fact that, in general, the insurance industry did not at all engage in systemically risky behavior. But, Mr. Massad, thank you.

And, Mr. Chairman, thank you.

Mr. MCHENRY. I thank my colleague.

In your testimony you say outright that Dodd-Frank was necessary because of the moral hazard created "when government provides emergency assistance to private firms." So you believe that Dodd-Frank answered the too big to fail question?

Mr. MASSAD. Congressman, yes. I believe Dodd-Frank gives us the tools to address the too big to fail problem.

Mr. MCHENRY. And so too big to fail is no longer permissible?

Mr. MASSAD. Well, Congressman, Mr. Chairman, as I said when you were out of the room, you know, we have to implement the law. The law is not a magic wand, it is a bit, as I said, like saying, when we passed the Civil Rights Act, that didn't eliminate discrimination. We have a lot of work to do.

Mr. MCHENRY. That is a heck of an analogy. In today's financial times, Alan Greenspan wrote, "The financial system on which Dodd-Frank is being imposed is far more complex than the lawmakers, and even most regulators, apparently contemplate. We will almost certainly end up with a number of regulatory inconsistencies whose consequences cannot readily be anticipated." Do you agree?

Mr. MASSAD. No. I guess what I would say is the question is what are we saying would be the alternative. I don't think anyone would say that we would be better off without the tools that we have now provided for through Dodd-Frank to regulate risk, to impose higher prudential standards, to be able to prevent a firm from threatening our entire system. The question is, again, we have to implement those wisely.

Mr. MCHENRY. Are we doing that?

Mr. MASSAD. I think we are doing that.

Mr. MCHENRY. OK. To continue with Mr. Greenspan's piece in today's Financial Times, "Under Dodd-Frank, the regulators are being entrusted with forecasting and presumably preventing all undesirable repercussions that might happen to a market when its regulatory conditions are importantly altered. No one has such skill." Do you agree or disagree?

Mr. MASSAD. Well, I think, again, we have to try. I don't think any of us want to be in the situation that we were in in the fall of 2008, where because we had a regulatory system that had been outgrown, we had a financial industry where there was a huge amount of risk being taken on without transparency, without adequate regulation, and that is what contributed to the crisis we had. I think because of that we learned the lesson that we need to overhaul our regulatory system. That is the judgment Congress has made, and I think the task is now to implement that judgment.

Mr. MCHENRY. Mr. Barofsky and a number of folks have testified that during the last financial crisis, in 2008, that the laws that we had then we could have prevented the crisis. Do you agree?

Mr. MASSAD. That is news to me. I would be happy to discuss that with Mr. Barofsky.

Mr. MCHENRY. OK. So basically it is your view that Dodd-Frank has ended too big to fail.

Mr. MASSAD. As I said, Mr. Chairman, Dodd-Frank gives us the tools to address the problem.

Mr. MCHENRY. OK. Now, moving back to HAMP, I want to give you an opportunity to respond now in our second round here. You know, you made an interesting face when I was saying that we have 740,000 homeowners who have actively been harmed by this program. Do you disagree?

Mr. MASSAD. I do, sir, and I appreciate your——

Mr. MCHENRY. So the folks that have fallen out of this program, that enter into the program, you tout 1.4 million, is that the number?

Mr. MASSAD. Trial modifications? That is correct.

Mr. MCHENRY. Trial modifications. Now, do you understand that when they are entered into a trial modification they are told verbally that oftentimes they are going to make a lower monthly payment going forward? Are you aware of that?

Mr. MASSAD. I am, sir.

Mr. MCHENRY. OK. Now, in a trial modification that is verbal, as all these are verbal, when you are paying less than what is contractually obligated by a homeowner, that harms your credit. Are you aware of that?

Mr. MASSAD. Mr. Chairman——

Mr. MCHENRY. Are you aware of that, yes or no?

Mr. MASSAD. Mr. Chairman, if I can answer how the trial modification works, because I think it is important to have all the facts on the table. The trial modification provides a 3-month period in which payments are lowered temporarily, and during that time we have to determine if someone qualifies for a permanent modification. What we did at the outset was we allowed people, we allowed servicers to accept people into trial modifications on the basis of what we called stated income; you could basically raise your hand and say this is how much I make, I qualify. Because it was a terrible crisis, because we had a lot of people who were in need.

Mr. MCHENRY. I understand; I read your editorial. The point I am asking—and I know you are trying to go through all this. I understand how this works operationally. I want to make sure that you understand how this works. So when you are given that verbal modification, this temporary modification, does that hurt your credit?

Mr. MASSAD. Mr. Chairman, I think——

Mr. MCHENRY. You are not answering the question.

Mr. MASSAD. Well, I don't——

Mr. MCHENRY. It either does or it doesn't. If it doesn't hurt your credit——

Mr. MASSAD. I think the answer can't be given as a simple one without, again, looking at what happens to those people. If I may answer—can I answer the question in this regard, if you will allow me? You refer to all these 750,000 people being hurt. We actually——

Mr. MCHENRY. It is 740,240 according to your last report.

Mr. MASSAD. Thank you. We actually publish statistics on what happens to those people. Now, those statistics are based on servicer surveys, but it is in our monthly report, and it shows what happens. The majority of them ended up in alternative modifications or alternative payment plans or are current. Very few of them went to foreclosure.

Mr. MCHENRY. Do you believe that HAMP has harmed any borrower?

Mr. MASSAD. I am sure there are people who were harmed.

Mr. MCHENRY. How many?

Mr. MASSAD. I don't know the answer to that.

Mr. MCHENRY. I thought you publish statistics about what happens.

Mr. MASSAD. Mr. Chairman, we publish a lot of statistics, and I am trying my best to address your concern. I think it is important to remember that whenever you implement a program like this on a massive scale in a crisis, what we were doing was buying time for people. Most of those people ended up in better situations. There are——

Mr. MCHENRY. How many?

Mr. MASSAD. Well, again, based on the servicer surveys, the majority, the vast majority of them were clearly in better situations; only a small number went to foreclosure. But the point even about those is——

Mr. MCHENRY. How many went to foreclosure?

Mr. MASSAD. About 5 percent. But the point is——

Mr. MCHENRY. How many? What is that number? I don't have the report in front of me.

Mr. MASSAD. Foreclosure completions is 58,000. But the point is that their loan wasn't increased; they owed the same amount.

Mr. MCHENRY. And so when the servicer comes back in, when they are not given a permanent modification, they owe those missed payments or the difference between the payment they were making and the payment they were obligated to make.

Mr. MASSAD. That is correct, sir.

Mr. MCHENRY. Right. And there are penalties and fees associated with that, as well as additional interest.

Mr. MASSAD. There may be in some cases.

Mr. MCHENRY. So, therefore, that temporary modification has left them worse off than had it not been given originally.

Mr. MASSAD. Sir, if, again, you are talking about a pool of people who are given that breathing room, and the majority of them, the vast majority of them end up being in better situations, I still think it was the right policy judgment to make.

Mr. MCHENRY. Even if this program is actively harming individuals and leaving them worse off?

Mr. MASSAD. Well, again, it is not that the program is actively harming them, sir, it is that they have a mortgage. They owe the same amount. It should have been explained to them that if they didn't get the permanent modification, they would still owe what was previously due.

Mr. MCHENRY. OK.

Mr. MASSAD. Now, if that wasn't explained to them, that was a mistake. But that should have been explained to them. But the program didn't make them worse off.

Mr. MCHENRY. Well, I have numerous examples from constituents that I could read to you. The program has harmed a large number of individuals, and the Treasury Department—you know, the Special Inspector General's report on HAMP has been out there for quite a while; you have had plenty of authority to go in and fix this program. You haven't fixed it. So you are touting some of these statistics. The other thing I just wanted to make sure to ask, while you have the survey there, or your statistics there, you quoted the foreclosure number. How many are in pending foreclosure? Do you have a statistic similar to that?

Mr. MASSAD. Foreclosure starts, those not accepted for trial modifications is 163,000. Now, a lot of those could have been in foreclosure starts even before they went into the trial.

Mr. MCHENRY. OK. Well, look, I wanted to give you an opportunity to respond. If you would like to add anything else, I would be happy to give you the opportunity right now.

Mr. MASSAD. I would be happy to. Again, I think we faced the worst housing crisis of a generation. We were trying to roll out a program that could help a lot of people. A lot of people were already delinquent for months, so we were trying to create some breathing room. Most of those people are in better situations. Those that are not I think, again, their mortgage didn't increase because of HAMP; they simply weren't accepted into the permanent modification because we have very prudent eligibility criteria so that we spend taxpayer dollars wisely.

Mr. MCHENRY. Thank you.

Mrs. Maloney.

Mrs. MALONEY. Thank you. First of all, Mr. Deputy Secretary, could I request to have your op ed, your editorial, placed in the record?

Mr. MCHENRY. Without objection.

[The information referred to follows:]

POLITICO

A case for home loan modifications

By: Timothy Massad
March 29, 2011 04:46 AM EDT

The House is set to consider legislation Tuesday that would terminate the Home Affordable Modification Program — which provides critical foreclosure prevention aid to struggling homeowners.

Let's be clear about the effect this proposal would have on neighborhoods and communities in every part of our country. It would deny critical assistance to struggling Americans who are working in good faith to save their homes. It would increase the number of avoidable foreclosures. It would also put the still-fragile housing market recovery at greater risk.

This would be a serious mistake. And it would cause damage not just to the families who would lose their homes through avoidable foreclosures — but to all Americans. More avoidable foreclosures could mean steeper home price declines and even more vacant homes in neighborhoods and communities across our nation.

To date, HAMP has helped more than 600,000 families lower their mortgage payments and stay in their homes after the worst housing crisis in a generation. On average, these homeowners are receiving about $500 per month in lower mortgage payments. Each month, we're helping an additional 25,000 to 30,000 homeowners with this program.

HAMP's positive effect goes beyond the number of mortgage modifications. By setting affordability standards and developing a framework for how the private sector should provide assistance to struggling homeowners, it has helped push the industry to modify the mortgages of about 2 million more homeowners outside of HAMP. And it has established new protections for borrowers — and kept the pressure on mortgage companies.

Without question, the mortgage-servicing industry still has a long way to go in meeting customers' basic needs. To help ensure that homeowners are better served by mortgage companies, Treasury is moving into our next phase of disclosure around servicer compliance.

Beginning next month, Treasury will release a quarterly compliance scorecard for each of the 10 largest HAMP servicers. Each will be graded on key performance metrics, including evaluation of homeowners for modifications and whether their staff resources and internal processes dedicated to program implementation are sufficient. These mortgage companies also will be rated against their peers. We have and will continue to require that servicers take remedial actions to address inadequacies, and Treasury will begin withholding financial incentives from for servicers that receive an unsatisfactory grade.

The industry must also move expeditiously to establish a single point of contact for homeowners seeking assistance from their mortgage company. Too often, homeowners receive contradictory or conflicting information from their servicer and cannot gain access to someone knowledgeable about their case. Ensuring a single point of contact for homeowners moving through the modification process should be key in advancing national servicing standards.

