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TURMOIL IN U.S. CREDIT MARKETS: RECENT ACTIONS REGARDING GOVERNMENT- SPONSORED ENTITIES, INVESTMENT BANKS, AND OTHER FINANCIAL INSTITUTIONS

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**TURMOIL IN U.S. CREDIT MARKETS:
RECENT ACTIONS REGARDING GOVERNMENT-
SPONSORED ENTITIES, INVESTMENT BANKS,
AND OTHER FINANCIAL INSTITUTIONS**

HEARING
BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED TENTH CONGRESS
SECOND SESSION

ON

THE RECENT ACTIONS TAKEN BY THE FEDERAL REGULATORY AGEN-
CIES TO CONTAIN THE FINANCIAL CRISIS, THE CURRENT STATE OF
THE FINANCIAL MARKETS, AND PROPOSALS TO ADDRESS THE CRISIS

TUESDAY, SEPTEMBER 23, 2008

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



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TUESDAY, SEPTEMBER 23, 2008

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:35 a.m., in room SD-G50, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. Good morning. I want to thank our colleagues, thank our witnesses, those who are in attendance. The Committee will come to order, and this morning we meet for a hearing on the "Turmoil of U.S. Credit Markets: Recent Actions Regarding Government-Sponsored Entities, Investment Banks, and Other Financial Institutions. We want to welcome our distinguished witnesses here this morning. We thank the Secretary of the Treasury, Hank Paulson, who is here; the Honorable Ben Bernanke, of course, the Chairman of the Federal Reserve; Christopher Cox, Chairman of the Securities and Exchange Commission; and Jim Lockhart, the Director of the Federal Housing Finance Agency.

The way we are going to proceed this morning is I will make a brief opening statement; turn to my colleague from Alabama, Senator Shelby, former Chairman of the Committee, to make his opening remarks; and given the magnitude of this issue and the seriousness of it, I am going to ask if my colleagues would like to make any brief opening comments quickly; and then we will get to our witnesses.

My goal would be that we terminate the hearing sometime around noon, if we can. We all recognize the gravity of the situation and the importance of these witnesses to be able to get back and do the work they are doing. So my hope would be that we try and move along here. But, again, I want to give each of my colleagues a chance to at least say something at the outset of these remarks. But I beseech you to try and keep them brief. All of your full statements will be included in the record, and any supporting documents you care to include in the record will be there as well.

So, with that admonition in mind, we will try and make the opening rounds here about 8 minutes apiece. That way we can at

least get decent responses and properly ask questions. And I am not going to gavel down tightly, but try to keep it within that framework, if we can.

With that, let me share some opening thoughts this morning, and then I will be turning to Senator Shelby.

The Committee gathers this morning at an extraordinarily and perilous moment in our Nation's history. The landscape of our Nation's economy has been radically reshaped by the U.S. Government over the course of just a few days in a totally ad hoc manner, it would seem. Companies that have formed the foundation of our financial markets are shrinking and disappearing practically overnight. Their insatiable appetite for risk in many cases has permeated all sectors of the financial services industry and has spread beyond our shores. It has felled giants like Bear Stearns and Lehman Brothers; brought others to their knees like Merrill Lynch, AIG, Fannie Mae, and Freddie Mac; prompted the largest, I might point out, thrift failure in our Nation's history, the Indy Mac Bank; and eliminated the final two independent investment banks, Morgan Stanley and Goldman Sachs.

These drastic changes have reverberated far beyond the trading floors and boardrooms of corporate America. Across our great Nation, families are gathering around their kitchen tables each night asking how they will weather this storm and how it will affect them very directly. Hundreds of billions of dollars that Americans invested in retirement accounts and mutual funds have evaporated. Homeowners are watching the value of their homes plummet. Foreclosures are forcing 9,800 families from their homes each and every day in our country. Families worry about how they will afford groceries and gasoline. Six hundred thousand Americans have lost their jobs while millions more have watched their paychecks shrink and their benefits wither away.

Perhaps the most dangerous consequence, the one that we do not speak enough about, in my view, of this economic maelstrom is that our collective confidence in our Nation's future has been badly shaken, and that needs to be restored.

Less than 6 months ago, our Banking Committee gathered in this very room to listen to the financial leaders of the Bush administration describe what at the time seemed an inconceivable event: the Government's \$30 billion intervention in the sale of Bear Stearns to JP Morgan. Now after spending hundreds of billions of dollars more to prop up, bail out, and wind down a multitude of institutions, the U.S. Government effectively runs, supports, or outright owns vast swaths of the financial sector.

American taxpayers are angry, and they demand to know how we arrived at this moment and, more importantly right now, how the architects of this economic landscape will put us back on a sound financial footing and restore American confidence and optimism.

As I and many Members of this Committee have argued for the past 17 months since I became Chairman of this Committee, the root cause of our economic crisis has been the collapse of our housing market, triggered by what Secretary Paulson himself has called "bad lending practices." These are practices that no sensible banker should have engaged in—and many did not, I might add—reckless,

careless, and sometimes unscrupulous actors in the mortgage lending industry that allowed loans to be made that they knew hard-working, law-abiding borrowers would not be able to repay. Financial regulators acted much too late and much too timidly. They failed to enforce the laws that Congress passed requiring them to prohibit these bad lending practices.

What is tragic and lamentable is that the ensuing calamity was entirely foreseeable and preventable. This was no act of God. It was not like Hurricane Ike. It was created by a combustible combination of private greed and public regulatory neglect. And now we must confront the present crisis.

Barely 72 hours ago, Secretary Paulson presented a proposal that he believes—and others do as well—is urgently needed to protect our economy. This proposal is stunning and unprecedented in its scope—and lack of detail, I might add. It would allow the Secretary of the Treasury to intervene in our economy by purchasing at least \$700 billion of toxic assets. It would allow the Secretary to hold onto those assets for years and to pay millions of dollars to hand-picked firms to manage those assets. It would do nothing, in my view, to help a single family save a home, at least not up front. It would do nothing to stop even a single CEO from dumping billions of toxic assets on the backs of American taxpayers, while at the same time do nothing to stop the very authors of this calamity to walk away with bonuses and golden parachutes worth millions of dollars. And it would allow this Secretary and his successors to act with utter and absolute impunity without review by any agency or a court of law.

After reading this proposal, I can only conclude that it is not just our economy that is at risk but our Constitution as well. Nevertheless, in our efforts to restore financial security to American families and stability to our markets, this Banking Committee has a responsibility to examine this proposal carefully and in a timely manner. In my view, any plan to address this crisis must embody three principles:

First, American taxpayers must have some assurance that their hard-earned money is being used correctly and responsibly;

Second, we must put in place proper oversight so that the executors of this plan are accountable and their actions are transparent;

And, finally, we must address the root cause of this crisis by putting an end to the rising number of foreclosures sweeping across our Nation.

In the longer term, it is clear that our current economic circumstances demand that we rethink, reform, and modernize supervision of the financial services industry. Certain basic principles should form the foundation for reform. We need a leader in the White House who will ensure that regulators are strong cops on the beat and do not turn a blind eye to reckless lending practices. We need to remove incentives for regulators to compete against each other for bank and thrift clients by weakening regulation. We need to ensure that all institutions that pose a risk to our financial system and taxpayers are carefully and sensibly supervised. And we need to accept the premise that consumer protection and economic growth are not in conflict with one another but inextricably linked.

If we learn nothing else from this crisis, it is that the failure to protect consumers can cause the collapse of our largest financial institutions, the loss of hundreds of thousands of jobs, and the draining of hundreds of billions of dollars of wealth from hard-working Americans.

Today, we are very fortunate to be joined, as I said at the outset, by Treasury Secretary Henry Paulson, Federal Reserve Chairman Ben Bernanke, SEC Chairman Chris Cox, and the Director of the Federal Housing Finance Agency James Lockhart.

Regardless of how so many feel about the decisions these leaders have made and the impact they have had, we all ought to be able to agree that these four individuals are good, talented, knowledgeable, and experienced individuals who, I think, want to do the very best for our country. And I agree as well that we need to move, and move quickly if we can, but I feel even more strongly that we need to move carefully and prudently and to make sure that what we do is right. I understand speed is important, but I am far more interested in whether or not we get this right. There is no second act to this. There is no alternative idea out there with the resources available if this does not work. So it is critically important that we get it right. And the purpose of this hearing is to discuss whether or not this is the right approach and how we can prove it if we need to.

Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Chairman Dodd.

This may be the most important hearing that this Committee has conducted, at least in the 22 years I have been a Member here. Over the last 10 years, trillions of dollars were poured into our mortgage finance markets, often with the encouragement of well-intended Government programs. At first, the money backed conventional mortgages with standard downpayments and properly verified incomes.

Over time, however, the number of homebuyers that met conventional loan requirements dwindled rapidly. In order to fuel the upward spiral, mortgage products became more exotic, requiring less of borrowers and involving more risk. Without regard for fiscal prudence and simple economics, bankers, investment bankers, mortgage brokers, realtors, home builders, mortgage bankers, and homebuyers created the conditions that helped inflate the housing bubble. At the same time, Wall Street was developing ever more sophisticated financing vehicles to ensure that money continued to flow into the mortgage markets to meet the demand.

Mortgages were pooled, packaged, and rated so-called investment grade by the credit rating agencies. They were then sold into a market eager to purchase securities with a wide range of risks and yields.

Many purchasers employed massive amounts of leverage, layering risk upon risk in an effort to maximize return. To cover their risks, many of the buyers also bought credit protection from one another, entered into derivatives contracts with nominal values in the hundreds of trillions of dollars. All the while, our financial regulators appeared to be unaware as they sat on the sidelines.

As early as July of 2003 here at the Banking Committee, I asked Chairman Greenspan, then Chairman of the Federal Reserve, whether he was concerned about the growing number of loans to borrowers with weak credit histories and the number of homeowners who spent more than 50 percent of their income on housing. I also asked him if he was concerned whether an economic downturn could lead to increasing delinquencies and foreclosures. Chairman Greenspan at this very Committee assured us that increasing home prices provided an equity cushion for mortgagors and that lending to such borrowers would pose “a rather small risk to the mortgage market and the economy as a whole.”

As recently as March of this year, Vice Chairman of the Federal Reserve Cohn, testifying before this very Committee, assured us that the banking system was in, and I will quote his words, “sound overall condition” and that losses “should not threaten their viability.”

Now, we now know that was not the case. Eventually, economic reality caught up with our housing market, and housing prices stalled and then began falling. Many who bought homes with unconventional loans found that they were unable to afford their rising payments. Because home values were dropping, they were unable to refinance, and delinquency rates skyrocketed, as we all know.

Once homeowners began defaulting, the value of mortgage-backed securities plummeted. Collateralized debt obligations—that we call them “CDOs”—that were comprised of the riskiest mortgage-backed securities became worthless. As a result, financial institutions holding securitized assets have suffered enormous losses and have been desperately trying to raise new capital.

Of the five investment banks regulated at the beginning of the year by the Securities and Exchange Commission under its Consolidated Supervised Entities Program, two have failed, one was forced to merge with a bank, and the remaining two have now left the program to become bank holding companies. The recent demise of our investment banks lies in stark contrast to the vote of confidence we received in the Banking Committee from Chairman Cox in February of this year, when he assured us that the CSE program was up to the task, and I will now quote Chairman Cox. According to Chairman Cox’s words, “The purpose of the CSE program is to monitor far and to act quickly in response to financial or operational weakness in a CSE holding company that might place regulated entities or the broader financial system at risk. The Commission—that is the SEC he is speaking of—“seeks to ensure that the holding company has sufficient stand-alone liquidity and financial resources to meet its expected cash outflows in a stressed liquidity environment for a period of at least 1 year.”

That was earlier this year. In late 2007, Mr. Erik Sirri, head of Market Regulation for the Securities and Exchange Commission, described a consolidated supervision program that had “demonstrated its effectiveness during the current credit market difficulties.” Nothing can be further from the truth.

He likewise assured us that the SEC’s consolidated supervision had achieved “the goal of reducing the likelihood that weakness within the holding company or an unregulated affiliate will place

a regulated entity or the broader financial system at risk. Notwithstanding assurances to the contrary, uncertainty about housing prices and the value of mortgage-backed securities have brought our markets to a halt.

We are now facing the most serious economic crisis, as Chairman Dodd said, in a generation. So far, the Treasury Department and the Fed's response to the crisis has been a series of ad hoc measures.

First came the bailout of Bear Stearns, which we were told was unavoidable. Then came Lehman Brothers, which was allowed to fail. And then, just last week, the Fed and Treasury organized a bailout of AIG.

I believe the absence of a clear and comprehensive plan for addressing this crisis has injected additional uncertainty into our markets and has undermined the ability of our markets to tackle this crisis on their own.

Unfortunately, the Treasury Department's latest proposal continues, I believe, its ad hoc approach, but on a much grander scale. The plan contemplates the purchase, as we know, of up to \$700 billion in troubled, toxic, mortgage-related assets from financial institutions that nobody would buy. Treasury expects, but is not required, to purchase most assets through a type of reverse auction process.

There are very few details in this legislation. In fact, Treasury officials admit that they will have to figure out the mechanics as they go along. Rather than establishing a comprehensive, workable plan for resolving this crisis, I believe this legislation merely codifies Treasury's ad hoc approach.

My hope is that this hearing will give us an opportunity to explore the parameters of the plan and why Secretary Paulson believed it will work. I also hope to hear why the plan does nothing to address the root cause of the crisis: the rise in default rates on mortgages. While Wall Street banks get to sell their bad investments to the Treasury Department, homeowners will still be saddled with mortgages that they cannot afford.

My record is very clear on taxpayer-funded bailouts. I have long opposed Government bailouts for individuals and corporate America alike. As a young Congressman, I voted against the loan guarantees for Chrysler, I believe in 1979 or 1980. However, if the Government is going to get into the bailout business, shouldn't we also be focusing our resources on average Americans, the taxpayers, rather than sophisticated and well-compensated Wall Street bankers?

The Treasury's plan has little for those outside of the financial industry. It is aimed at rescuing the same financial institutions that created this crisis with the sloppy underwriting and reckless disregard for the risk they were creating, taking, or passing onto others. Wall Street bet that the Government would rescue them if they got into trouble. It appears that bet may be the one that pays off.

Once again, what troubles me most is that we have been given no credible assurances that this plan will work. We could very well spend \$700 billion or \$1 trillion and not resolve the crisis. Before I sign off on something of this magnitude, I would want to know

that we have exhausted all reasonable alternatives. But I do not believe we can do that in a weekend. Unfortunately, the incredibly accelerated process for considering this bill means that Congress does not have time to determine if there are better alternatives or any alternatives to the Treasury's plan.

I am very concerned that the express need to pass something now may prevent us from devising a plan that would actually work. Without question, our markets and financial institutions need serious attention. I do not believe, however, that we can solve this crisis by spending a massive amount of money on bad securities. It is time for this administration and the Congress to do the work of devising as quickly as possible a comprehensive and workable plan for resolving this crisis before we waste \$700 billion to \$1 trillion of taxpayer money.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Shelby.
Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Thank you, Senator Dodd.

This administration has asked Congress for the authority to buy up to \$700 billion worth of residential and commercial mortgage—related assets from troubled Wall Street financial institutions. They are asking that this package have no strings. In South Dakota, we believe strongly in personal responsibility. When you make mistakes, as many of these companies have, you should be held accountable for those decisions. This package may be a necessary evil, but we cannot allow it to become a gift.

It should have teeth, with real oversight from Congress. We should not use this package or American tax dollars to benefit foreign banks. And this package should contain limits on executive compensation. People in South Dakota work hard for the taxes they send to Washington, and their earnings should not be wasted on the bloated compensation of a CEO.

Today we need answers from the regulators as to how we got to this point and specifics about how our regulatory system failed us. We also need to begin the dialog between the regulators and this Committee as to how to best change the regulatory structure so that this type of crisis does not happen again. Our system needs good, effective regulation that balances consumer protection and allows for sustainable economic growth.

For years many Members of this Committee, and myself included, have been calling for just this sort of regulation. There should be no mistake that change is coming. I look forward to working with the Members of this Committee to institute the changes needed to regulate and to guarantee a responsible, modern regulatory system.

Please submit my full statement for the record.

Chairman DODD. Thank you, Senator. Let me urge again, as I said at the outset, to try and keep these comments as brief as we can so we can get to the testimony. I am very grateful, by the way—we have been working as a Committee, by the way, many of us over the weekend, a lot of us, and Senator Bennett and I have talked at length, and I thank him for his participation.

Senator Bennett.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

We have had a housing bubble, and the bubble has burst. And every time we have a bubble, whether it is housing or dotcom stocks or anything else, when the bubble bursts there is disaster. And we will have bubbles in the future because the human propensity to believe that the market will always go up is still there. Let us understand that.

The economy runs on credit, credit is granted on confidence, and confidence is based on one of two assumptions: the collateral is worth it or the cash-flow will be sufficient. One way or the other, the loan will be repaid. What we are faced with now is finding a way to restore the confidence in the system so that credit can start to flow again. That is what we are here to try to do.

Thank you, Mr. Chairman.

Chairman DODD. Thank you.

Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman.

The essence of the proposition that the administration is presenting to us today is that the taxpayers will assume the risk of disastrous investment decisions made by very highly compensated individuals and institutions on Wall Street. I think the custom on Wall Street is that when you assume the risk, you get paid to do that. I believe it is essential that the taxpayers of this country are compensated for their assistance. I think the only effective way to do that is a mandatory program of warrants as a prerequisite to participating in this assistance for non-voting equity in companies. And as these companies improve, which is the hope and expectation of this program, the American taxpayers could also benefit from that improvement.

I think this also goes to the very difficult issue of pricing these securities, that if the Treasury or its agents misprice the securities and they overpay, presumably the benefits of that will flow to the companies and, frankly, with the appreciated stock, again, I think taxpayers should benefit from that.

I think also, too, there is some discussion that if we do this, there will be some limitation in participation, but I would suggest that might not be altogether a bad thing; that if this system can be gamed by people who are not desperately in need of Government assistance, that will be done. I think to present a company with the choice between surrendering warrants and participating or simply getting through on their own is not an unfair choice for sophisticated business managers who, we presume or we hope, are dedicated to preserving their company and benefiting the shareholders.

And, finally, I want to associate myself with the comments of the Chairman and others who say that we cannot simply assist Wall Street. We have to assist hundreds of thousands of homeowners who are facing foreclosure. If we do not do that, that will be, I think, unfair and it will not result in a program that is legitimate in the eyes of the American people.

Thank you very much.
Chairman DODD. Very good. Thank you.
Senator Enzi.

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Thank you, Mr. Chairman.

In the past 6 months, our Federal Government has devised a dozen strategies to save America's financial markets. Each plan has been more costly, more risky, and less aligned with the principles of our country's free market economy than the last. I am disappointed to say that this latest plan puts all the rest of them to shame. This proposal means a full-scale intervention into our country's free markets with the Treasury buying every bad asset in sight with taxpayer money.

To make this point clear, if approved in this current form of \$700 billion, this plan will cost every man, woman, and child in this country approximately \$2,300. This plan will come with an enormous cost and enormous risk. Unfortunately, the only plan more costly would be doing nothing at all.

Last week, I was given the legislative language for this proposal, and it was only three pages long—\$700 billion, three pages. I know that it has grown to six pages and perhaps to 42 pages. When I questioned Secretary Paulson and Chairman Bernanke about this plan on Sunday, they explained that flexible and broad authority was the only way the plan would work. I was immediately reminded of the last time the Chairman and the Secretary appeared before this Committee and asked for such broad authority; that was to save Fannie Mae and Freddie Mac from insolvency this past summer. I hope this time the plan is more successful.

I have no illusions about the urgency of the problem our economy faces today, but Congress cannot be expected to approve this bill without a guarantee of proper oversight and accountability for the taxpayers. As I said before, we are talking about the equivalent of \$2,300 from every U.S. citizen. This Committee would not be doing its job if that were allowed to happen.

Where is the accountability for these banks and their management? The Treasury and the Federal Reserve have asked us to cut them the biggest bailout check in history, and that money will be handed out to the same banks that put us in the mess to begin with. Nowhere in the text of this bill do I see any equity sharing or loss mitigation that will protect taxpayers from unknown costs. It did make a difference to AIG stockholders who are trying to pay off their loan already. A Treasury buy from our banks will be priced by the seller, not buy the buyer. The Federal Government could end up owning mortgages that cost multiples of the resale value, and yet there is no recourse for our taxpayers. It does not make any sense. It will reward the banks first who got us in the financial mess and the taxpayers second, many of whom were completely unaware that this kind of financial—

Chairman DODD. I am going to ask the audience—we will have to clear this room. I do not want to do that. It is a public hearing. Let's have respect for the speakers, and there will be no outbreaks, applause or other comments. This is a serious hearing.

Senator.

Senator ENZI. I have heard the argument that punitive or prescriptive measures could cause sellers to leave the market. I think that offends common sense. If banks can get a better price for their paper from someone other than Treasury, they should not be bailed out in the first place. If they choose to fail rather than sell their debt at its real market value and record their loss on the books, they should be free to take that option.

This legislation must be passed to help Main Street, not because the Federal Government is being held hostage by Wall Street.

I have some ideas. This Committee must find a way to make financial regulation more efficient, effective, and accountable. I have some ideas, including a reevaluation of the marked-to-market accounting. It is clear that such a method is not sustainable in a volatile market. Providing some relief today could prevent firms from needing this expensive Federal bailout. Reforms in the long term could prevent capitalization issues down the road.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator.