We've been clear from the beginning: HAMP wasn't intended to prevent every foreclosure. It

We've been clear from the beginning: HAMP wasn't intended to prevent every foreclosure. It does not help with vacation homes, investors with vacant properties or jumbo loans. And it doesn't cover modifications that homeowners can afford themselves or for modifications that homeowners are unlikely to afford — even with government help.

But for Americans facing financial hardship, and where it makes economic sense to help prevent foreclosure, HAMP can make all the difference.

Gabe from Springfield, Ohio, is one of those Americans. In 2008, he was laid off from his IT job right after Christmas, and he struggled to keep up with his mortgage payments while searching for work. Gabe and his family got a HAMP modification. It lowered their monthly mortgage payment by more than $400 – and gave the family the breathing room they needed to keep their home. HAMP is, Gabe said, "the only way we survived my unemployment."

Americans like Gabe, represent the people who would be hurt the most if HAMP were terminated. They're the reason we're fighting so hard to ensure that this program remains in place.

Those homeowners are also the reason we're continuing to work hard to refute misinformation about HAMP, which those intent on terminating the program are circulating. Some have tried to portray this critical assistance to homeowners as a waste of money. But HAMP uses taxpayer funds prudently through a "pay-for-success" model. And funds cannot be used for any other purpose.

HAMP money is spent only after homeowners complete a trial period and demonstrate that they can make their modified mortgage payments on time. Eligibility standards help ensure that fewer people with permanent HAMP modifications have redefaulted than for traditional private-sector modifications.

There is no easy way to repair the deep damage caused by the housing crisis. It will take time and a sustained, comprehensive effort.

But what's clear is that terminating HAMP and denying critical assistance to struggling Americans isn't the answer. We'll continue to fight on behalf of homeowners to make sure that doesn't happen.

Timothy Massad serves as the acting assistant treasury secretary for financial stability.

Mrs. MALONEY. And I would like to say that at meetings with the HPD department in the city of New York, they are very grateful, as are the 35,000 families that were able to stay in their homes because of the HAMP program.

I would, with all respect, say that it is very easy to throw stones and criticize. It is harder to come up with a program that addressed this crisis, which a large part of it was the housing crisis. And for every person who stayed in their home, not only did it help that person, it helped their community, because vacant homes bring down the value of housing for their neighbors; it helped their communities, it helped their city, and it helped with the overall financial stability of our country.

Mark Zandi and other economists have testified that housing is roughly 25 percent of our economy. So if we do not stabilize housing and grow in housing, we are not going to stabilize out of this great recession.

Now, I am very concerned that the Republican majority in the past 3 weeks have eliminated four critical housing programs that helped people stay in their home, and I would say that it is very, very dishonest to criticize a program for not helping people that had no help to begin with, and they didn't get in the program because they did not meet the high criteria that the program had, that tax dollars would not be spent unless people had a job, had a credit record, and were believed to be able to meet that commitment going forward.

So I want to congratulate the Treasury Department and really the Obama administration for not just criticizing and saying we have a problem, but getting out there and doing something, like FDR. When FDR had a problem, he didn't just look at it, he started working on it. And, granted, not every program works, but come in with some ideas of how to make it better. But to come in and criticize a program when you have no ideas of your own, when you haven't come forward with a program, when you haven't done anything to help the people and I would say the overall economy.

So I want to congratulate you on the work that you have done. I support the HAMP program. I hope that President Obama has a lot of veto ink in his pen, and if the Republican bill gets to his desk, it is my hope that he will veto it.

And I respectfully ask the if they will have a hearing where we can bring in HPD directors from across the country, people on the front line that were working with our government to help people stay in their home. In the city that I represent, the officials that do this every day, the not-for-profits that are committed, and the banks that have voluntarily stepped up to the plate to help have said this program works.

So instead of just being critical, come up with ways to improve it if you think there is a problem. But to criticize because people didn't get into the program because the criteria was so high—and I agree with the proposal from Treasury to keep that criteria in a way that protects taxpayers' money.

Now, I would like to move on to the TARP workout. I really want to quote from an article that was written recently, October 20, 2010, in Bloomberg. It is one of our big papers and media experts there. They testified, and I would like your response to this, Mr.

Massad, that TARP investments have actually provided taxpayers with "higher returns than yields paid on 30-year Treasury bonds, enough money to fund the Securities and Exchange Commission for the next two decades." The article also states, "The government has earned $25.2 billion on its investment of $309 billion in banks and insurance companies, an 8.2 percent return over 2 years."

Now, that beat out U.S. Treasury's high yield savings accounts, money market funds, and certificates of deposit, am I correct?

Mr. MASSAD. Congressman, you are correct that we have had some good returns on the programs. I am not familiar with those exact numbers, but the bank program is making a profit and some of the other——

Mrs. MALONEY. Well, could I ask could you describe generally the ways in which Treasury is seeking to maximize taxpayers' investment under TARP and ensure that our country and taxpayers are made whole?

Mr. MASSAD. Certainly, Congresswoman. Let me first just say that, obviously, the purpose of TARP was to stabilize the system, not to make money. But it is terrific that this program will not cost the taxpayers very much, and we are looking to maximize the returns on the various programs. As I say, we have earned about, we estimate we will earn about $20 billion on the bank investments. AIG right now is at a profit. We will have some loss on the autos.

Let me just note one other thing, though, going back to HAMP, and I apologize to the chairman; I misquoted the numbers. In terms of those who were in trials and didn't make permanent mods, they were actually about half of what I said. The foreclosure completions are only 28,000 and the foreclosure starts at only 84,000.

Mr. MCHENRY. The gentlelady's time has expired and, with that, I gave the gentlelady 6 minutes and I will give the ranking member 6 minutes, since I went well over my time, out of fairness to all that are here. I am sorry, I will give the ranking member, I am sorry, Mr. Cummings, 6 minutes now.

Mr. CUMMINGS. Very well, Mr. Chairman. Thank you very much.

I do want to associate myself with every syllable that Mrs. Maloney just said. I think part of the frustration, Mr. Massad, and I think you are well aware of this, we want even more people to be helped because there are so many people suffering.

Mr. MASSAD. Absolutely.

Mr. CUMMINGS. And I guess the reason for the criteria was the dilemma that people didn't want a program—I mean Congress didn't want a program that standards would be so low that there would be a lot of people failing. Is that part of the reason?

Mr. MASSAD. Well, I think it is a few things. You know, we did have what we felt were very prudent eligibility criteria. We don't, for example, provide modifications for vacation homes, for vacant homes; we don't provide assistance for those people who can afford their mortgage without it; we don't provide assistance for those who need to move on to another situation. And we make sure that the modification economically makes sense.

And as a result of that, the pool of people that we currently estimate are eligible, as you probably know, is about 1.4 million today. That is a pool of families. We have reached a lot of those. We want to continue to reach more of them. But it is a very difficult problem. We have had a lot of people looking at whether there are other ways we can do this. Our authority to implement new programs, as you know, has expired. We did take funds and reallocate them to the States so that the States can come up, particularly those States that are hardest hit by these problems, so those States can innovate with some programs that in particular address the needs of the unemployed and the problem of falling house prices.

Mr. CUMMINGS. Now, early on much has been made with regard to the whole issue that it was projected by the President that more people would be helped by HAMP than was. Is there something that happened along the way that caused you all to look at this thing and say, wait a minute, maybe we cannot accomplish those numbers that we really wanted to accomplish? And, if so, what was that?

Mr. MASSAD. We recognized that, No. 1, the eligibility pool wasn't as big as we originally thought it might be; it was very hard to know when the program was launched. And, again, we were in a crisis; people had no sort of historical basis to say, well, you know, this is how you should do it. That was No. 1.

No. 2 was servicers were not equipped to deal with this crisis; their business model was set up to basically collect payments on performing loans, so it was very, very difficult to implement. We have tried to take a lot of actions to improve that. As we discussed earlier, we need more. We need national servicing standards. There is a lot of work going on a lot of fronts to address the servicer performance.

And No. 3 was it is hard to reach people sometimes. People don't necessarily want to talk on the phone when they get a call from their mortgage servicer; they don't even want to hear what it is about. It was hard to reach people.

Mr. CUMMINGS. And so going back to this issue of the trial modifications, so that we will have a clear picture, so you are saying—and this is a very important point—that a lot of the people who did not end up with permanent modifications were able to resolve their problems in other ways, is that right?

Mr. MASSAD. That is absolutely true, and it is important to remember that before we launched our program there were no, there were very, very few modifications getting done by the industry, and many of those that were being done increased people's payments. HAMP set standards that the industry then largely adopted in its proprietary programs, what we call the affordability standard in terms of the ratio of the payment to one's income.

And as a result of that, and as a result of other borrower protections we have put in place, HAMP's effect has also been very indirect in terms of helping a lot of people. There have been about two million modifications done outside of HAMP since we launched this program, and I think our standards helped cause that. We have put in, as you know, a number of protections that now the industry is following in terms of prohibitions on dual track, where someone who is in the process of being considered for a modification could otherwise be foreclosed upon; other types of appeal processes for people who are rejected. And we require the servicers to not only evaluate someone for HAMP; we require them to then look at other types of assistance, to make sure that person can't qualify for something else, before they are allowed to foreclose upon them.

Mr. CUMMINGS. Now, I don't know whether you have—I assume you do—have some type of access to information or maybe you are a part of these negotiations with the Attorney Generals. Are you a part of that?

Mr. MASSAD. I am not directly.

Mr. CUMMINGS. Not you, but do you have access?

Mr. MASSAD. I am aware of what is going on, yes.

Mr. CUMMINGS. And I am not trying to get into any confidentiality on the part of those negotiations, might HAMP be affected by anything that comes out that?

Mr. MASSAD. Well, it certainly will be. What is going on in that, and again I appreciate the question. As you know, I can't comment on the details of it because it is an enforcement matter, but clearly this is another example of the fact that this industry is broken. It didn't have the standard that we needed and it didn't have the ability to cope with this crisis, and we saw that through HAMP, we saw that through what they were doing on foreclosures, which was outside of HAMP. And I think what is emerging from this is clearly a push to get national servicing standards. And, yes, those will have an effect across the whole industry, and that is what we need.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

Mr. MCHENRY. I appreciate the ranking member's questions, especially the last question is of interest. So it is a push for national servicing standards.

Mr. MASSAD. Mr. Chairman, what I said was I think what we need, what is evident by what has been found as to foreclosures and what we found as to HAMP is that we do need national servicing standards.

Mr. MCHENRY. OK. Thank you.

Mr. MASSAD. As to what comes out of——

Mr. MCHENRY. Go right ahead, go ahead and finish your sentence.

Mr. MASSAD. As to what exactly would be in a settlement, I wasn't commenting on that.

Mr. MCHENRY. Oh, OK.

Mr. MASSAD. That would be determined by the various parties to the settlement.