Senator SCHUMER.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman, and thank you for holding this hearing.

My colleagues and fellow Americans, we live in amazing and dangerous times. Who would have thought that the lowly mortgage, long regarded as the safest of investments, could bring our financial system to its knees? But that is where we are. And while we must look back and see what went so dramatically wrong, our immediate task is to look forward and to try and avoid a meltdown of the financial system. And as we look forward in the week ahead, we face both a Scylla and a Charybdis—dangers on both sides.

On the one hand, as we are reminded, there are real dangers if we do not act. The description Chairman Bernanke gave us when the leadership of the Democratic and Republican House and Senate met in Speaker Pelosi's conference room, the description Chairman Bernanke gave, in quiet terms, without hyperbole, was astounding. Chairman Bernanke told us that our American economy's arteries, our financial system is clogged, and if we do not act, the patient will surely suffer a heart attack, maybe next week, maybe in 6 months, but it will happen. So we must act, and we must act soon.

And make no mistake about it, while Wall Street caused the problems we face, unfortunately if we do nothing, Main Street will also pay a severe price. Pension funds, money market mutual funds, 401(k) plans will be negatively impacted. The lockdown in lending has widespread consequences. I have heard from car companies that it is virtually impossible to get an auto loan right now unless you have a credit score over 720. And if that continues, the auto industry will sell 6 million fewer cars this year than it did in years past. Even though the workers in Buffalo and Detroit and St. Louis are blameless, they will suffer. It is not fair. It is not right. But that is the world we live in.

So I want to assure the markets—and I think I speak for all of us—that we will not be dilatory, we will not “Christmas tree” this

bill with extraneous amendments, and we will work in a bipartisan way to act, and to act soon.

But there is also the Charybdis, the other danger of acting so quickly that we choose a bad solution. The markets want action, and we understand that. But if we act so quickly that we create an ineffective solution without adequate safeguards, then we risk the plan failing, which would be an even worse outcome for the markets, for the economy, for our country. Even on Wall Street, \$700 billion is a lot of money, and none of the thousands of money managers would invest that sum without appropriate due diligence.

This hearing today and the discussions that will follow are our congressional due diligence, and we take that responsibility seriously, and we will make intelligent and relevant improvements. Secretary Paulson has proposed his plan, the Troubled Asset Relief Program, or TARP, to Congress. And while I certainly recognize the need for action and want to move quickly, I think some changes are necessary.

To Secretary Paulson's TARP program I believe we need to add THOR: T for taxpayer protections; H for housing; O for oversight; and, down the road, R for regulation.

I can talk about each of these at some length, but we do not have time, Mr. Chairman. But on taxpayers, we must put taxpayers first, should this program work. They must come ahead of bondholders, shareholders, and executives, and we need to add to this legislation those types of protections, such as my colleague Senator Reed has spoken about in terms of warrants. That would be more of a mandatory than an optional nature.

Homeowners. Secretary Paulson has labored mightily to try to improve the homeowner problem, and Chairman Bernanke has said repeatedly until we find a floor to the housing markets—and foreclosures are directly related to the housing markets—we will not solve this problem. And that affects not just those who made bad mortgages or not just those who will lose their home through not fault of their own, but every homeowner. The number of foreclosures and the price of the average American's home is related and cannot be separated.

Oversight. There have been lots of discussions of oversight led by Chairman Dodd, and there are excellent suggestions, and we must do them.

And R, regulation. We must have a much better system of regulation, and many of us have begun thinking about this. It will probably have to wait until after we act here, but we must do it.

The bottom line, Mr. Chairman, is this: We do have to act, but we have to act smartly, wisely, and relevantly. And I believe that is what this Committee will do over the next few days.

Chairman DODD. Thank you very much, Senator.

Senator HAGEL.

STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Thank you, Mr. Chairman.

The essence of our efforts and final product is accountability, transparency, and timeliness. We must define a rescue agreement based on the common interests of our country. We have a responsi-

bility to construct a program based on the general principles of agreement, not held hostages to the details of the differences.

We are in uncharted waters. We are living in a 21st Century global marketplace. We are behind in not only understanding that, but regulating that. This is going to require a new 21st Century regulatory regime.

But our current effort—we must stay focused on our current effort—is a short-term rescue effort, clearly in the interests of our country and the world. And it must be done. And it must be done with responsibility but also with timeliness.

Mr. Chairman, thank you.

Chairman DODD. Thank you, very much.

Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Mr. Chairman, thank you.

Gentlemen, thank you very much for joining us again here today.

What I would like to just mention, I am going to mention four things that I hope to take away from this hearing today. The first of those is to better understand how we got into this mess. Chairman Cox and I were talking about short selling yesterday and I want to understand better the role that that played in getting us where we are today. I want to better understand how changing leverage ratios has gotten us to where we are today. But I want to know when we walk out of here today, I want just a better understanding of how did we end up in this mess.

The second thing I hope to get out of this is after understanding how we got into this mess, how do we get out of this mess? And how do we do so in a way that does not reward bad behavior from people who should not be rewarded for the bad behavior?

The third thing I would like to take away with me today is to have some assurance myself in the plan that we are discussing here or that eventually evolves, so that we can make sure this kind of tragedy does not occur again in our lifetime and beyond.

And finally, I want to better understand how we maximize the chances that the Treasury will be made whole or maybe even make a buck or two for the taxpayers at the end of the day. I mentioned at another meeting here on Capitol Hill this morning, I went back and recalled the bailout at the time of Chrysler where the Federal Government did not provide loans to Chrysler, they provided loan guarantees issued in conjunction with warrants which were exercised—we never had to backup the loans but we did have the opportunity to exercise the warrants. We made money for the taxpayers on that deal.

When the S&L debacle occurred, we ended up creating the Resolution Trust Corporation. The Resolution Trust Corporation, you all will recall, came in and bought not the savings and loans, but what were deemed to be the bad assets of the savings and loans. And as it turned out, a lot of them were not bad assets. They were assets whose value had diminished during that crisis but assets that over time appreciated in value. We were able to sell them and recover most of the taxpayers' money.

My hope is as we go forward here, that we look to those two examples as maybe a bit of a road map to enable us, while we find

out how we got into this mess, how we get out of it, how we make sure it does not happen again, how we do all of that without rewarding bad behavior, at the end of the day—putting this much taxpayer money at the risk—at the end of the day I would feel a lot better if we had a pretty good assurance that when all is said and done that we have actually recovered this money for our taxpayers.

And if we can make a buck or two at the end of the day, so be it.

Thank you.

Chairman DODD. Thank you, Senator, very much.

I want to point out, I turn to Senator Bunning, it was 2 years ago that Senator Bunning and Senator Allard held a joint hearing on subprime mortgages, at the conclusion of which Senator Schumer, Senator Reed, Senator Sarbanes, and myself, joined them in a letter to the regulators asking what actions and steps they were going to take in the subprime mortgage problem.

Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

So much has happened since the last time we had our witnesses before us that we could probably hold this hearing for a week and still have more to talk about. It is hard to even know where to begin.

What is pressing is the \$700 billion Treasury proposal that is being negotiated with the Chairman of the House Financial Services Committee. The Paulson proposal is an attempt to do what we so often do in Washington, D.C., throw money at a problem.

We cannot make bad mortgages go away. We cannot make the losses that our financial institutions are facing go away. Someone must take those losses. We can either let the people who made the bad decisions bear the consequences of their actions or we can spread that pain to others. And that is exactly what the Secretary's proposal is to do, take Wall Street's pain and spread it to the taxpayers.

The plan has not even passed and already Americans are paying for it because of the fall in the dollar as a result of all of the new debt that we will be taking on.

I know there are problems in the financial markets and I share a lot of the same concerns that other members and witnesses do. However, the Paulson plan will not fix those problems. The Paulson plan will not help struggling homeowners pay their mortgages. The Paulson plan will not bring a stop to the slide in home prices. But the Paulson plan will spend \$700 billion worth of taxpayers' money to prop up and clean up the balance sheets of Wall Street.

This massive bailout is not a solution. It is financial socialism and it is un-American.

Thank you.

Chairman DODD. Senator Menendez.

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman.

Certainly in my 16 years in Congress, there has not been a more critical time for our economy and a more important Banking Committee hearing than this one. The Administration's economic and regulatory policy over the last 7 years has led us to today. Now we have been told that we have less than 7 days to make our choices and 8 minutes to ask questions, so you will forgive me if I am not signing right away on the bottom line.

Unfortunately, the Administration comes to the Congress at the final hour instead of before, and in doing so leaves us with undesirable choices. The credit crunch and the failing investment banks did not occur in a vacuum. At their core they are about the housing foreclosure crisis. And that weakness was created by lax regulation, regulators asleep at the switch, and an unwillingness by many to acknowledge the direness of the situation early on.

In March of 2007, Mr. Chairman, at this Committee I raised the prospect of a tsunami of foreclosures in the Banking Committee, but the Administration dismissed it. A few months later, as foreclosures mounted, they assured us that the problems would be contained to the housing market. And in July, we asked them about the prospect of a bailout of Fannie and Freddie, but they could not foresee it.

So how many times can the Administration be wrong and still instill confidence?

This is why, while I need to know—and I think we need to act, and I agree we need to act—I am not going to be stamped into rubber-stamping this proposal. There are serious questions that we need answers to before you have at least my vote.

Illiquid assets are illiquid either because they are non-performing, they are over valued, or even worse, we do not even know what their true values are. Questions range from are you intending to buy these bad loans at a significant discount or will we be overpaying? If they are at a deep discount, how does that create the much-needed capital for their cash future, and therefore solve the problem? If Treasury is overpaying and working to create capital for the institutions, why aren't we getting equity just as shareholders do so that the taxpayers can recoup their money? And as Treasury has amended their proposal for foreign entities to also be subject to this bailout, what are the central banks of those countries doing to establish and prop up their own institutions?

Why are we asked to put \$700 billion to keep CEOs in their office while families get kicked out of their homes and the public gets the bill while this Administration says it is all about Main Street?

We cannot say that homeowners should bear all of the consequences of bad decisions but that financial institutions get to share the pain of their bad decisions through public debt.

So Mr. Chairman, last week the President said "The risk of doing nothing far outweighs the risk of the package." As his statement inherently implies, there is a risk involved. And with risk comes responsibility. We need to quantify that risk. We need to limit taxpayer exposure. We need to work to keep families in their home as part of their effort.

Therefore, I look forward to some honest answers here today. The Secretary's testimony, as it has been presented to the Committee, just reiterates the need. But I hope we will get to the an-

swers of how do they intend to have this work and work in a way that limits the taxpayers' exposure, puts homeowners back in their home, and creates responsibilities by those who have believed that private risk can now become public debt.

Chairman DODD. Thank you, Senator.
Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman.

I share many of the concerns and observations that have been made by my colleagues, so I will not restate all of them.

I do want to indicate, however, that I agree that this is probably the most critical threat to our economic circumstances in our country that we have faced since I have served in Congress. And one which has the type of urgency that requires us to take prompt action.

But I also share the sentiments that we must take the time to get it right. And I have a lot of the same concerns that others have shared about whether we have the right proposal or whether we need to continue to work through a refinement of it.

I have a number of questions. For example, as have been raised by some already today, how will these assets be priced? If there is a market value that the holder or seller simply does not want to sell at, will the taxpayer be asked to buy them at a premium simply to help recapitalize those who are facing capital problems?

And if so, how will the taxpayer ever regain its investment in this circumstance if more than the assets are worth are paid for them?

In fact, that raises another very interesting question. And that is if it does require a significant infusion of capital, should the plan be having the taxpayers purchase distressed assets? Or should the plan involve the taxpayers gaining some type of ownership interest or some type of ability to come ahead of the shareholders in terms of the losses that are taken in the operations of the firms?

The question as to what type of investment or what type of capitalization should take place is critical and I think that the basic bottom line here is that we must protect the taxpayers. So that as losses must be taken, those losses are taken not by the American taxpayer but they are taken by those who have the ownership interests in the firms involved.

I have many, many other questions. But again, the bottom line to me is how do we make sure that the connection between Main Street and Wall Street is understood not only by America but by the policymakers here in this Committee and in this Congress so that we address the issue in such a way that we make sure that the taxpayer is protected and that the markets are strengthened and reassured?

I think that Senator Schumer's comment about assuring the markets that we are going to be diligent and careful and prudent as we move forward is very helpful. I think the markets need to know that. We also need to make sure that the markets know that we will be efficient and careful and prudent to making sure that the solution that we get is the right solution.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator, very much.
 Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Senator Dodd, for calling today's hearing. Thanks to the witnesses for joining us. They have had many long nights lately and this may be a long morning. I make no apologies for that. I doubt they seek any.

Like my colleagues, my phones have been ringing off the hook. The sentiment from Ohioans about this proposal is universally negative. I count myself among the Ohioans who are angry. Had the Federal Government acted to contain the epidemic in subprime lending, I do not think we would be sitting here today. The time we spend this morning will be time well spent, not just for our own benefit but for the benefit of the people we represent. I am not sure they will be convinced, but they sure deserve a better explanation than they have received to date.

A man from Westerville, Ohio was so concerned he took a day off work and drove to Washington this week—a 7 hour drive—to share his views with me. He quite rightly asked why we are rushing to bail out companies whose leaders got rich by gambling with other people's money?

Here is another communication, and I quote, "The Federal Government must not prolong necessary corrections in the housing market, bail out lenders, or subsidize irresponsible borrowing and lending at the expense of hard-working people who have played by the rules." Except that statement did not come from Ohio. It came from the Office of Management and Budget three short months ago.

Throughout this sorry chapter in our Nation's financial history, the Administration has shown extraordinary attention to the problems of Wall Street while at times showing hostility to rebuilding Main Streets across the country. The statement I quoted above was from the Administration's veto threat of the housing bill. Congress had the audacity to include \$4 billion to rebuild neighborhoods devastated by the foreclosure crisis but the Administration did not want to reward irresponsible borrowing and lending.

Now it does. But before we agree, there are many, many unanswered questions that Congress and the American people have a right to ask that the Administration needs to answer.

As Chairman Bernanke knows, the bank panic of 1933 started in Detroit and in 2 weeks spread to Cleveland. Two of the city's largest banks were shuttered and never reopened. One had ties to my predecessor in this seat, Republican Marcus Hanna. Rumors flew that the bank's closure was a political decision. If we do not know the rules now, these types of rumors will be reborn.

Secretary Paulson, as much as I respect your judgment, you will not be making the hundreds of individual decisions that this effort will require. And as your colleague, Secretary Kempthorne has found, a lack of close supervision and adherence to rules can lead to disastrous results.

Many of the people who will be making these decisions as to the purchase of these troubled assets have come from Wall Street, and they may be returning to Wall Street. The notion that they can op-

erate without clear guidelines is not just unfair to taxpayers, I think it is unfair to them.

So I hope this morning we go into considerably greater detail. I hope we can give Main Street a good bit more help and attention than we have to date. I think the taxpayers need to be protected. And I think the leadership of these companies have to be held accountable.

If any CEO hesitates to participate because of his or her narrow self-interest, his or her compensation, I would say it is time to get a new CEO. It is fine to say that people's 401(k) accounts may be affected. They will be if we do not act. But for most people, their home is their 401(k). We need to help them, as well.

Mr. Chairman, gas is expensive. I want that man from Westerville, Ohio to know that his time and his money were well spent.

Chairman DODD. Thank you very much, Senator.

Senator Dole.

STATEMENT OF SENATOR ELIZABETH DOLE

Senator DOLE. Mr. Chairman, I have very strong concerns that this rescue proposal will unfairly hold taxpayers responsible for the costly and reckless decisions of investment bankers on Wall Street.

I, like the North Carolinians I am hearing from, am very skeptical of this proposal. And frankly, I am extremely frustrated that we find ourselves in this position.

So much of what is happening with regard to the credit crisis, the housing slump, the bankruptcy and dissolving of major financial institutions can be linked to the mismanagement of Fannie Mae and Freddie Mac, which was made possible by weak oversight and little accountability.

Since arriving in the Senate, I have been one of a handful of members pushing for stronger oversight of Fannie Mae and Freddie Mac. I have helped introduce—as have Senators Chuck Hagel, John Sununu, Mel Martinez, and Richard Shelby—legislation to strengthen oversight. And I have raised the issue in the Banking Committee hearings time and time again. Unfortunately, Fannie and Freddie dispatched an army of lobbyists, reportedly spending more than \$100 million, to gain protection in Congress and this Committee to oppose our legislation.

As we know, one of my Committee colleagues proclaimed in April 2005 that Fannie and Freddie have done, and I quote, “A very, very good job.” It was only 2 months ago that our bill was finally included in the housing stimulus package. So it took 5 years to finally get appropriate action.

This problem could have been resolved years ago. It is astounding that despite the years of widely publicized mismanagement at Fannie and Freddie, despite our group of United States Senators sounding the alarm about the lack of oversight, despite Alan Greenspan in 2005 urging Congress to act, warning that we are placing the total financial system of the future at a substantial risk, despite the preponderance of red flags, it took—of all things—the Investment Banking Division of Morgan Stanley, hired by the Treasury Department, to uncover that Fannie and Freddie were

still using overly aggressive accounting techniques to inflate their capital adequacy positions.

Now my constituents, and indeed taxpayers across the Nation, are asking how we arrived at this crisis. It is infuriating. We need to end the existing structure of an implied Government guarantee. We need to end the practice of private rewards at public risk. I fully support the mission of affordable housing and believe the Government will continue to play an important role in this area.

That said, it is abundantly clear that Fannie and Freddie have utterly failed to deliver on their intended purpose. In fact, because of their Congressional apologists, Fannie and Freddie have effectively done just the opposite. They have put us on the brink of a situation in which almost no one can obtain financing for a home.

One of the big casualties in all this mess is AIG. As we know, Treasury had to swoop in with an \$85 billion loan to prevent the largest company failure in history. The AIG downfall was caused, in large part, by the hemorrhaging credit default swaps on mortgage-backed securities.

Consistently throughout the year, I have been one of the few members who called for more oversight and tougher reporting requirements for the \$60 trillion credit default swaps market, which we now know also played a significant role in the collapse of Lehman Brothers. I reference this as yet another example of what is now painfully obvious, the Federal Government's oversight structure for the financial sector is fatally flawed. And I am not at all convinced that this bailout plan, which appears incredibly expensive and hastily concocted, is the answer.

I welcome today's hearing, not only for us lawmakers to get answers but for the taxpayers who need to understand in no uncertain terms why they are being asked to foot this bill.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator.

Senator Casey.

STATEMENT OF SENATOR ROBERT P. CASEY

Senator CASEY. Mr. Chairman, thank you very much.

I want to thank Secretary Paulson, Chairman Bernanke, Chairman Cox, and Director Lockhart for your presence here today.

I think my reaction to the proposal that was sent by the Administration this weekend was similar to not just members of this Committee and others, but I think the American people, in a couple of ways. One was I thought it was far too broad a grant of authority to the Treasury Department, and I will talk more about that. But I think in terms of what was missing from it were a couple of basic features. First of all, I think it missed completely the idea of addressing directly the root cause of this problem, which you know started with foreclosures. And I know there has been work done this weekend to try to fill in that hole, fill in that blank.

On Friday, I sent a letter both to you, Secretary Paulson and Chairman Bernanke, outlining a couple of things on housing. First of all, HOPE for Homeowners is a way to further amplify or expand our efforts in that area. The moratorium issue that Senator Brown, Senator Menendez, and Senator Schumer and I proposed.

And also, an innovative way in the city of Philadelphia, where literally the city government, the court system intervened, to try to prevent foreclosures. And it is a very successful model.

And I think there are other ideas that we will hear. I know that Chairman Dodd has made a series of proposals just in the last couple of days that I think are very instructive here and very helpful on transparency and accountability, the idea of oversight, certainly in the area of assistance for homeowners.

So we are going to have a chance to review those today and in the next couple of days.

I think overall, people are looking for—taxpayers and families are looking for a couple of things. They are looking for more oversight. They want to know that if a department of their Federal Government is given the opportunity to exercise power which involves the expenditure of maybe \$700 billion, that there is some oversight by the elected officials and others who are charged with that responsibility.

I think taxpayers have a real concern, obviously, a deep abiding concern about their own savings. What will this mean to their own livelihood, any kind of short-term livelihood, but especially long-term, in terms of their own personal savings. I think they know that we need more performing loans, not loans that are headed to foreclosure. And I think the bankruptcy strategy here, in terms of that enhancing our ability to modify loans, is central to achieving that kind of result where you have more performing loans instead of loans headed to foreclosure.

But I think in the end what people are most concerned about is staying in their homes. We have got to do everything possible with limited time, I realize, and under duress and urgency, to do everything possible to keep people in their homes. And I think that is, in the end, what most Americans are concerned about. They are concerned about not just their own family, but their own neighborhoods. And it really comes down to peace of mind in so many ways.

I would hope that in your efforts, and I know that you are trying to do this, but in your efforts to explain what has to happen to support financial institutions and other entities which will, in turn, strengthen our economy and help on Main Street, that you keep in mind what individual families are up against.

In my home State of Pennsylvania, which has been spared somewhat, in a relative sense, what other States have gone through, the foreclosure crisis got a lot worse in August of 2008 compared to August of 2007, up 60 percent, a much higher rate than the rest of the country.

And then if you add the foreclosure problem in a State like Pennsylvania and add the other challenges that people have, with gas prices, health care costs, the costs of education. One that stood out for me is child care. If you are a family in Pennsylvania and you have got two kids, your monthly cost for child care is \$1,311. That is weighing on people as they worry about making the house payment this month and next month and all these months ahead of us.