Mr. MCHENRY. OK. Well, thank you for your testimony. Thank you for being here today.

At this time, I ask unanimous consent to submit for the record three written testimonies of what would have been a panel today, testimony by Joshua Rosner, testimony by the Independent Community Bankers, and, finally, testimony by Anthony B. Sanders. I ask unanimous consent they be submitted for the record. Without objection, so ordered.

[The information referred to follows:]

Testimony of Joshua Rosner before the Subcommittee on TARP, Financial Servicer and Bailouts of Public and Private Programs.

"Has Dodd-Frank Ended Too Big to Fail?" –

2154 Rayburn House Office Building

March 30, 2011

Almost three years have passed since the United States financial system shook, began to seize up, and threatened to bring the global economy crashing down. The seismic event followed a long period of neglect in bank supervision led by lobbyist-influenced legislators, "a chicken in every pot" administrations, and neutered bank examiners.

While the current cultural mythology suggests the underlying causes of the crisis were unobservable and unforeseeable, the reality is quite different. Structural changes in the mortgage finance system and the risks they posed were visible as early as 2001.[1] Even as late as 2007 warnings of the misapplications of ratings in securitized assets[2] such as collateralized debt obligations and the risks these errors posed to investors, to markets, and to the greater economy[3] were either unseen or ignored by regulators who believed financial innovation meant that risk was "less concentrated in the banking system"[4] and "made the economy less vulnerable to shocks that start in the financial system." Borrowers, these regulators argued, had "a greater variety of credit sources and (had become) less vulnerable to the disruption of any one credit channel."[5]

In the wake of the crisis, and before either the Congressional Oversight Panel or the Financial Crisis Inquiry Commission delivered their final reports[6] on the causes of the crisis, Congress passed the Dodd-Frank Act. The act claimed to end the era of "too-big-to-fail" institutions and sought to address the fundamental structural weaknesses and

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[1] Joshua Rosner, "Housing in the New Millennium: A Home Without Equity Is Just a Rental with Debt" (paper presented at the midyear meeting of the American Real Estate and Urban Economics Association National Association of Home Builders, Washington, DC, May 28–29, 2002). http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1162456
[2] Rosner and J. R. Mason, "Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions" (2007). http://www.hudson.org/index.cfm?fuseaction=hudson_upcoming_events&id=393
[3] Rosner, and Mason, "How Resilient Are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions?" (2007), http://www.hudson.org/files/publications/Mason_RosnerFeb15Event.pdf
[4] Timothy Geithner, "Liquidity Risk and the Global Economy" (May 15, 2007), http://www.ny.frb.org/newsevents/speeches/2007/gei070515.html (see: "The dramatic changes we've seen in the structure of financial markets over the past decade and more seem likely to have reduced this vulnerability. The larger global financial institutions are generally stronger in terms of capital relative to risk. Technology and innovation in financial instruments have made it easier for institutions to manage risk. Risk is less concentrated in the banking system, where moral hazard concerns and other classic market failures are more likely to be an issue, and spread more broadly across a greater diversity of institutions.")
[5] Donald L. Kohn, "Financial stability and policy issues" (May 16, 2007), http://www.federalreserve.gov/newsevents/speech/kohn20070516a.htm (see: "There are good reasons to think that these developments have made the financial system more resilient to shocks originating in the real economy and have made the economy less vulnerable to shocks that start in the financial system. Borrowers have a greater variety of credit sources and are less vulnerable to the disruption of any one credit channel; risk is dispersed more broadly to people who are most willing to hold and manage it. One can see the effects of these changes in the reduced incidence of financial crises in recent years.")
[6] "Congressional Oversight Panel Reports," accessed March 28, 2011, http://cop.senate.gov/reports/ , and "Financial Crisis Inquiry Commission Report," accessed March 28, 2011, http://www.fcic.gov/report.

conflicts within the financial system. To falsely declare an end to Too Big to Fail without actually accomplishing that end is more damaging to the credibility of U.S. markets than a failure to act at all. The historic understanding that our markets were the most free to fair competition, most well regulated and transparent, has been the underlying basis of our ability to attract foreign capital. It is this view that, in turn, had supported our markets as the deepest, broadest, and most liquid.

In fact, Dodd-Frank reinforces the market perception that a small and elite group of large firms are different from the rest. While the act sought to reduce the risks that too-big-to-fail (TBTF) institutions pose to the financial system and the broader global economy, it is unclear whether any such meaningful reduction has actually occurred.[7] Moreover, although not fully implemented, Dodd-Frank has not reduced the number of systemically risky firms or placed meaningful new limits on their size, interconnectedness, or leverage. In fact, since the crisis began the largest financial firms have become even larger. In 1995 the assets controlled by JPMorgan Chase, Bank of America, Citigroup, Wells Fargo, Goldman Sachs, and Morgan Stanley represented 17 percent of GDP; as of January 2011 these firms controlled assets equal to 64 percent of our nation's GDP. Today, the five largest banks, which controlled slightly more than 10 percent of deposits in the early 1990s, control over 45 percent.

During the panic of 2008, regulators approved mergers of massive firms that left the banking system far more concentrated. Rather than protecting society from the underlying problems inherent in a system comprised of a small number of highly correlated, leveraged and concentrated firms who, by size and undue economic advantage, have the ability to hold taxpayers hostage to their failings, today our legislators and the Obama White House appear complacent and uninterested in reviewing actions taken in crisis or considering whether those actions have enhanced or reduced longer-term stability.

It is of course understandable to want to "move on" from the crisis. But if we continue on our current path – and, allow the debts of certain companies to be viewed as implied sovereign obligations, the artificial economic advantages these firms receive will accelerate the demise of small and vibrant community banks, which successfully diversified the nation's risks during the crisis. Moreover, if we again find ourselves in crisis, there is a strong likelihood that, like Ireland, creditors will demand the U.S. government explicitly accept these banks' obligations as sovereign obligations, leaving taxpayers rather than creditors to once again shoulder the costs, as they have been forced to do with Fannie Mae and Freddie Mac.

In the years before the crisis, regulators and legislators confidently espoused now-disproven notions that the orderly resolution of Long Term Capital Management, the giant hedge fund, demonstrated that no firm should be considered "too big to fail." As a result, regulators were believed to have armed themselves with new analytical tools and

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[7] Neil Irwin, "Paulson to Urge New Fed Powers," *Washington Post*, June 19, 2008, accessed March 28, 2011, http://www.washingtonpost.com/wp-dyn/content/article/2008/06/18/AR2008061803225.html (see: "We must limit the perception that some institutions are either too big to fail or too interconnected to fail. . . . If we are to do that credibly, we must address the reality that some are.")

systems so that no financial firm would ever take risks that would imperil the institution. This absurdity of thought permeated even the most global bank policy initiative, the intended move from a Basel Capital Accord to a Basel II Capital Accord. Where Basel required banks to reserve for "expected losses," Basel II supported the premise that rational actors reserve for expected losses and should only be required to reserve for "unexpected losses."

Among the paradoxes in Dodd-Frank is this one: Key elements of the Act that seek to reduce risks to the system – branding institutions as "systemically important", increasing their exposure to risk assets, and implementation of a subjective, and untested resolution regime – actually increase risk to the system and even accelerate the moment of our next crisis. Furthermore, the broad discretion Dodd-Frank confers to regulators, combined with the fact that regulators so miserably failed us in the most recent crisis as well as the history of legislative and regulatory capture by the industry[8], only serves to increase uncertainty and promise a future relationship between the government and financial system that is not only corporatist, but promotes cronyism.

IDENTIFYING "SYSTEMIC"—DANGEROUS TO DO

Dodd-Frank requires that the Financial Stability Oversight Council identify and designate certain financial firms as "systemically important". These firms automatically include all bank entities with over $50 billion in assets and such other firms that the FSOC determines to be systemically significant. Once branded as "systemically important, these firms will be subject to "enhanced supervision" by the Federal Reserve and, in case of failure, could be subject to a special resolution regime under Title II of Dodd-Frank.

"Systemically important," firms will also be required to submit a resolution plan that provides regulators with a road map to their resolution under a Chapter 11 bankruptcy process. This is particularly ironic, given that they are being asked to craft their own resolution using a regime that has been determined to be ineffective for them and to which they will not be subject unless, on the "eve of bankruptcy," the Treasury Secretary, Federal Reserve, and FDIC fail to agree to place them in a Title II receivership regime.[9] It also demonstrates that the Title II Orderly Liquidation Authority is wholly unnecessary, since regulators will only allow those firms that have an adequate plan for resolution under Chapter 11 bankruptcy to maintain its existing risk profile.

Far more troubling, though, is that this part of Dodd-Frank implicitly expands the taxpayer safety net for large institutions and does so explicitly for systemically important financial market utilities, "the implicit support or guarantee provided by government to creditors of banks that (are) seen as 'too important to fail.'" In fact, like the government-

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[8] Gretchen Morgenson and Rosner, *Reckless Endangerment: How Outsized Ambition, Greed, and Corruption Led to Economic Armageddon* (Times Books, May 2011), 352

[9] Davis Polk, "Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010," accessed March 28, 2011 (see: "Subject to the exceptions described below for broker-dealers or insurance companies, a financial company will be designated as a covered financial company, and the FDIC will be appointed as its receiver, if at any time, including on the eve of bankruptcy, the Treasury Secretary makes the following determinations, upon the recommendation of 2/3 of the Federal Reserve Board and 2/3 of the FDIC Board, and in consultation with the President.")

sponsored entities before them "such banks could raise funding more cheaply and expand faster than other institutions."[10] Just as there was no explicit support and a strong denial by government officials of the implicit government guarantee backing the GSEs,[11] these banks and their creditors remain of the view "if they were sufficiently important to the economy or the rest of the financial system, and things went wrong, the government would always stand behind them."[12]

While Dodd-Frank's identification process is intended to reduce the moral hazard, it is more likely that "when the government singles out particular institutions or markets as being especially critical to the stability of the system, moral hazard concerns may well follow. A perception that some institutions are 'too big to fail' may create incentives for excessive risk-taking on the part of those institutions or their creditors. For that reason, part of an effective risk-focused approach is the promotion of market discipline as the first line of defense whenever possible."[13]

Given the massive failures of the Federal Reserve, which had almost six months' notice after the collapse of Bear Stearns to plan for the possibility of failure at Lehman Brothers, Merrill Lynch, AIG, Wachovia, GMAC, Citigroup, and Indymac, it is unclear what has led the authors of the Dodd-Frank Act to believe that enhanced supervision by the Federal Reserve would prevent similar outcomes in the future. Furthermore, given the lack of unanimity among the members of the FSOCs to designate firms, there is ample reason to question the Fed's resolve to direct firms that fail to submit an adequate resolution road map to begin to sell or disgorge assets or businesses as required by Dodd-Frank. Given the conflicting roles of the Federal Reserve, as monetary authority and prudential regulator, and its monetary policy mandates of price stability and full employment, it seems unreasonable to expect that they could or would embark on such a path.