So I would urge you, as we finalize a proposal, I know we are trying to work together to make this happen, that we keep in mind those families and their peace of mind and their economic security.

Thank you very much.
Chairman DODD. Thank you, Senator.
Senator Martinez.

STATEMENT OF SENATOR MEL MARTINEZ

Senator MARTINEZ. Thank you, Mr. Chairman.

I look forward to hearing from the witnesses, and I will be very, very brief. But I do think it merits for us to look for a moment to how we got here because a lot can be said about the lack of regulation. And I want to associate myself with the excellent comments from Senator Dole.

I cannot help but have a sense that a lot of what has transpired here, a lot of what we are dealing with today, has its origins in Fannie Mae and Freddie Mac. And as we look at that, and we try to deal with the current problem, we cannot help but also look back. We have not looked back enough to know how Fannie Mae and Freddie Mac got the entire financial world in the mess that we are in today.

One of the problems is that it did not have a world class regulator. And I know it is real popular today and easy to do to just beat up on the Administration and blame everything from tsunamis to hurricanes on them. But having been a part of this Administration and having come to this Congress, and before this very Committee, to testify in 2003, along with then-Secretary of Treasury Snow, to ask for stronger regulation over Fannie and Freddie, to have a world class regulator, I find it just a little troubling to just exactly overlook and not pay some attention to how we got here.

And I do want to recall also Chairman Greenspan's comments in 2005 before this Committee where he said that if Fannie and Freddie continue to grow, continue to have the low capital that they have, continue to engage in the dynamic hedging of their portfolio—which they need to do for interest rate aversion—they potentially create ever growing potential systemic risk down the road. And that is where we are today, systemic risk.

So that is just a little bit on how we got here, where I think we need to, Director Lockhart, I hope we are going to drill down and find out a lot more about how Fannie and Freddie got us here. But beyond that, we need to do what we need to do now. We need, in the long term, to also deal with a complete revamping of our regulatory scheme of our financial institutions.

But that will come in the future. For now, I believe we are saddled with a problem that needs and requires action, that action needs to be thoughtful but timely. We need to talk about oversight. We need to talk about the size of this fund, and whether it will work or not. But it does appear to me that there are also some questions that we need to have answered, which is if the underlying problem regarding this entire matter has to do with the ever declining home values, what are we doing here that will help to stem that decline in home values?

It seems to me, when we look at the State of Florida, that it is about a tremendous inventory of unsold properties, as well as the availability of credit. Hopefully, what we are doing here may help

with the availability of credit. But certainly the tremendous inventory is something that I think we also need to address.

So I look forward to hearing the testimony from the witnesses, having many questions answered. But at the end of the day, I do believe that it is our responsibility to act, to act timely, and to act responsibly but yet to act.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator. Senator Bayh.

STATEMENT OF SENATOR EVAN BAYH

Senator BAYH. Thank you, Mr. Chairman and thank you, gentlemen, for your public service. We may not agree on everything but we are all grateful for your efforts to try and deal with this important moment for our Nation.

Mr. Chairman, we gather here today at a time of the most palpable sense of national crisis since we gathered here in this building immediately following the 9/11 attacks. It has been less than 72 hours since we listened to the Chairman of the Federal Reserve tell us that we were only a matter of perhaps days from the beginning of a major economic collapse, the free fall of our financial markets, and the beginnings of a severe and protracted recession that could cost businesses going out of business, many jobs being lost, savings being wiped out, people losing their homes, real distress for our country. And coming from a man who I think, Mr. Chairman, it is safe to say is not known for engaging in hyperbole, this tended to focus the mind.

So the sense of urgency is palpable. And yet, we also have to focus on getting it right.

I am going to focus my questions on what alternatives have been considered? Why are we convinced that this is the right path? Were there no private sector solutions available that would perhaps lead to better outcomes than the ones that have been proposed?

If it takes us a couple of extra days to increase the likelihood that this will work and work well, well it is worth working through the weekend. It may be worth postponing going home to campaign for. I mean, this is important enough that we take the time to get it right.

And so I am going to focus my questions first on what other alternatives were considered? And why do we think this is the optimal solution to the problem?

Several of my colleagues, including Senator Menendez, have mentioned is our purpose here to protect the taxpayers by buying these instruments at market prices? If that is the case, how does it help solve the problem by recapitalizing these institutions? If we are paying above market prices, what do the taxpayers receive in return? If equity is the answer, that is one thing. If it is not equity, then we have to ask why not? And if it is not equity, we have to ask why do we encourage, or at least permit, sovereign wealth funds to invest in our companies and markets but perhaps not allow the American taxpayers to take a similar interest in our own companies and markets? So I will be asking about that, as well.

Finally, and perhaps my greatest concern, Mr. Chairman, and you and I have discussed this. We have to act. But we also have to be willing to take the steps to make sure that this situation does

not reoccur. As my colleagues have indicated, there is a sense of outrage on the part of ordinary taxpayers. I hear from my citizens all the time, people who behaved prudently, who did not take inordinate risks, who saved their money, who did not get in over their heads, who did not participate in highly leveraged instruments that have not come back to haunt them.

What about them? Who speaks for them? Who will protect them? We owe it to them to make sure that we learn the lessons from this so that it does not happen again.

And the way Washington works—I must say, I am not a cynic but I am a skeptic. We will act in this moment of crisis. But once the crisis has abated, the sense of urgency will dissipate. The forces of reform will not have the energy they have today. All of the interests will circle this place like hungry birds looking at carrion to prevent us from taking the steps that are necessary. And we must not let that happen.

So I understand we cannot make the long-term reforms in this vehicle. It is not possible in the time frame that is at our disposal. But I am going to be looking for some incentive, Mr. Chairman, some mechanism that will force us to revisit this issue. Because if we do not revisit the issue of long-term reform to keep this from happening again, it will happen again. And history will judge us poorly and our children and grandchildren will not forgive us, nor should they.

Chairman DODD. Thank you, Senator.
Senator Corker.

STATEMENT OF SENATOR BOB CORKER

Senator CORKER. Senator Bayh made some good comments.

I want to say to all of you that I thank you for coming. I think it is absolutely reprehensible that in the biggest financial crisis in modern history, our timeline is to get out of here on Friday so we can adjourn for the year in September. And I agree with those who think we ought to get this right. I will focus these comments to Secretary Paulson and Chairman Bernanke.

I cannot imagine two people that have a better background to deal with this, nor people that I respect more from the standpoint of that and their perspective. I did not support the rebate stimulus, and I did not support the “bazooka in the pocket” theory. And history will judge whether that was a good decision or not. But in both cases, you came to us with strength of commitment and telling us that that absolutely was the right thing to do. I disagreed.

In this case, what bothers me is that each of you—and I realize you are trying to solve a problem, and I truly believe you are trying to do it in a way that you think is best for the country. I believe that with all of my heart. But I get a sense that it is with more of a deer-in-the-headlights mentality.

This is a much bigger undertaking, this bailout, and I do not, by the way, criticize you for not knowing exactly what to do. But this is being done on the fly. If this \$700 billion were to be extended per Bloomberg data today, it would add up to \$1.8 trillion that we have extended to the markets, not counting the rebate checks that went away at \$168 billion or somewhere thereof.

So I just have to tell you that I hope today that what you will do in questions and answering is talk about some of the options that you have thought about that Senator Bayh brought forth, and I hope you will be able to convince us that this solves the problems that we are dealing with.

I am getting letters from bankers throughout the State of Tennessee that were not involved in this, and yet they have severe issues that are caused by some of the things that have happened on Wall Street.

So I hope this meeting will be full, Mr. Chairman. I did the math for you. I hope you do not object. But 21 times 8 is 168 minutes. I know no one will stay within that 8 minutes, and I do hope that this hearing will last long enough so that we leave here fully understanding what it is we are talking about.

Chairman DODD. I appreciate that very much, and, again, I thank my colleagues. And there are a couple more members who want to be heard from, but this is, as many have pointed out, probably the single most important hearing this Committee has held, certainly in my tenure. Therefore, having the opportunity for Members to be heard on this I think is particularly important. And it is important, I think, that our witnesses have the opportunity as well. They are reflecting the views of their constituents about these matters, and it is clearly important that we be working together on this.

So I apologize for the length of it, and I will try and make sure we move along here, recognizing our witnesses have work to do as well. But it is a critical moment in our system that we hear from Members. So I thank my colleagues for their comments as well.

Let me turn to Senator Akaka and then Senator Allard, and then we will then go to our witnesses. Senator Akaka.

STATEMENT OF SENATOR DANIEL AKAKA

Senator AKAKA. Thank you very much, Mr. Chairman. I appreciate your conducting this hearing today, and I want to add my welcome and thanks to the witnesses who are here today.

Mr. Chairman, I understand the need to act to stabilize the markets. However, we must not give the Secretary of Treasury a blank check with no accountability or oversight. We must deliberate and provide a solution that protects taxpayers as much as possible and limits the potential for this new authority to be abused. Seven hundred billion dollars is a huge sum of money.

I know the President has said that the whole world is watching Congress now. I remind all of you that the Members of this Committee and the rest of the taxpayers will be closely watching the development of the Troubled Assets Program. The purchase and sale of assets has great potential to be abused and lead to corruption. Members of Congress, the GAO, the Treasury Inspector General, and the public must review the activities of Treasury authorized by this proposed act. We must make sure that this situation, which has been caused partially by greed, will not be exploited to enrich individuals and corporations.

In addition to stabilizing the markets, we must do more to help working families. We need to help those who have already suffered the consequences of the current economic downturn. We must do

more to try and keep people in their homes. Consumer protections must be improved to better protect families from being exploited by predatory lenders.

Mr. Chairman, we are here today due to a massive market failure. In addition to this emergency legislation, we need a complete reexamination of our financial services oversight system in order to strengthen regulation and prevent the need for future bailouts. While most of those issues will be considered in the next session of Congress, I look forward to working with all of you to bring together a fair proposal to stabilize the markets, improve the lives of working families, and overhaul the financial services regulatory system.

Thank you very much, Mr. Chairman.

Chairman DODD. Thank you, Senator.

Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman.

I want to thank the panel for being here with us today. This is a critical time in our Nation and our economy, and we must move forward from here. I hope to get more details on how we do that.

We need to act on solid facts so that we can act in the interests of the taxpayers of this country. I urge the administration to be more forthcoming with facts on their plan, their cost estimates and implementation. Telling Congress to give full discretion in implementing the bailout program is not the way to go. Congress needs to be involved, and I urge more cooperation and sharing with the Congress in the hope that we can act in a limited way and avoid going beyond what is necessary to stabilize the markets. This Committee, this Congress, must act to preserve our free market tradition. We have tried to avoid propping up failed businesses on Main Street. We should not prop up failure, malfeasance, and avarice on Wall Street.

Second, we cannot do so successfully, even if we wanted to. The history of Government's ineptitude at running business is known now the world over.