It is especially problematic that Dodd-Frank allows for ambiguity when defining institutional failure. The manner in which one is allowed to fail determines and defines its "going concern" value when alive. Every firm must be able to fail under the same regime—a different resolution regime for a select group of firms will create incentives for creditors of those firms to treat them differently in life than the "less important" firms.

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[10] Mervyn King, "Speech by MERVYN KING GOVERNOR OF THE BANK OF ENGLAND to Scottish business organisations, Edinburgh" (October 20, 2009), http://www.scribd.com/doc/21406275/Mervyn-King-Speech-Break-Up-Banks .

[11] Barney Frank, "Hearing Before the Committee on Financial Services, US House of Representatives, 108th Congress, 1st Session" (September 10, 2003), http://financialservices.house.gov/media/pdf/108-51.pdf (see: "I support the role that Fannie Mae and Freddie Mac play in housing, but investors should not look to me or the Federal Government for a nickel. If investors take some comfort and want to lend them a little money at lower interest rates, because they like their affiliations, then housing will benefit. But there is no guarantee, there is no explicit guarantee, there is no implicit guarantee, there is no wink-and-nod guarantee. Invest, and you are on your own.")

[12] Ibid.

[13] Ben Bernanke, "Regulation and Financial Innovation" (May 15, 2007), http://www.federalreserve.gov/newsevents/speech/bernanke20070515a.htm (see: "Some care is needed in applying a risk-focused approach to regulation, however. In particular, when the government singles out particular institutions or markets as being especially critical to the stability of the system, moral hazard concerns may well follow. A perception that some institutions are 'too big to fail' may create incentives for excessive risk-taking on the part of those institutions or their creditors. For that reason, part of an effective risk-focused approach is the promotion of market discipline as the first line of defense whenever possible.")

It was this ambiguity that created the incentives for Lehman to make itself less able to fail and thus less easily resolved.

WHAT HAVE WE DONE? —TITLE II LIQUIDATION RATHER THAN BANKRUPTCY!

It is often argued that the bankruptcy of Lehman precipitated the broader contagion in financial markets. While this is a convenient narrative, it is neither accurate nor is it justification for the resolution regime created by Title II of the Dodd-Frank Act.

In reality, it was neither the failure of Lehman Brothers nor any supposed mortal deficiency of the Bankruptcy Code that necessitated bailouts. Rather, I would argue, it was a panicked reaction of regulators who rushed to pay out the creditors of AIG, frightened markets, and exacerbated the crisis. After all, within days of its failure, much of Lehman was sold to Barclays and a relatively orderly bankruptcy process ensued. .

Are there problems with the Bankruptcy Code that need to be addressed? Yes, but these problems were not unknown prior to the crisis. In April 1999, in the wake of the failure of Long Term Capital Management, the President's Working Group on Financial Markets recognized that the derivatives termination rules in the Bankruptcy Code work well to facilitate the continued functioning of derivatives markets when a financial firm fails, but that in very rare instances, where the failing firm has concentrated a great deal of risk, the rules may not be adequate in mitigating market volatility. The Working Group stressed the need for new bankruptcy rules but it did not, however, recommend an entirely new and overreaching resolution regime.[14]

The failure of regulators and legislators to address these identified problems for almost a decade make the actions of regulators in 2008 seem even more pathetic. After all, their

[14] Robert E. Rubin, Alan Greenspan, Arthur Levitt, Brooksley Born, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," accessed March 28, 2011, http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf (see: 26 "The LTCM episode raises some issues involving the U.S. Bankruptcy Code. The first involves clarifying the ability of certain counterparties to exercise their rights with respect to closeout, netting, and liquidation of underlying collateral in the event of the filing of a bankruptcy petition without regard to the Bankruptcy Code's automatic stay. These provisions, which the President's Working Group on Financial Markets urged Congress last year to expand and improve, are generally recognized to be important to market stability. They serve to reduce the likelihood that the procedure for resolving a single insolvency will trigger other insolvencies due to the creditors' inability to control their market risk. In other words, this protects the market from the systemic problem of "domino failures." Nevertheless, in certain circumstances, a simultaneous rush by the counterparties of a defaulting market participant to replace their contracts could put pressure on market prices. To the extent that the default was due to fluctuations in market prices in these contracts, this pressure might tend to exacerbate those fluctuations, at least in the near term. This problem could be significant where the defaulting debtor had large positions relative to the size of the market. The possibility of a debtor defaulting during volatile markets where the debtor had large positions relative to the size of certain markets was the specter created by the potential default of the LTCM Fund. In the highly volatile markets of September 1998, the failure of the LTCM Fund would have left a number of creditors with open market positions subject to extreme volatility. Termination of those contracts would have required counterparties to replace contracts that they held with the LTCM Fund in the relatively near term. However, had termination not been available to the LTCM Fund's counterparties in the bankruptcy process, the uncertainty as to whether these contracts would be performed would have created great uncertainty and disruptions in these same markets, coupled with substantial uncontrollable market risk to the counterparties. The inability to exercise closeout netting rights could well have resulted in an even worse market situation if the LTCM Fund had filed for bankruptcy than the exercise of such rights in this situation.")

predecessors had recognized the nuances of market volatility nearly ten years earlier. In this light, it is unsurprising that regulators responded to their ongoing uncertainty by panicking and indiscriminately handing out massive bailouts.

Analyzing and fixing these sources of volatility and potential market instability is very important. The Bankruptcy Code remains the answer, and the first choice even in Dodd-Frank, but when bankruptcy is deemed unlikely to work, the Fed, Treasury, and FDIC would be forced to consider their "Orderly Liquidation Authority" (OLA) under Title II. If, on the eve of bankruptcy, the Treasury, Fed, and FDIC fail to agree to place a firm in Title II resolution regime ("turning the three keys"), this would result in that firm being nonetheless subject to the bankruptcy process. As a result, it is critical to amend the Bankruptcy Code in a manner that would provide the necessary tools to handle such an event. Logic requires one to ask: "If the bankruptcy process remains the fall-back outcome, wouldn't it be necessary to fix that process?" If it were understood that fixing that process is necessary, why would Congress not merely accept that such a fix would mitigate any necessity of a separate, Title II regime for these firms? The answer appears clear. If regulators fail to turn the "three keys" and the Bankruptcy Code is understood to be inadequate to manage an orderly resolution of the ailing firm, then the Fed and Treasury would likely go back to Congress, as they did on the eve of the crisis, and demand an emergency allocation of governmental funds to support the financial system.

Importantly, in addressing weaknesses in the Bankruptcy Code, Congress will have to analyze how to improve the derivatives termination rules in a way that is responsive to potential volatility and market instability. For instance, Congress should consider new mechanisms that facilitate a transfer/sale of a failing firm's derivatives book before a counterparty termination kicks in. Before making such changes it is important to remember that the landscape of the derivatives world is changing significantly due to the new derivatives requirements in Dodd-Frank. Clearing requirements will mean that a vast majority of market exposure will be concentrated in clearing-houses and that the bi-lateral model is no longer the rule. As long as these clearinghouses can withstand the shocks, then these problems that regulators have been concerned about for a decade will not and cannot be systemic events.

Instead of making surgical fixes to the Bankruptcy Code, Congress and regulators created the poorly designed OLA. At its heart it is a bailout regime. Shortly after the seizure of a large firm under Orderly Liquidation, the government may disparately treat similarly situated creditors of the financial institution that are deemed "systemically important". The Fed may also deploy a broad-based lending program to facilitate the cash needs of other market players. (Supporters of Dodd-Frank like to say that it is not a "taxpayer bailout" because the government will recoup these initial bailout expenditures by taxing unrelated private financial institutions in the years following the bailout.) It is, nonetheless, a government-run giveaway where regulators, mostly unchecked by judicial review, get to decide who receives liquidity that would otherwise not be available.

Another fundamental flaw of OLA is that there are now two very different regimes under which a large financial firm can fail – the Bankruptcy process and the Dodd-Frank process. This is very unsettling to creditors and other stakeholders of the large firms because without adequate foresight of which resolution process the firm may enter, it is impossible for a creditor to adequately calculate one's downside. (Even more troubling is the fact that stakeholders will have no idea which process will be employed until the firm is already seized by the regulators or has entered Chapter 11.) Regulators will argue that there is some level of certainty due to the fact that in either a chapter 11 or a Dodd-Frank Orderly Liquidation, a creditor must receive at least as much as the creditor would receive in a chapter 7 bankruptcy. However, this only demonstrates the regulators ignorance of how markets for distressed claims function, since there are multiple layers of analysis used by claims holders to determine the *likely* return on a claim not the "floor" return on a claim. In reality, Dodd-Frank and the Bankruptcy Code are two very different processes with very different outcomes for creditors. The value of a firm in its "going concern" state is dependent on the resolution process employed when it fails. All non-financial firms and most financial institutions use the Bankruptcy Code; commercial banks use the FDIA; broker-dealers use SIPA. There may be different systems for different types of firms, but there are not, and there should not be, multiple processes for the same firm.

In sum, the absolute worst thing that regulators can do is exactly what they're doing now: signaling to the public and the markets, ex ante, which firms will cause systemic instability and then providing a U.S. Treasury–funded bailout scheme through the Orderly Liquidation Authority. Where investors have great certainty and clarity about the workings of the U.S. bankruptcy process, the Orderly Liquidation Authority's dangerous subjectivity, increased opacity, preference for short-term creditors, and ambiguity in how it will treat similarly situated creditors will only increase the uncertainty among creditors of a failing institution and cause necessary risk capital to pause at precisely the time their capital is most needed.

WHAT SHOULD BE DONE? —BRING IN THE BOMB SQUAD

Beyond highlighted consideration of whether Title II or the Bankruptcy Code is a more efficient tool to manage the resolution of too-big-to-fail firms, there is ample reason to consider that neither would be effective in addressing the failures of our largest and most interconnected firms. Many of these firms have international businesses, foreign depositors, and foreign creditors and are subject to various legal regimes in different international jurisdictions. Without harmonization of international approaches to resolution there is little reason to believe that resolution by U.S. regulators or bankruptcy courts would be feasible.[15] It is as difficult to imagine a scenario in which U.S. regulators

[15] Jim Hamilton, "SEC and CFTC Chairs Participate in FDIC Roundtable on Dodd-Frank Resolution Authority Title," *Jim Hamilton's World of Securities Regulation*, September 6, 2010, http://jimhamiltonblog.blogspot.com/2010/09/sec-and-cftc-chairs-participate-in-fdic.html (see: "There was also a consensus among industry participants that the resolution authority must involve international regulators in the process because global firms may have to prepare different resolution plans. It is important to coordinate internationally on a multi-jurisdictional basis since preparing multiple living wills for different jurisdictions is fundamentally impractical. The FDIC Chair said that the reality is that, in the short term, there will be ring fencing, but in the long term regulators will work together to have globally consistent resolution regimes. There was a consensus among industry participants that firms will structure some businesses differently because of ring-fencing.")

would haircut the depositors in a foreign bank entity of a U.S. firm as it is to believe that the United States would have haircut significant foreign creditors of Fannie Mae or Freddie Mac.