And, third, we must prevent panic both in the market and in the Government. Overreaction will in the long run be worse for our freedom and our economy. We must remember the long run.

Mr. Chairman, thank you.

Chairman DODD. I thank the Senator very much.

Before turning to Secretary Paulson, let me just say for the benefit of my colleagues and others, our intention had been, quite frankly, barring events of the last few days, to actually use this month and next month to have some hearings and informal conversations on exactly the issue of long-term restructuring of our financial service regulatory system. My intention is at some point to do this. In fact, Chairman Bernanke and I ever chatted about this yesterday as well, and we hope to get to that to be able to start that process before the inauguration of the new President in January to be able to present some ideas. It is impossible this week to do that, but I want my colleagues to know it is our intention. I know certainly Members—Senator Allard and others—have worked on regulatory reform for a long time, and so I am going to be call-

ing upon us as a Committee, informally or formally, to actually have those conversations in the coming weeks even before we commence our work in January to actually consider ideas that would allow for the restructuring of that. So I want the witnesses as well as our colleagues to know that.

With that, Secretary Paulson, let me underscore what has been said by others here. We admire immensely your willingness to serve our country, and that goes for all of you there at the table. There are obviously concerns that are being expressed here strongly this morning. I hope it has been valuable for you to hear from across the country how our colleagues are hearing from their constituents and their own concerns about these issues.

In no way should this be an interpretation of our lack of respect and admiration for those willing to serve our country, and we appreciate immensely your willingness to do it. We admire as well your background and experience you bring to this issue.

So, with that, we thank you for being here this morning and are anxious to receive your testimony and ask some questions.

**STATEMENT OF HENRY M. PAULSON, JR., SECRETARY,
DEPARTMENT OF THE TREASURY**

Secretary PAULSON. Thank you very much, Chairman Dodd, Senator Shelby, Members of the Committee. Thank you very much for the opportunity to appear before you today. I very appreciate the comments you made, and I understand them and I appreciate them.

Chairman DODD. Could you pull that microphone a little closer?

Secretary PAULSON. I also share the comments that you all made about the importance of the situation and the importance of this hearing.

This is a difficult period for the American people. I very much appreciate the fact that congressional leaders and the administration are working closely together so that we can help the American people by quickly enacting a program to stabilize our financial system.

We must do so in order to avoid a continuing series of financial institution failures and frozen credit markets that threaten American families' financial well-being, the viability of businesses both small and large, and the very health of our economy.

The events leading us here begin many years ago, starting with bad lending practices by banks and financial institutions and by borrowers taking out mortgages they could not afford. We have seen the results on homeowners—higher foreclosure rates affecting individuals and neighborhoods. And now we are seeing the impact on financial institutions. These loans have created a chain reaction, and last week our credit markets froze. Even some Main Street non-financial institutions—or, excuse me, some non-financial companies had trouble financing their normal business operations. If that situation were to persist, it would threaten all parts of our economy.

Every American business depends on money flowing through our system every day, not only to expand their business and create jobs, but to maintain normal business operations and to sustain jobs.

As we have worked through this period of market turmoil, we have acted on a case-by-case basis, addressing problems at Fannie Mae and Freddie Mac, working with market participants to prepare for the failure of Lehman Brothers, and lending to AIG so it can sell some of its assets in an orderly manner.

And here I would make the comment, you know, I have heard your comments on executive compensation. I share your frustrations. I feel those frustrations. Practices throughout America also upset me. Let me just say that, with regard to Freddie and Fannie and AIG, in case you or your constituents do not know, in those cases CEOs were replaced, the Government got warrants for 79.9 percent of the equity, golden parachutes were eliminated, strong action was taken.

I will also say to the comments made about Freddie and Fannie and the bazooka, you all can be darn glad you gave us the bazooka, because we needed it.

Let me tell you something. The root of that problem was in congressional charters started many, many years ago. We were living up to our obligations here. There are ambiguities. There are obligations around those charters. And what we did was we came in, we stabilized the market, mortgage rates went down so that capital could flow through our system. And I can just say I for one—and I know that the other witnesses feel very glad about this—thank goodness that was done and they were stabilized before we had some investment banks report their earnings, or let me tell you, this would be a much more serious situation than it is today. So there is an example of broad authorities working the way they were supposed to work to stabilize our system.

Sorry for that ad hoc response, but we have also taken a number of powerful tactical steps to increase confidence in the system, including a temporary guaranty program for the U.S. money market mutual fund industry. These steps have been necessary but not sufficient.

More is needed. We saw market turmoil reach a new level last week and spill over into the rest of the economy. We must now take further, decisive action to fundamentally and comprehensively address the root cause of this turmoil.

And that root cause is the housing correction, as you have all pointed out, which has resulted in illiquid mortgage assets that are choking off the flow of credit which is so vitally important to our economy. We must address this underlying problem and restore confidence in our financial markets and financial institutions so they can perform their mission of supporting future prosperity and growth.

We have proposed a program to remove troubled assets from the system. We would do this through market mechanisms available to thousands of financial institutions throughout America—big banks, small banks, savings and loans, credit unions—to help set values of complex, illiquid mortgage and mortgage-related securities to unclog our credit and capital markets and make it easier for private investors to purchase these securities and for the financial institutions to raise more capital after the market learns more about the underlying value of these hard-to-value, complicated mortgage-related securities on their balance sheets.

This Troubled Asset Relief Program has to be properly designed for immediate implementation and be sufficiently large to have maximum impact and restore market confidence. It must also protect the taxpayer to the maximum extent possible and include provisions that ensure transparency and oversight while also ensuring the program can be implemented quickly and effectively.

And let me give you another ad hoc comment there. When we all met Thursday night, as you will recall, Chairman, with the leaders of Congress, you all said to us, "Don't give us a fait accompli. Come in and work with us." We gave you a simple three-page legislative outline, and I thought it would have been presumptuous for us on that outline to come up with an oversight mechanism. That is the role of Congress. That is something we are going to work on together. So if any of you felt that I did not believe that we needed oversight, I believe we need oversight. We need oversight. We need protection. We need transparency. I want it, we all want it. And we need to do that in a way that lets this system, lets this program work effectively, quickly, because it needs to work effectively and quickly, and it needs to get the job done.

Now, the market turmoil we are experiencing today poses great risk to U.S. taxpayers. When the financial system does not work as it should, Americans' personal savings and the ability of consumers and businesses to finance spending, investment, and job creation are threatened.

The ultimate taxpayer protection will be the market stability provided as we remove the troubled assets from our financial system. Don't forget that. This system has to work, and has to work right, and that will be the ultimate market protection. I am convinced that this bold approach will cost American families far less than the alternative—a continuing series of financial institution failures and frozen credit markets unable to fund everyday needs and economic expansion.

Again, I am frustrated. The taxpayer is on the hook. The taxpayer is already on the hook. The taxpayer is going to suffer the consequences if things do not work the way they should work. And so the best protection for the taxpayer and the first protection for the taxpayer is to have this work.

Over these past days, it has become clear that there is a bipartisan consensus for an urgent legislative solution. We need to build upon this spirit to enact this bill quickly and cleanly, and avoid slowing it down with provisions that are unrelated or do not have broad support. This troubled asset purchase program on its own is the single most effective thing we can do to help homeowners, the American people, and to stimulate our economy.

Earlier this year, Congress and the administration came together quickly and effectively to enact a stimulus package that has helped hard-working Americans and boosted our economy. We acted cooperatively and faster than anyone thought possible. Today we face a much more challenging situation that requires bipartisan discipline and urgency.

When we get through this difficult period, which we will, our next task must be to address the problems in our financial system through something you have all talked about. We need reform that fixes this outdated financial regulatory structure. You have all

heard me talk about that a lot. And we need other strong measures to address other flaws and excesses in the system. And there are plenty, and we have all talked about them, and they cannot be addressed this week. We need to take time to address these. I have already put forward my recommendations on this subject. Many of you have strong views based on your expertise. We must have that critical debate, but we must get through this period first.

Right now, all of us are focused on the immediate need to stabilize our financial system, and I believe we share the conviction that this is in the best interest of all Americans. Now let's work together to get it done.

Thank you.

Chairman DODD. Thank you very much, Mr. Secretary. I would be remiss if I did not just point out—and thank you, by the way—that but for the cooperation that Senator Shelby and the overwhelming majority of Members of this Committee, we were able to enact that legislation in July that you have referenced. It does not mean that everybody was supportive of every detail of it, but it was an example of coming together and getting a job done. It took some time, but we got it done, and I thank you for your comments about it, and I thank Senator Shelby and Members of this Committee, Democrats and Republicans, who worked with us to get that done. Chairman Bernanke.

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

Mr. BERNANKE. Mr. Chairman, Senator Shelby, I have submitted formal written testimony for the record. With your permission, I would like to speak just a few minutes about the Treasury proposal.

The Fed supports the Treasury initiative. We believe that strong and timely action is urgently needed to stabilize our markets and our economy. But I believe some clarification is needed about why this proposal could make a positive difference, and I would like to offer a few thoughts on that subject.

Let me start with a question. Why are financial markets not working? Financial institutions and others hold billions in complex securities, including many that are mortgage related. I would like to ask you for a moment to think of these securities as having two different prices. The first of these is the fire-sale price. That is the price a security would fetch today if sold quickly into an illiquid market. The second price is the hold-to-maturity price. That is what the security would be worth eventually when the income from the security was received over time.

Because of the complexity of these securities and the serious uncertainties about the economy and the housing market, there is no active market for many of these securities. And, thus, today the fire-sale price may be much less than the hold-to-maturity price.

This creates something of a vicious circle. Accounting rules require banks to value many assets at something close to a very low fire-sale price rather than the hold-to-maturity price, which is not unreasonable in itself given their illiquidity. However, this leads to big writedowns and reductions in capital, which in turn forces additional sales that send the fire-sale price down further, adding to

pressure. Meanwhile, private capital is unwilling to come in because of uncertainty about the value of institutions and because of the prospect of more writedowns.

One suggestion that has been made is to suspend mark-to-market accounting and use banks' estimates of hold-to-maturity prices. Many banks support this. But doing this would only hurt investor confidence because nobody knows what the true hold-to-maturity price is. Without a market to determine that price, investors would have to trust the internal estimates of banks. So let me come to the critical point.

I believe that under the Treasury program auctions and other mechanisms could be designed that will give the market good information on what the hold-to-maturity price is for a large class of mortgage-related assets. If the Treasury bids for and then buys assets at a price close to the hold-to-maturity price, there will be substantial benefits.

First, banks will have a basis for valuing those assets and will not have to use fire-sale prices. Their capital will not be unreasonably marked down.

Second, liquidity should begin to come back to these markets.

Third, removal of these assets from balance sheets and better information on value should reduce uncertainty and allow the banks to attract new private capital.

Fourth, credit markets should start to unfreeze; new credit will become available to support our economy.

And, fifth, taxpayers should own assets at prices close to hold-to-maturity values which minimizes their risk.

Now, how to make this work. To make this work, we do need flexibility in design of mechanisms for buying assets and from whom to buy. We do not know exactly what the best design is. That will require consultation with experts and experience with alternative approaches.

Second, understanding the concerns and the worries of the Committee, we cannot impose punitive measures on the institutions that choose to sell assets. That would eliminate or strongly reduce participation and cause the program to fail. Remember, the beneficiaries of this program are not just those who sell the asset, but all market participants and the economy as a whole.

But, finally, and very importantly, this is not to say that the financial industry should not be reformed. It should be. It is critical. I agree with the Treasury Secretary. The Federal Reserve will give full support to fundamental reform of the financial industry. But whatever reforms the Congress makes should apply to the whole industry, whether they participate in this program or not.

So, in summary, I believe that under the Treasury authority being requested, a program could be undertaken that will help establish reasonable hold-to-maturity prices for these assets. Doing that will restore confidence and liquidity to the financial markets and help the economy recover without an unreasonable fiscal burden on taxpayers. So I urge you to act as soon as possible.

Thank you.

Chairman DODD. Thank you, Mr. Chairman, for that testimony. Christopher Cox.

**STATEMENT OF CHRISTOPHER COX, CHAIRMAN,
SECURITIES AND EXCHANGE COMMISSION**

Mr. COX. Thank you, Chairman Dodd, Ranking Member Shelby, and Members of the Committee, for inviting me here to today to discuss the current turmoil in our markets and our policy responses to it. The extraordinary nature of recent events has required an extraordinary response from both policymakers and regulators.

Last week, by unanimous decision of the Commission and with the support of the Secretary of the Treasury and the Federal Reserve, as well as in close coordination with regulators around the world, the SEC took emergency action to ban short selling in financial securities to stabilize markets as you consider this legislation. At the same time, the Commission unanimously approved two additional measures to ease the crisis of confidence in the markets. One makes it easier for issuers to repurchase their own shares on the open market, thus providing additional liquidity. The second requires weekly reporting to the Securities and Exchange Commission by large investment managers of their daily short positions.

In addition, the SEC recently issued new rules that more strictly enforce the ban on abusive naked short selling under our Regulation SHO. Beyond these immediate steps, the SEC is vigorously investigating how illegal activities may have contributed to the subprime crisis and the recent instability in our markets.

First and foremost, the SEC is a law enforcement agency, and we already have over 50 ongoing investigations in the subprime area alone. The Division of Enforcement has undertaken a sweeping investigation into market manipulation of financial institutions, including through the use of credit default swaps, a multi-trillion-dollar market is completely lacking in transparency and is completely unregulated.

Last month, the Enforcement Division, working with State regulators, entered into agreements that will be the largest settlements in SEC history, in behalf of investors who bought auction rate securities from Merrill Lynch, Wachovia, UBS, and Citigroup. Happily, the terms of these agreements would provide complete recovery for individual investors.

The Commission also recently brought enforcement actions against portfolio managers at Bear Stearns Asset Management for deceiving investors about the hedge funds' overexposure to subprime mortgages.

The Commission is using its regulatory authority simultaneously to ensure that the market continues to function. Last week, the Commission's Office of Chief Accountant provided guidance to clarify the accounting treatment of banks' efforts to support their money market mutual funds. This will help protect investors in those funds. And our examinations of the major credit rating agencies for mortgage-backed securities exposed weaknesses in their ratings processes and led to our sweeping new rules to regulate this industry under the new authority that this Committee and the Congress have given us.

We are also moving quickly to mitigate the impact of recent events. In the past week, the SEC oversaw the sale of substantially all of the assets of Lehman Brothers, Inc., to Barclays Capital.

Hundreds of thousands of Lehman's customer accounts with over \$1 billion in assets can now be transferred in a matter of days, instead of going through a lengthy brokerage liquidation process.

With all that has happened, it is important to keep in mind how we got here. The problems that each of these actions has addressed have their roots in the subprime mortgage crisis, which itself was caused by a failure of lending standards. The complete and total mortgage market meltdown that led to the taxpayer rescue of Fannie Mae and Freddie Mac was not built into the stress scenarios and the capital and liquidity standards of any financial institution. Bank risk models in every regulated sector, for better or for worse, failed to incorporate this scenario that has caused so much damage in financial services firms of all kinds.

The SEC's own program of voluntary supervision for investment bank holding companies, the Consolidated Supervised Entity program, put in place in 2004, was fundamentally flawed because it adopted these same bank capital liquidity standards and because it was purely voluntary. It became abundantly clear with the near collapse of Bear Stearns that this sort of voluntary regulation does not work. Working with the Federal Reserve, the Division of Trading and Markets moved quickly last spring to strengthen capital and liquidity at investment bank holding companies far beyond what the banking standards require, and we immediately entered into a formal Memorandum of Understanding with the Fed to share both information and expertise. But the fact remains that no law authorizes the SEC to supervise investment bank holding companies let alone to monitor the broader financial system for risk.

For the moment, this regulatory hole in the statutory scheme is being addressed in the market by the conversion of investment banks to bank holding companies. But the basic problem must still be addressed in statute by filling that regulatory hole, as I have reported to Congress on previous occasions.

I will conclude, Mr. Chairman, by warning of another similar regulatory hole in statute that must be immediately addressed or we will have similar consequences. The \$58 trillion notional market in credit default swaps, to which several of you have referred in your opening comments—that is double the amount that was outstanding in 2006—is regulated by absolutely no one. Neither the SEC nor any regulator has authority over the CDS market, even to require minimal disclosure to the market. This market is ripe for fraud and manipulation, and indeed we are using the full extent of our antifraud authority, our law enforcement authority, right now to investigate this market. Because CDS buyers do not have to own the bond or the debt instrument upon which the contract is based, they can effectively “naked short” the debt of companies without any restriction, potentially causing market disruption and destabilizing the companies themselves.

As the Congress considers reform of the financial system in the current crisis, I urge you to provide in statute for regulatory authority over the CDS market. This is vitally important to enhance investor protection and to ensure the continued operation of fair and orderly markets.

Mr. Chairman, I appreciate the opportunity to discuss the current market turmoil, and I look forward to answering your questions.

Chairman DODD. Thank you, Mr. Chairman. Just very briefly, we received your testimony about 20 minutes before the hearing began today. Other Chairmen over the years have talked about it, and again, I would just raise it briefly here with you. We need to get the testimony—and I appreciate the fact we did from other witnesses last evening. We need to get it from the SEC earlier than 20 minutes before a hearing.

Mr. Lockhart.

**STATEMENT OF JAMES B. LOCKHART III, DIRECTOR,
FEDERAL HOUSING FINANCE AGENCY**

Mr. LOCKHART. Chairman Dodd, Senator Shelby, and Members of the Committee, thank you for the opportunity to testify on the Federal Housing Finance Agency's decision to place Fannie Mae and Freddie Mac into conservatorship.

Fannie Mae and Freddie Mac share the critical mission of providing stability, liquidity, and affordability to the Nation's housing market. Between them, these enterprises have \$5.3 trillion of guaranteed mortgage-backed securities and debt outstanding, which is equal to the total publicly held debt of the United States. Their market share earlier this year reached 80 percent of all new mortgages made.

During the turmoil that started last year, they had played a very important role in providing liquidity to the conforming mortgage market. They required capital to support a very careful and delicate balance between safety and soundness and mission. That balance was upset as house prices, earnings, and capital have continued to deteriorate. In particular, the capacity to raise capital without Treasury Department support vanished. That left both enterprises unable to fill their mission. Worse, it threatened to further damage the mortgage and housing markets if they had to sell their assets.

Rather than letting those conditions worsen and put the financial markets in further jeopardy, FHFA decided to take action. The goal of these dual conservatorships is to help restore confidence in Fannie Mae and Freddie Mac, enhance their capacity to fulfill their mission, reduce systemic risk, and make mortgages—and this is the most important—make mortgages available at lower cost for the American people.

FHFA based its determination on five key areas, each of which worsened significantly over the last several months: First, there were accelerating safety and soundness weaknesses. Second, there was a continued and substantial deterioration in equity, debt, and MBS market conditions. Third, the current and projected financial performance and condition of each company, as reflected in the second quarter financial reports and our ongoing examination. Fourth, the inability of the companies to raise capital or to issue debt according to normal practices and prices. And, last, the critical importance of each company in supporting the country's residential mortgage market.

I shared our growing concerns with Federal Reserve Chairman Bernanke, who was made our consultant in the law you passed in July, and with Secretary Paulson. They agreed that a conservatorship was necessary, as did the boards of both firms. A detailed list of events leading to our conclusion to appoint a conservator is provided in my written statement. I will just highlight a few.

It became apparent during this intense supervisory review that began in July that market conditions were deteriorating much more rapidly than anybody expected. We supplemented our examination team with senior examiners from the Fed and the OCC. All three sets of examiners corroborated that there was a significant deterioration in the credit environment and it was a threat to the capital of these two companies. We also finished our semi-annual examination ratings of the companies and, across the board, there were significant and critical weaknesses.

The companies themselves disclosed in their second quarter filings how rapidly the environment had deteriorated and was negatively affecting their outlook and their ability to raise capital. Freddie Mac reported losses of \$4.7 billion over the last year. Fannie Mae reported losses of \$9.7 billion.

Now, let me turn to the conservatorships. The first signs are that the conservatorships are positive. The enterprise funding costs and the spreads on MBS have declined. This lower cost has been passed on to homebuyers, with 30-year mortgage rates well below 6 percent for the first time since January. On the first day, business opened as normal but with stronger backing for the holders of their mortgage-backed securities, their debt, and their subordinated debt.

Over the next 15 months, they are allowed to increase their portfolios to provide support to the housing market. They will also be able to continue to grow their guaranteed MBS books.

As the conservator, FHFA assumed the power of the board and management. Highly qualified new chief executive officers and non-executive chairmen have been appointed. They will be delegated significant powers. In order to conserve over \$2 billion in annual capital, the common stock and preferred dividends were eliminated.

The U.S. Treasury financing facilities, which are critical to this conservatorship, are all in place and will provide the needed support to Fannie Mae and Freddie Mac to fulfill their mission over the long term, while giving upside potential for taxpayers. FHFA will continue to work expeditiously on the many regulations needed to implement the new law. The new legislation adds, importantly, affordable housing, a trust fund, and mission enforcement to the responsibilities of the safety and soundness regulator. We are also continuing to work with the enterprises on loan modifications, foreclosure preventions, pricing, and credit issues.

The decision to appoint a conservator for each enterprise was a tough but necessary one. They can now become part of the solution. Unfortunately, all the good and hard work put in by the FHFA and the enterprises was not sufficient to offset the consequences of the antiquated regulatory structure which was overwhelmed by the turmoil in the housing markets. Conservatorship will give the enterprises the time to restore the balances between safety and soundness and their mission.