Dodd-Frank misses a key reality. Rather than accepting a world in which instability is identified and left unchecked, prudential regulators should be encouraged to act on the notion that you don't employ a bomb squad to sit around and wait for a bomb to explode; you engage them to dismantle it as soon as they find one.

While bankers and politicians are fast to warn that breaking up the big banks would reduce the competiveness of the U.S. banking system, this argument is fallacious on several counts. "Those who argue against a more proactive reduction in risk and size of TBTF institutions will, as always, revert to an argument that strikes a natural chord in every American's heart: 'Doing so would create an unleveled international playing field for our institutions relative to their international competitors.' Level playing fields are a worthy goal, but this is not a relevant argument. Instead, this tired bromide must be resoundingly dismissed on several counts."[16]

Historically, large commercial enterprise was funded not by large banks but rather by syndicates of smaller banks and capital market participants. Resurrecting such a reliance on smaller firms would diminish the risk that if they failed, like Ireland's or Iceland's banks, our largest banks would imperil the solvency of the U.S. Treasury. Even Alan Greenspan, a former believer in the deregulation and consolidation of banking, had acknowledged, "If they're too big to fail they are too big," and highlighted the need to

[16] Rosner, "Congress and TBTF: Bring in the Bomb Squad," *The Huffington Post*, October 29, 2009, http://www.huffingtonpost.com/joshua-rosner/congress-and-tbtf-bring-i_b_338325.html (see: "*Those countries with the largest banks as a percentage of GDP [Iceland, Ireland, Switzerland] demonstrated that a concentration of banking power can cause significant sovereign risk and tilt global economic playing fields away from that country.
* The likely breakups of ING, Lloyds, and KBC suggest that it is we who seek to support an unlevel playing field where we subsidize our TBTF banks while other nations recognize the policy failures of moral hazard. If we continue down this path, we will likely be at risk of violating international fair trade regimes.
* When the "unlevel playing field" argument is cited, keep in mind this reasoning supports the disadvantaging of 8000+ community banks relative to our largest banks, all in the name of protecting big banks from government-subsidized international competition.
* There is no longer any evidence that, beyond a cost of capital advantage that comes with implied government support, there are sustainable and tangible economies of scale arising from being the largest. The financial supermarket concept has been proven a failure. The only ones who benefit are the high-level executives.
* We must demand that our legislators no longer allow unelected officials at the independent Federal Reserve to sign international accords created by the TBTF banks through supra-national bodies like the Basel Committee.
* Are we to believe that if we did not have such large and globally dominant firms, US borrowers might be paying more that the 29% interest that several of the TBTF firms are now charging on their card accounts? Perhaps we should think about what advantage our population has gained as a result of our financial institutions being such a large part of our economy or being globally dominant.
* Since when did we accept a national strategy of following rather than leading? When we do what is right, others follow. As example, consider the bank secrecy havens—they made money for a bit. Now, even the Swiss and the Cayman authorities are coming around to our view.
* We are already at a disadvantage given that the largest foreign banks operate in the US without any tier one capital requirement and yet most large, foreign banks have not built a bricks and mortar presence here. Nobody screams about their undercapitalization nor has that undercapitalization caused deposits to migrate to foreign banks.")

address the problem: "If you don't neutralize that, you're going to get a moribund group of obsolescent institutions which will be a big drain on the savings of the society."[17]

While political ideology supporting supposedly "free market" capitalism creates a natural antipathy to proactively breaking up private firms, we must recognize that, like the trusts of old, these firms have grown not by economic outperformance but by governmentally conferred benefits. This is the basis of our antitrust laws and the success of such proactive action has demonstrable benefits.[18]

Even in the absence of a consensus to break up large firms, there are other solutions that would more properly align the incentives of the management and boards of directors of these firms with the interests of broader society. Rather than demanding the breakup of specific firms, Congress could pass legislation that would meaningfully reduce the risk of taxpayer support. The legislation should seek to cause those senior bank officials to act in a manner more consistent with the traditional partnership model of private investment banks. As has been said, "risk is the price you never thought you'd have to pay,"[19] so the executives' acknowledgment of the real and personal costs of excessive risk taking would be a significant step forward in self-regulation.

Where senior executives have real economic and reputational risk exposures, they are more focused on proper risk management. I would suggest that if an institution was found to need extraordinary government support, in the form of government asset purchases, debt guarantees, or borrowings extending beyond sixty days at the Fed window, the primary regulator should take "prompt supervisory action." If the entity does not replace government support in a timely manner, the board and senior executives of the firm should be replaced at the earliest convenience of the regulator and then barred from employment as consultant, director, or employee of a regulated entity for a period of five years.

Just as limit on compensation for executives who received TARP funds created incentives for those institutions to repay TARP quickly, such a law or regulation would create incentives for officers and directors of a firm to proactively increase their risk management environment to a level at which they would never require any government support or cause them to consider selling off businesses and assets and shrinking the company to a size that could be efficiently and effectively managed. How could any regulator, policymaker, executive, or free marketeer argue against such a policy?

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[17] Michael McKee and Scott Lanman, "Greenspan Says U.S. Should Consider Breaking Up Large Banks," *Bloomberg*, October 15, 2009, accessed March 28, 2011, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aJ8HPmNUfchg .

[18] Ibid. (see: "In 1911 we broke up Standard Oil—so what happened? The individual parts became more valuable than the whole. Maybe that's what we need to do.")

[19] Alex J. Pollock, "One Banker's Real Definition of Risk," *American Enterprise Institute for Public Policy Research*, December 22, 2007, http://www.aei.org/article/27296 .

THE FALSE COMFORT OF RISK RETENTION

As I have written previously,[20] recognizing failures in the process of securitization, legislators included provisions in Dodd-Frank intended to prevent loan originators and securitization issuers from selling loans to investors without regard to the quality of the loans. They reason that if issuers retain some ongoing responsibility and financial liability for the underlying loans they sell, then they will have a greater incentive to make better loans or at least make sure that the cost of those loans to borrowers will be priced relative to the risks market participants identify as inherent in the loans. To that end, Dodd-Frank generally requires financial regulators to ensure that loan originators and/or securitization issuers retain at least 5 percent of the structure of a securitization.

While the rule creates a standard and expectation of retention, it recognizes differences among the character of residential mortgages, auto loans, commercial loans, commercial mortgages, and other asset classes, as regulators deem appropriate. In recognition of these differences, Dodd-Frank permits, at origination, adequately capitalized third-party purchasers of the first-loss position to substitute for the retention requirements of the securitizer.

Does the risk retention ensure better underwriting, better lending, or safer markets? On the surface the logic is compelling. If a lender or securitizer knows he will have to drink the poison in the chalice he offers to others, then of course he would be unlikely to offer it. If, however, because of his belief in his own systemic importance or financial strength, the chalice bearer believes that he has an enhanced immunity to poison or that he will be first to receive an antidote, then perhaps he will ignore the disincentive to poison others.

More likely, as we saw in the past crisis, the same firms that poisoned their investing customers failed to recognize the power or dilution of the poison. After all, the banks that were in most dire need for direct government support were dying precisely because they had ingested large quantities of the toxic goods they had sold to others. Even with a relatively small 5 percent retention of each structure, we have seen that the different structures of similar underlying collateral were highly correlated. Thus, if securitization returns and grows, this part of the Dodd-Frank Act will have the effect of creating a future systemic risk and aid in the creation of another class of too-big-to-fail issuers.

Instead of creating further concentrations of possibly mispriced risks at the largest issuers, as Dodd-Frank's risk retention rule does, it would make more sense to require that private issuers of securitizations finalize collateral pools prior to deals being sold. In the private-label mortgage securitization market, prior to the crisis, deals typically came to market before all of the underlying collateral had been identified or transferred to the pool. As a result investors had no way to analyze the specific collateral they were buying. It was this feature that supported mispricing of assets and allowed issuers to arbitrage deals by manufacturing the weighted average characteristics of loan pools. Just as regulation requires that an initial prospectus, with disclosure of all material information, be offered to prospective investors for a period before an equity offering could be sold,

[20] Rosner, "Securitization: Will the 'Wild West' become a 'Ghost Town' or a 'Thriving Metropolis'?" (paper presented at the Roosevelt Institute's Will It Work? How Will We Know? Conference, New York, NY, October 4, 2010).

the same should hold true in the private-label securitization market. Issuers should be required to provide investors a standardized data-warehouse of loan-level information. This would serve two purposes: It would require the issuer to retain the risk for a period before the deal came to market and it would allow investors to inspect the loan-level collateral information and therefore appropriately risk-price the offering.

OTHER ISSUES TO CONSIDER

The Volcker Rule

Legislators included a rule, the Volcker Rule, to reduce conflicts and enhance safety and soundness by placing limits on the ability of large and complex banking firms to act both in their utility role as aggregators and allocators of capital and in a self-interested role of proprietary trading. After all, nobody would rationally support the notion of proprietary risk taking being covered by the safety net of implicit or explicit government support. This rule, in intent, is one step toward returning banks to their historic and appropriate narrower banking activities. Unfortunately, given the market-making roles of banks and investment banks, it is difficult to easily define which activities are consistent with their utility mission as liquidity providers to customers. Legislators left the determination and implementation of activities that would be considered proprietary to regulators. Unfortunately, there is no bright line that can be drawn to separate these activities and, as witnessed by the positive market action in the stock prices of these firms upon the release of the final rule,[21] it appears that significant loopholes in the implementation will continue to allow these firms to engage in some significant level of proprietary trading activity. Still, even if the rule were sufficiently strong in implementation and successfully eliminated the proprietary activities of these firms, the firms would remain too large and interconnected to be seen as manageable in failure.

Office of Financial Research—A New Moral Hazard

The Dodd-Frank Act also established, within the Department of Treasury, a new Office of Financial Research (OFR). A key goal of the office is to "improve the quality of financial data and provide analytic support to the FSOC and its members." The goal is to create a series of timely databases, available to the Financial Stability Oversight Council members and market participants, that would allow for more accurate regulatory and market assessments of systemic and firm risks. As stated in the OFR's "Frequently Asked Question" paper[22]:

> The problem of monitoring systemic risk is closely related to the risk management challenge that individual firms face.
> To monitor risk in the financial system, positions in thousands of diverse financial products, involving thousands of individual financial firms, have to be aggregated across the entire financial system in ways that are

[21] "Board of Governors of the Federal Reserve Press Release," last modified February 9, 2011, http://www.federalreserve.gov/newsevents/press/bcreg/20110209a.htm .
[22] "Office of Financial Research Created Under the Dodd-Frank Wall Street Reform and Consumer Protection Act: Frequently Asked Questions," http://www.treasury.gov/initiatives/Documents/OFR_FAQ-11242010-FINAL.PDF .

meaningful.
Standardizing the way financial transactions are reported, and the consistent use of robust reference data on the key characteristics of individual financial instruments and counterparties, can greatly facilitate this process for regulators and individual firms alike.

The OFR will, in consultation with relevant stakeholders, develop standards for financial data and publish reference databases of financial entities and instruments that will be made available to the public.
As mandated by the Act, data security and confidentiality will be a top priority for all of the OFR's data activities, including the publication of the reference databases. These reference databaseswill also likely be used by market participants.

The industry-wide standards for financial data and reference databases will help the FSOC to monitor systemic risk and improve the efficiency and efficacy of risk management, reporting and other business functions at individual financial institutions.
These actions will enhance both supervision and market discipline by giving both supervisors and market participants better visibility into the risks that individual financial firms take.

One of the key lessons that should have been learned from the crisis appears to have been left unconsidered: There is a great difference between data and information, and the value of data is only as good as the user's ability to apply the data in a valid and informative manner. As Federal Reserve Chairman Bernanke has previously stated, it is unlikely that these databases and the information gathered will result in practically useful information. In fact, the collection of such information may increase the perception of a government support for the underlying products or institutions:

> Given the complexity of trading strategies and the rapidity with which positions change, creating a database that would be sufficiently timely and detailed to be of practical use to hedge funds' creditors and investors or to regulators would be extremely difficult. Collecting such information also risks moral hazard, if some traders conclude that, in gathering the data, the regulators have somehow reduced financial risk. The principle of consistency on which I am focusing today raises an additional objection to this proposal, which is that it would make little sense to collect data on hedge funds' positions without gathering the same information for other groups of market participants that use similar strategies and take similar risks.[23]

[23] Ben Bernanke, "Regulation and Financial Innovation" (May 15, 2007), http://www.federalreserve.gov/newsevents/speech/bernanke20070515a.htm.

INDEPENDENT COMMUNITY
BANKERS *of* AMERICA

Statement for the Record

By the

Independent Community Bankers of America

Before the

United States Congress
Committee on Oversight and Government Reform
Subcommittee on TARP, Financial Services & Bailouts of Public and Private Programs

Hearing on

"Has Dodd-Frank Ended Too Big To Fail?"

March 30, 2011
Washington, D.C.

On behalf of its nearly 5,000 member banks, ICBA is pleased to submit this statement for the record for this hearing on "Has Dodd-Frank Ended Too Big To Fail?"

Thank you for convening this hearing on the problem of too-big-to-fail financial institutions. This issue has long been among ICBA's top policy priorities. In normal economic times as well as in crises, community banks and their customers feel the direct impact of a marketplace warped by the presence of too-big-to-fail institutions.

Before the financial crisis of 2008, megabanks and other large financial firms could argue, however implausibly, that they didn't enjoy any implicit government guarantee. If there were any doubt that too-big-to-fail firms would be bailed out in a crisis, that doubt is now resolved, at enormous cost to the taxpayer, consumers and competing institutions. Too-big-to-fail was more than a market perception; it was a reality and remains a reality. The financial crisis of 2008 has exacerbated the problem of too-big-to-fail by leaving industry more concentrated than ever and by confirming that moral hazard existed in the market place. Provisions of the Dodd-Frank law may alleviate many of these concerns, but hazards remain.

We would like to use this testimony to describe the impact of too-big-to-fail on community banks and the economy at large, to describe and assess the provisions of Dodd-Frank meant to address too-big-to-fail, and to discuss where we go from here. We will preview one of our conclusions here by saying that while ICBA believes that the Dodd-Frank Act provides regulators with potentially meaningful tools for ending too-big-to-fail, it is too soon to say they will effectively do so. The ultimate success of the Act, with regard to too-big-to-fail, will depend on the implementing rules and the enforcement of those rules in the coming months and years. Powerful interest groups will lobby doggedly to undermine both.

Impact of too-big-to-fail on community banks and their customers

Community banks are keenly aware of economic distortions caused by concentration of risk in the banking sector and the rise of mega-banks, even in normal economic times. ICBA has warned about too-big-to-fail and moral hazard for years, long before these terms entered common usage, because community banks and their customers have felt the direct impact of these phenomena – big banks enjoy lower funding costs and a dominant market share that significantly impacts the financial system and the broader economy. ICBA strongly believes community banks will thrive and best serve their communities and customers in a free market. However, a market dominated by too-big-to-fail financial firms, firms whose failure would have such devastating consequences for the economy that the market perceives them as implicitly guaranteed by the government, is not a true free market. It is a market distorted by the government's implicit guarantee of a favored few. The policies advocated by ICBA will allow financial services to flourish in a free market.

Today, the four largest banking companies control more than 40 percent of the nation's deposits and more than 50 percent of the assets held by U.S. banks. The largest banks have grown larger since the financial crisis. The 10 largest hold 77 percent of all U.S.

bank assets compared with 55 percent of total assets in 2002, according to a recent Bloomberg study. We do not believe it is in the public interest to have ten institutions controlling a significant majority of the assets of the banking industry. A more diverse financial system would reduce risk, and promote competition, innovation, and the availability of credit to consumers of various means and businesses of all sizes.

As a result of the financial crisis, our nation went through an agonizing series of forced buy-outs or mergers of some of the nation's largest banking and investment houses that cost American taxpayers hundreds of billions of dollars. Some mega-institutions – too big to fail and also too big to be sold to another firm -- were directly propped up by the government. One large institution, Lehman Brothers, was allowed to go bankrupt, with disastrous consequences that only confirmed the policy of too-big-to-fail. The doctrine of too-big – or too-interconnected – to-fail finally came home to roost, to the detriment of the American taxpayer and our economy. Our nation cannot afford to go through that again. Systemic risk institutions that are too big or inter-connected to manage, regulate or fail should either be broken up or required to divest sufficient assets so that they no longer pose a systemic risk.

In a speech made as the country was emerging from the crisis, Federal Reserve Chairman Ben S. Bernanke outlined the risks of the too-big-to-fail system:

> The belief of market participants that a particular firm is considered too big to fail has many undesirable effects. For instance, it reduces market discipline and encourages excessive risk-taking by the firm. It also provides an artificial incentive for firms to grow, in order to be perceived as too big to fail. And it creates an unlevel playing field with smaller firms, which may not be regarded as having implicit government support. Moreover, government rescues of too-big-to-fail firms can be costly to taxpayers, as we have seen recently. Indeed, in the present crisis, the too-big-to-fail issue has emerged as an enormous problem.

Unfortunately, government interventions necessitated by the too-big-to-fail policy have exacerbated rather than abated the long-term problems in our financial structure. Through Federal Reserve and Treasury orchestrated mergers, acquisitions and closures, the big have become bigger. A recent Bloomberg Government study concluded that the number of too-big-to-fail banks will increase by 40 percent over the next 15 years.

Community banks have struggled for years with the competitive impact of too-big-to-fail. The financial and economic crisis of 2008 – another consequence of too-big-to-fail – compounded the injustice of a failed policy. The community banking industry has remained well capitalized and, taking a conservative, commonsense approach to lending, had fewer problem assets than other segments of the financial services industry. Still, community banks were not unaffected by the financial collapse. The general decline in the economy has caused many consumers to tighten their belts and reduced the demand for credit. Commercial real estate markets in some areas are stressed. Many bank examiners are overreacting, sending a signal that contradicts recommendations from Washington that banks maintain and increase lending.

Government efforts to stabilize the financial system, though necessary to stave off a full scale financial collapse and even deeper recession, were deeply unfair to community banks. The government bailed out too-big-to-fail institutions, while the FDIC summarily closed too-small-to-save institutions, victims of a crisis created on Wall Street. Community bankers were deeply angered by the results of too-big-to fail.

This is why ICBA supports measures to end too-big-to-fail by preventing firms from getting too big, offsetting the advantages of being too big, more diligent monitoring for systemic risk, subjecting large, interconnected firms to enhanced capital and prudential standards to minimize the risk they pose to the system, downsizing them, and creating a resolution authority for large firms so that the government is never again forced to choose between propping up a failing firm and allowing it to fail and wreak havoc on the financial system.

Dodd-Frank Act Too-Big-To-Fail Provisions

ICBA generally supports the too-big-to-fail measures that were part of the Dodd-Frank Act. However, the question of whether the Dodd-Frank Act will succeed in ending the market perception that large, interconnected firms are too-big-to-fail will largely depend on the implementing rules and how diligently they are enforced in the coming months and years.

Financial Stability Oversight Council

ICBA supported the creation of FSOC under the Dodd-Frank Act whose duties include identifying risks to the financial stability of the U.S. that could arise from the failure of a large, interconnected banking institution or nonbank financial institution and responding to emerging threats to the stability of the U.S. financial system. FSOC is in the process of writing rules and making recommendations to the Federal Reserve as required under Dodd-Frank.

Concentration limits

The Dodd-Frank Act establishes a financial sector limit that prohibits a financial company from merging or consolidating with or otherwise acquiring control of another company if the resulting company's consolidated liabilities would exceed 10 percent of the aggregate consolidated liabilities of all financial companies. This limit would be in addition to the 10 percent nationwide deposit cap imposed by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the "Riegle-Neal Act")[1]. There's an exception for the acquisition of failing banks where the benefit to the Deposit Insurance Fund of preventing a bank failure outweighs the risk to the DIF of greater concentration of financial liabilities that would result from the acquisition.

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[1] The Riegle-Neal deposit cap prohibits any bank holding company from making an interstate acquisition of a bank if it would result in the acquirer controlling 10 percent or more of the total insured deposits in the United States.

ICBA supports both the statutory provision and the FSOC proposed rule. While we have long advocated for a lower deposit limit and continue to do so, we support this approach which has the benefit of being more comprehensive because it takes into account non-depository liabilities and off balance sheet exposures. The deposit cap provides incentives for banking firms near, at, or over the cap to shift liabilities from deposits to potentially more volatile on-and-off balance-sheet liabilities. The concentration limit is likely to promote greater future financial stability by restricting the rapid growth and further domination of the largest firms in the U.S. financial markets.

Systemically Risky Non-banks

In addition to the large banks (i.e., those with total consolidated assets of $50 billion or higher), ICBA strongly believes that certain large nonbank financial companies should be subject to enhanced prudential standards including higher capital, leverage, and liquidity standards, concentration limits and contingent resolution plans. The list should include, but not necessarily be limited to, large investment banks, insurance companies, hedge funds, private equity funds, venture capital firms, mutual funds (particularly money market mutual funds), industrial loan companies, special purpose vehicles, and nonbank mortgage origination companies.

The over dependence of shadow banks on short-term wholesale funding including commercial paper, repurchase agreements (repos), interbank loans and contingent funding commitments made them particularly vulnerable to runs, much like commercial banks were before the establishment of FDIC deposit insurance.[2] Money market mutual funds proved particularly vulnerable to runs and liquidity pressures after the collapse of Lehman Brothers when short-term wholesale funding markets came under severe stress and there was a flight away from purchasing any type of asset-backed commercial paper. Shadow banks were not subject to consistent and effective regulatory oversight. Many types of shadow banks, including various special purpose vehicles, asset-backed commercial paper vehicles, hedge funds and nonbank mortgage-origination companies, lacked meaningful prudential regulation. No regulatory body restricted the leverage and liquidity policies of these entities, and few if any regulatory standards were imposed on the quality of their risk management or the prudence of their risk-taking.

It is therefore important that the Council's process for determining which nonbank financial institutions should be considered systemically important should be a sufficiently broad enough inquiry to include as many large or interconnected nonbank financial firms that pose systemic risk to the financial system and the economy as possible. The list should include, but not necessarily be limited to, large investment banks, insurance companies, hedge funds, private equity funds, venture capital firms, mutual funds (particularly money market mutual funds), industrial loan companies, special purpose vehicles, and nonbank mortgage origination companies. Any company that is "predominantly engaged in financial activities" as the Dodd-Frank Act defines that term

[2] For instance, repo liabilities of U.S. broker dealers increased by 2-1/2 times in the four years before the crisis.

should be considered if its failure or material financial distress could cause financial instability in the United States.

Volcker Rule

There should not be a federal safety net for proprietary trading or investing in or sponsoring hedge funds and private equity funds. Insured depository institutions have access to federal deposit insurance and liquidity facilities. These privileges that should be strictly limited to the fundamental business of banking -- facilitating economic growth by intermediating between savers and borrowers, *i.e.*, taking deposits and making loans, and maintaining liquidity in the economy throughout the economic cycle. They should not subsidize activities that serve only to generate profits for a bank's owners and are unrelated to the fundamental business of banking and serving customers. For this reason, ICBA generally supports the Dodd-Frank limitations on proprietary trading and sponsoring or investing in hedge funds or private equity funds, commonly known as the "Volcker Rule." The Volcker Rule prohibits conflicts of interest and ensures that government subsidies like federal deposit insurance and liquidity facilities will not fund, even indirectly, speculative trading by banks or their affiliates.

Speculative trading is especially pernicious in an over-concentrated financial system, and the Volcker Rule is made necessary by the closely related problem of too-big-to-fail banks. Problems at mega banks or within a financial system controlled by a few mega banks quickly infect other institutions, ultimately harming taxpayers, smaller community banks, and the larger U.S. financial system.

Resolution Authority

The Dodd-Frank Act provides a process for the appointment of the FDIC as receiver of a failing financial company that poses significant risk to the financial stability of the United States (covered financial company). The Act also defines the policy goals of the liquidation proceedings and provides the powers and duties of the FDIC as receiver for a covered financial company.

It is important that the FDIC's regulations pursuant to its orderly liquidation authority carry out the goal of the Act which is to provide a way of liquidating failed financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard. It is important that the FDIC clarify that all unsecured creditors of the failed company should expect that they will incur losses and that the statutory standards for the application of this authority will be rigorously applied. We presume that the FDIC will engage in further rulemaking about other aspects of Title II of the Dodd-Frank Act including the requirement that shareholders of a failing covered financial company also must bear losses and the mandate that any management and members of the board of directors who are responsible for the failing condition of the covered financial company should be removed.

To minimize the moral hazard associated with liquidating large financial companies while ensuring fairness to creditors, the liquidation rules of Title II of the Dodd-Frank Act attempt to create parity in the treatment of creditors with the Bankruptcy Code and other normally applicable insolvency laws. We agree that the FDIC's rules should implement the goal of trying to treat creditors as they would be treated under the Bankruptcy Code. For instance, the rules clarify that the authority to make additional payments to certain creditors will never be used to provide additional payments, beyond those appropriate under the defined priority of payments, to shareholders, subordinated debt holders, and bondholders.

To ensure that all unsecured creditors expect to absorb losses along with other creditors, the FDIC's orderly liquidation rules narrowly define the circumstances under which creditors can receive any additional payments or credit amounts. Under the rules, such payments or credit amounts can be provided to a creditor only if the FDIC Board of Directors, by a recorded vote, determines that the payment or credits are necessary to the essential operations of the receivership or bridge financial company, to maximize the value of the assets or returns from sale, or to minimize losses.

Contingency Plans

ICBA agrees with the FDIC that extensive planning is essential for the effective use of these orderly liquidation powers and will improve the likelihood that the assets or operations of a failed financial company can be sold immediately. It is essential that the largest financial companies submit credible contingent resolution plans that will facilitate a rapid and orderly resolution of the company and will describe how the liquidation process can be accomplished without posing systemic risk to the public and the financial system. If the company cannot submit a credible plan, the FDIC and the Federal Reserve should exercise their authority under the Dodd-Frank Act to order a divestiture of those assets or operations that might hinder an orderly resolution. We look forward to the FDIC issuing rules on contingent resolution plans in the next few months.

Additional ICBA Recommendations

ICBA recommended additional provisions that were not included in the Dodd-Frank Act. These include a prefunded resolution fund, the downsizing of systemic risk institutions over a five year period, stronger anti-trust provisions that take systemic risk into account in reviewing mergers, not merely the impact on geographic markets, permanent separation of banking and commerce by closing the industrial loan company loophole that allows a commercial firm to own a bank, and a lower deposit concentration cap. We continue to urge Congress to enact these recommendations. It is particularly important for Congress to close the ILC loophole, because the Dodd-Frank moratorium expires in just 27 months.

Closing

Thank you again for convening this hearing. We appreciate your interest in the community bank perspective on too-big-to-fail. We've suffered direct harm from this disastrous policy, before and since the financial crisis, and we and the customers and communities we serve have a great deal at stake in correcting the policy. An economy with too-big-to-fail institutions cannot be a truly free market and cannot reach its potential by providing credit and other financial services to diverse communities.

ICBA believes that Dodd-Frank will go a long way toward mitigating too-big-to-fail, but risks remain. Dodd-Frank gives potentially powerful tools to financial regulators, but does not guarantee that they will use them. ICBA will remain deeply engaged in the implementation of Dodd-Frank.

We hope that this subcommittee will play a key role in shaping too-big-to-fail policy going forward.

Mercatus Center at George Mason University
FINANCIAL MARKETS WORKING GROUP

Testimony of Anthony B. Sanders
on "Has Dodd-Frank Ended Too Big to Fail?"
House Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs
March 30, 2011

I would like to thank the members of the committee for the invitation to testify today. My name is Anthony B. Sanders. I am Distinguished Professor of Real Estate Finance at School of Management, George Mason University and a Senior Scholar at the Mercatus Center at George Mason University. I am an expert on real estate finance, mortgage risk and mortgage-backed securities. I wrote a book entitled "Securitization" with Andrew Davidson and continue to perform research on housing and commercial real estate markets. I am formerly the Director of Asset-backed and Mortgage-backed Securities Research at Deutsche Bank.

Too Big to Fail is a Big Problem

Federal Reserve Board of Governors Chairman recently stated that "Too big to fail [is] a 'pernicious' problem."[1] I could not agree more. The term Too-big-to-fail (TBTF) has become commonplace in the media, but it has usually been applied only to banks.

TBTF industries and firms pose a major problem to economic recovery and stability. Just knowing that the government can intervene to bailout industries or firms can lead to excessive risk taking and poor management.

But TBTF is not just restricted to the banking sector. It applies to other industries as well as government agencies and programs, government budgets and expenditures, and even the

[1] Kristina Cooke, "Bernanke: Too big to fail a 'pernicious' problem," Reuters, March 20, 2010, http://www.reuters.com/article/2010/03/20/us-usa-fed-bernanke-idUSTRE62J0SM20100320.

In 2008, the housing bubble collapsed resulting in a spike in mortgage delinquencies and defaults resulting in financial chaos. Did the government stave off wholesale collapse as economist Mark Zandi claims or did it actually cause further damage as economist John Taylor at Stanford stated in his recent testimony?[5] Of course, it is a tradeoff. But the key point that should be made is that having highly concentrated industries and TBTF firms complicates any reaction to a "black swan" event. Hence, the Federal government (and the Fed) should not be encouraging TBTF policies; rather, government should be discouraging TBTF policies so we avoid bailouts and the "black swan" bailout waves in the future.

With each bailout or government loan to save industries, there comes incentives for excessive risk taking which increases systemic risk. The answer to this systemic death spiral is for government to stop bailing out failing institutions or industries.

Government Finance Housing is TBTF

Fannie Mae and Freddie Mac

The Federal government has an effective monopoly on the secondary mortgage market with Fannie Mae, Freddie Mac, and FHA purchasing or insuring over 90% of mortgages originated in recent years.[6] Fannie Mae and Freddie Mac were placed into conservatorship on September 6, 2008 and are now under Federal government control. Although the final cost of this bailout has not been determined, it is likely to exceed $400 billion.

This is a classic TBTF example. Fannie Mae and Freddie Mac had grown to be of enormous size with large retained portfolios which only served to allow Fannie Mae and Freddie Mac to generate higher returns, but at enormous risk to shareholders and ultimately taxpayers. In

[4] See Garett Jones and Katelyn Christ, "Speed Bankruptcy: A Firewall to Future Crises," *Working Paper No. 10-02*, Mercatus Center at George Mason University, January 2010, http://mercatus.org/publication/speed-bankruptcy-firewall-future-crises.

[5] John Taylor, "Evaluating the TARP," testimony before the Senate Committee on Banking, Housing and Urban Affairs, March 17, 2011, http://www.stanford.edu/~johntayl/Taylor%20TARP%20Testimony.pdf.

[6] While one could argue the market is actually an oligopoly, the fact that all three are controlled by government makes it a monopoly.

technically are not TBTF. But even FHA Commissioner David Stevens testified that the FHA should shrink its market share. [9]

It is clear that raising the FHA's conforming loan limit to $729,750 in selected areas of the country[10] led to crowding out of private mortgage insurance companies.[11] However, all is not well with the private mortgage insurance industry either.[12] The crowding out by Fannie Mae, Freddie Mac and the FHA has taken quite a toll on industry structure of the housing finance market. While conforming loan limits are scheduled to be reduced, there is already resistance forming to reducing it from a variety of players.

Will the FHA shrink in size as Commission Stevens recommended? Dodd-Frank Act allows regulators to exempt certain mortgages from securitization rules. Remember, one of the alleged goals of Dodd-Frank was to discourage risky lending by banks. As it stands, loans where borrowers put down equity of 20 percent or more are exempt from securitization rules. The meaning of this exemption is that lenders can securitize 20 percent or greater down payment loans without keeping part of the loan (aka "skin in the game") on their books. A 20 percent or more down payment loan is effectively riskless in terms of credit risk.

There is an exception to this Qualified Residential Mortgage rule, and that is loans issued or guaranteed through government agencies (specifically FHA) are to be exempt from the rule.[13] The major implication of the FHA exemption is that banks may decide against securitizing or holding low down payment loans unless they are insured by the FHA. This is the exact opposite of what FHA Commissioner Stevens had recommended. In other words, Dodd-Frank set the stage for the FHA is further crowd out competition in the low down payment space. This potentially creates a TBTF or "too big to control" situation where the FHA continues to grow (again). Raising the guarantee fees for the FHA (and Fannie Mae and Freddie

[9] David H. Stevens, "Are There Government Barriers to the Housing Market Recovery?" testimony before the House Financial Services Committee Insurance, Housing, and Community Opportunity Subcommittee, February 16, 2011, http://financialservices.house.gov/media/pdf/021611stevens.pdf.
[10] The conforming loan limit was only $271,050 in North Dakota.
[11] See Anthony B. Sanders, "The Future of Housing Finance: The Role of Private Mortgage Insurance," testimony before the House Committee on Financial Services Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee, July 29, 2010, http://financialservices.house.gov/Media/file/hearings/111/Sanders%207_29_10.pdf.
[12] See "Wanted: Private Investors Seeking First Loss Exposure on RMBS," *The Insitutional Risk Analyst*, March 28, 2011, http://us1.institutionalriskanalytics.com/pub/IRAMain.asp.
[13] See section 941 of Dodd-Frank bill.

loans increasing the instrument's market share.[15] As a result, the FRM has been the dominant instrument throughout the post-Depression time period.

A key feature of the FRM is the ability of the borrower to prepay the loan without penalty.[16] A majority of states have outlawed prepayment penalties on FRMs and the GSEs will not honor such penalties in mortgages they purchase. This feature effectively converts the FRM into a downwardly adjustable rate mortgage. When market rates fall the borrower can refinance into a new loan at a lower rate. When market rates rise the borrower is protected through the long term fixed rate feature. The ability to refinance lowers mortgage payments and can stimulate consumer spending in a recession.

So, the 30 year FRM is unique in that the majority of the benefits are in favor of the borrower, at the expense of the lender or investor. When interest rates rise, the value of the 30 year FRM falls harming the lender or investor. When interest rates fall, the value of the 30 year FRM increases, but borrowers can refinance their mortgage causing harm to the lender or investor (since they are receiving less interest than expected). There is a range of small interest rate changes where the borrower does not refinance and the lender or investor gains in value; but this range is fairly small (100 – 150 basis points).

This dominance of the FRM has now been enshrined in legislation through the "qualified mortgage" defined in the Dodd-Frank Financial Reform bill. Lenders will get safe harbor from risk retention requirements for qualified residential mortgages (QRMs) as well as other regulatory benefits. So, it is likely that lenders will choose the QRMs as their loans of choice and the non-QRMs will be relegated to the FHA, non-banking, non-GSE realms of private market securitizations through private equity funds, REITs and other vehicles.

Pre-payable mortgages such as the FRM have higher rates than non-callable mortgages. In effect all borrowers are paying for the option to refinance regardless of whether they exercise it. This contrasts with the Canadian and European view of risk allocation. In this view the borrower receives a medium to long term fixed rate loan without a free prepayment option. If the borrower wants to prepay for financial reasons (as opposed to moving houses) they must pay a penalty equivalent to the cost to the investor/lender of reinvesting the proceeds at the new lower market rate. In those countries the cost of the option is individualized – borne by the individual exercising the option. In the US the cost of the

[15] See James Vickery, "Interest Rates and Consumer Choice in the Residential Mortgage Market," *Federal Reserve Bank of New York Working Paper*, September 16, 2007, http://www.newyorkfed.org/research/economists/vickery/Interest_Rates_Consumer_Choice.pdf.
[16] Prepayment is not costless, however. There are significant transactions costs associated with refinance.

companies). Nonetheless, it appears TBTF creation was, in part, a conscious decision by the Federal Reserve.

Dodd-Frank and the Federal Reserve System

The omission of Fannie Mae and Freddie Mac from Dodd-Frank and the FSOC oversight is well known. But also missing from Dodd-Frank is whether they intend to reign in the Federal Reserve System as well.

As I mentioned earlier, the Federal Reserve Board of Governors allowed for the expansion of TBTF. Even if their actions were a short-run action to prevent systemic financial meltdown, it still sent the signal that TBTF is a preferred stature to achieve.

Recently, the Fed disclosed that the size of their balance sheet is around $2.584 trillion, $1 trillion of it in mortgage-backed securities (MBS). Much of the remainder represents the Fed's purchase of Treasury debt as part of their quantitative easing actions. I am concerned that the Fed's balance sheet is quite large already and should be unwound (or stopped from growing further). The Fed already has been buying about 70 percent of all new Treasury debt. What will happen when the Fed stops the purchases and begins to unwind its $2.6 trillion balance sheet?

While the Federal Reserve System is not too-big-to-fail *per se*, they are like the FHA in that they are quite large and have enormous influence over the economy. The Fed's actions manipulate interest rates as well as inflation. While bank lending continues to be lower than pre-2007 levels, inflation could spike significantly once banks start lending again to businesses and consumers (See Exhibit 3).

My question relates to why the Fed was exempted from Dodd-Frank and FSOC. The Fed is extremely powerful and the government will back their risk-taking behaviors. It seems like that is one of the definitions of TBTF, particularly if the Fed is unable to manage inflation once the proverbial genie is out of the bottle.

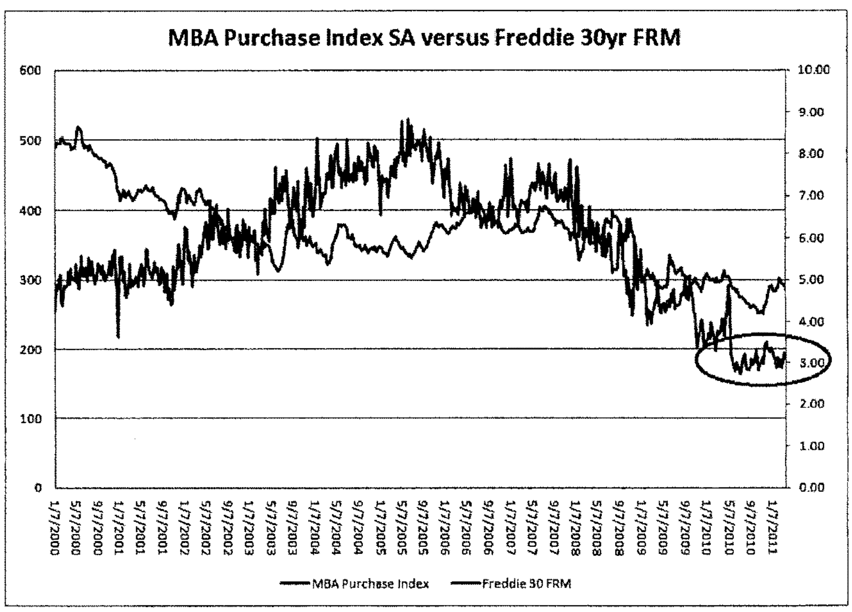
Conclusion

1. TARP actually increased the incentive for risky lending since bailouts may follow from the government

Exhibit 1. Government Bailouts Since 1970

Firm/Industry	When	Cost
Penn Central Railroad	1970	$3.2 billion
Lockheed	1971	$1.4 billion
Franklin National Bank	1974	$7.8 billion
New York City	1975	$9.4 billion
Chrysler	1980	$4.0 billion
Continental Illinois Bank	1984	$9.5 billion
Savings & Loan	1989	$293.3 billion
Airline Industry	2001	$18.6 billion
Bear Stearns	2008	$30 billion
Fannie Mae / Freddie Mac	2008	$400 billion
American International Group (A.I.G.)	2008	$180 billion
Auto Industry (GM, Chrysler)	2008	$25 billion
Citigroup	2008	$280 billion

Exhibit 2. Mortgage Bankers Association Purchase Index



Mr. McHENRY. Today's hearing was certainly interesting; we had two oftentimes dramatically different views of the facts, views of the lay of the land, but certainly stimulating and interesting for us to inform Congress's thinking on how the implementation of Dodd-Frank is progressing, the impact of the TARP program and the bailouts, and whether or not bailouts continue to be the rule of the day.

A couple of interesting points in terms of Mr. Barofsky's testimony. He refers to HAMP as a broken promise, as well as it being poorly designed and executed, and that the Main Street goals of TARP were not followed through with. Finally, he also testified that what he said was "resolution authority is a joke," and that goes to the heart of really what many of us here, in terms of Congress, believe is one of the lasting impacts of Dodd-Frank, is that we have codified the bailouts in terms of calling it resolution authority.

Now, that was Mr. Barofsky's testimony. Now, Mr. Massad did an able job of defending the administration's actions, in particular HAMP. We simply disagree on the impact it has in terms of those that it is hurting. I appreciate your testimony and your willingness to be here. Thank you.

This meeting is adjourned.

[Whereupon, at 12:15 p.m., the subcommittee was adjourned.]

[The prepared statement of Hon. Gerald E. Connolly follows:]

Opening Statement of Congressman Gerald E. Connolly

Subcommittee on Technology, Procurement and Intergovernmental Relations

March 30th, 2011

Chairman Lankford, this is one of the least glamorous and most important subcommittees in Congress because it has jurisdiction over technology and procurement policies that create or diminish economic opportunity for America's growth sector: the technology industry. We have oversight authority over all technology policy and legislative authority over those policies of critical importance to technology companies that are government contractors. While I support efforts to curtail unfunded state and local government mandates, I fear that using the Unfunded Mandates Reform Act as a subterfuge to block or delay thoughtful regulation on the *private* sector would not only harm the public we serve but also waste time that could be used to develop better technology and procurement policy. As Senator Cutler said, "UMRA was adopted in an effort to curb the practice of imposing unfunded federal mandates on state and local governments." We should remain faithful to that intent of the legislation.

I do not support efforts to attack reasonable regulations on the private sector, such as EPA clean air standards of health care reforms such as a prohibition on rescission. Our time would be better spent focused on improving the skill set of our procurement workforce, for example. In fact, a Republican Senator, Susan Collins, introduced just such a bill last year, which passed the Senate in the last days of the session. We should work together to pass an updated version of that bill—the Federal Acquisition Institute Improvement Act—early in this session. I intend to introduce the House version of that bill and hope the Chairman, Mr. Lankford, will join me as an original cosponsor. I included this and other important technology priorities in a memo I wrote to Chairman Lankford at the beginning of this session. Other items of importance included passing legislation to provide a growth path for successful small businesses, reducing federal costs through expanded use of cloud computing and energy efficiency, conducting oversight of insourcing to protect small and minority-owned businesses, and making the Chief Technology Officer a permanent position.

Unfortunately, this agenda has been deferred--temporarily, I hope. This subcommittee cannot change the agenda of the Republican leadership, but we could report legislation and conduct oversight of issues that are important for the technology sector as well as state and local governments. This subcommittee's mandate, after all, is technology, procurement, and intergovernmental relations.

Let us leave the partisan warfare to other committees or the House floor. Chairman Lankford, I would request that we hold the next subcommittee hearings on legislation or oversight related to the acquisition workforce, cloud computing, the role of the Chief Technology Officer, and other subjects of importance to the information technology sector.