Working together with the enterprises, Congress, the administration, and other regulators, I believe we can restore confidence in the enterprises and, with the new legislation which you passed, build a stronger and safer future for the mortgage markets, homeowners, and renters in America.

Thank you. I would be pleased to answer questions.

Chairman DODD. Thank you very much, Mr. Lockhart.

Senator Tester was presiding over the Senate when we were gathering here, and everyone else had a chance to make a brief comment. And, Senator Tester, do you have a brief comment you would like to make?

STATEMENT OF SENATOR JON TESTER

Senator TESTER. I do. Thank you, Mr. Chairman, and thank you for allowing me to just ask a few questions.

Ten years ago, I got involved in politics because of electrical deregulation in the State of Montana. It was a total disaster. I have got plenty of questions to ask about the plan, and I will as they come forth. But I guess my concern is this: Six months ago, we heard about Bear Stearns, and then we have had Fannie and Freddie, and we have had some other ones come down the pike. A week ago, you came forth with a \$700 billion bailout plan—\$700 billion, and it was made clear that this was going to be—there was going to be nothing added on to it. Accountability, demand of re-regulation was not going to be accounted. And my question—and this is the concern I have. You guys are a lot smarter in financials than I am. I am a dirt farmer. You guys have been in the business, former Chairman of Goldman Sachs. Why do we have 1 week to determine \$700 billion that has to be appropriated or this country's financial systems go down the pipes? Wasn't there some opportunity sometime down the line where we could have been informed of how serious this crisis was so we could take some preventative steps before this got to this point?

That is it. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator, very much.

Well, again, we will turn the clock on here and try and move along, and let me pick up sort of on that question. I appreciate, Chairman Bernanke, your laying out why you think this particular plan will work. But I would like you, if you could, to step back, in addition to laying out why you think the plan would work, tell us—and, again, Senator Schumer mentioned the other evening when we sat on Thursday night, the reason why we have to act. Put aside whether or not we are going to act this week or next week. But for a minute tell us why you believe it is critically important, one, that we act; what are the circumstances out there that warrant us responding as quickly as we are being asked to; and, second, do you believe that the amount being asked for is going to adequately address the issue, particularly if we adopt the plan as suggested by the Secretary?

Mr. BERNANKE. Mr. Chairman, the financial markets are in quite fragile condition, and I think, absent a plan, they will certainly get worse. But even in the current state, they are not serving the necessary function to support the economy. Credit is not being provided. As Secretary Paulson mentioned, non-financial companies

are not able to finance themselves overnight. Credit is just not going to be available. It is going to also affect savers because of the values of their assets that they have.

So even in the current condition, even if things do not get severely worse—but I think they would get worse without some kind of action—this will be a major drag on the U.S. economy and will greatly impede the ability of the economy to recover in a healthy way.

The amounts involved are intended to be enough. We do not want to go in and overwhelm the situation. That might be to suggest more problems down the road. There have been some ways of looking at it. This is about 5 percent of all the mortgages outstanding, for example, \$700 billion. But it certainly illustrates the size of these markets and the size of the problem.

I think it is important to state that, as I mentioned before, this is not an expenditure of \$700 billion. This is a purchase of assets, and if auctions are done properly, if the valuations are done properly, the American taxpayer will get a good value for his or her money. And as the economy recovers, most all or perhaps more than all of the value will be recovered over time, as was the case in other similar situations in the past.

Chairman DODD. Let me ask you this. Again, we have heard our colleagues, again, across the spectrum here, both politically and geographically, talk about the impact this is having beyond, obviously, the information we are aware of in terms of firms that have disappeared or been consolidated and the concerns about what is happening to people in the country, their homes being lost and the like.

Explain, if you would, what is your concern as Chairman of the Federal Reserve if we were not to act. Give us some idea of what you think the implications would be if we did not respond in one way or another to this situation that you just described.

Mr. BERNANKE. Well, again, I think—

Chairman DODD. In terms of what happens outside of the financial services sector, what happens to people out there who have a job, are getting ready to retire, are worried about their kids' education? These are matters which are going to be directly affected, I presume. That is the argument you are making. Give us some sense as Chairman of the Federal Reserve why those people's concerns are going to be even more dire straits than they would be if we did not act.

Mr. BERNANKE. Senator, you made my point for me. I am a college professor. I was criticized for taking the job without having worked on Wall Street. I never worked on Wall Street. I do not have those interests, those connections. My interest is solely for the strength and the recovery of the U.S. economy. I believe that if the credit markets are not functioning, jobs will be lost; the unemployment rate will rise; more houses will be foreclosed upon; GDP will contract; that the economy will just not be able to recover in a normal healthy way, no matter what other policies are taken.

I, therefore, think this is a precondition for a good, healthy recovery by our economy. These institutions provide credit for homeowners. They provide credit for businesses that create jobs. It is about the people who need those services and that credit. It is

about people retiring who need to have assurances about the value of their investments and their assets.

Again, I think that if this is not done, there will be significant adverse consequences for the average person in the United States.

Chairman DODD. And that is your recommendation as Chairman of the Federal Reserve?

Mr. BERNANKE. Yes, sir, it is, and I do believe we need to act to stabilize the situation, which is continuing to be very unpredictable and very worrisome.

Chairman DODD. Let me, if I can, look just quickly at the foreclosure mitigation issue. I think there is general consensus here about oversight and accountability. We may argue about specifics, but I think every one of us here feels very strongly that there has got to be strong areas now. I think we all sort of agree as well on the issue of taxpayer protection, one way or the other how the taxpayers are going to be covered in this proposal.

There is, I think, greater debate probably about foreclosure mitigation, but let me run back, if I can, and remind you in May what you told this Committee. You said, "High rates of delinquency and foreclosure can have substantial spillover effects on the housing market, the financial markets, and the broader economy. Therefore, doing what we can to avoid preventable foreclosures is not just in the interest of lenders and borrowers. It is in everyone's interest." That was Federal Reserve Chairman Bernanke.

Would policies that help American families keep their homes and prevent foreclosures help address the root cause, in your view, of the present crisis?

Mr. BERNANKE. Well, foreclosures are not all of it, but it is an important part. The housing market is very central to this whole issue, and I support and I have supported efforts to avoid preventable foreclosures. I have spoken about this on a number of occasions, and I think it would be helpful to the economy.

I would note that steps have been taken. The GSE conservatorship, for example, has already lowered interest rates and has helped to stabilize the mortgage market, which will be supportive of house prices and, therefore, reducing foreclosures.

The Federal Reserve is on the board of the Hope for Homeowners bill that was just passed by this Congress that involves \$300 billion of purchases of mortgages to be refinanced into the FHA. I am sure much more could be done. I will support further action.

I would note two things. First, as a minor point, one of the things that this program being discussed could do would be to purchase second liens, which have proved to be a very significant barrier to the resolution of foreclosures. But, more importantly, the housing market is not going to recover if the economy is declining, if jobs are being lost, if credit is not available. And so I do think you cannot separate these as two completely separate issues. You need to have financial stability and financial markets working properly for the economy and the housing market to have a chance to recover.

Chairman DODD. Well, my quick follow-on question, then, to Secretary Paulson is—and I understand why you have been reluctant to get into the oversight and accountability questions. But given the fact that this is not just a cosmetic issue and a feel-good issue but it goes to the very core of why we are here today, and if that

is the core reason—and you have said it over and over again. I have quoted you. It is the “bad lending practices” that went on. Why didn’t we include some mitigation for foreclosure as part of this, not because we want to send a message that we care about Main Street, but because if we do not address that, the bad mortgages out there are still going to be a lingering problem, and our ability to address this is going to be less.

Secretary PAULSON. Mr. Chairman, thank you very much. As we thought about what is the best thing we could do to minimize foreclosures and deal with this problem, we thought, first of all, stabilizing Fannie and Freddie; second, Treasury has a program where we are going to be buying and holding agency securities, and now that the Government is really behind them, it is, I think, a good use of taxpayer money, and it will help get—it will help the market. And then, of course, we all believe that the very best thing we can do is make sure that the capital markets are open and that lenders are continuing to lend. And so that is what this overall program does, it deals with that.

Now, as the Chairman said, we both have been very involved in working with servicers and others in avoiding preventable foreclosures, and there is no doubt that this program will give us more leverage in doing that, given the securities that will be owned, the second-lien mortgages and so on. So that was the way we looked at it, and we looked at it, let’s address the root cause through these authorities we are asking for.

Chairman DODD. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

I would like to address my first question to Secretary Paulson and Chairman Bernanke. I assume that during your deliberations dealing with this crisis, you must have considered a range of proposals before you decided on the one that you proposed to us. Is that correct? Is that right, you considered other proposals?

Secretary PAULSON. Yes.

Mr. BERNANKE. Yes.

Senator SHELBY. Could you just in a few minutes describe several of the proposals that you considered, telling us in detail in specific terms why those proposals were deemed inadequate by both the Treasury and the Fed?

Secretary PAULSON. OK. I will go first. We have, as you know, Senator, been talking with Congress and talking among ourselves for some time about what is going on in the housing area. And we have worked very hard together to approach the foreclosure issue. And so there is a lot of work that was done in dealing with foreclosures, No. 1.

No. 2, as you yourself have said, you saw some case-by-case approaches, and, you know, I would argue that every one of those was absolutely essential and was necessary. And as we looked at this situation, we said the root cause of this is housing. The root cause is housing and the housing correction, and until we get at that, we are not going to solve it.

And as we looked at how we get at that, there are some that said we should just go and stick capital in the banks—put preferred stocks, stick capital in the banks. And that is what you do when

you have failures. That is what happened in Japan. That is what happened in other spots.

We have dealt with some failures, and we have dealt with them where there is capital. But we said the right way to do this is not going around and using guarantees or injecting capital—and there have been various proposals to do that—but to use market mechanisms. And, again, I think that some of the questions here and some of the frustration here I share, you know, on compensation and so on. And when you deal with ad hoc situations, when you deal with an institution that is failing or about to fail, and you have to buy mortgages or securities well above value, or you need to put capital in, then you take tough compensation measures.

But as we looked at it and thought about this—and we consulted together about this, you know, for a long time—and said ultimately—and we hope we do not get there. We hope that this decline can be arrested. But we both had said that until the biggest part of the correction in housing prices is over, there is no way to really have a stable financial system. So we decided that this market mechanism and going out very broadly—this is broadly to financial institutions all over, and working on the asset prices and helping develop value that the market can build around.

Senator SHELBY. Do you agree with that, Chairman Bernanke?

Mr. BERNANKE. I do, Senator, but let me just add a couple comments.

As you know, I am a student of financial crises and financial history, and we have looked at past experiences in the United States and other countries, like the Homeowners Loan Corporation, the RTC, the RFC, Japan, other situations. Those were all situations, again, as the Secretary said, where you were dealing with failed institutions and having to dispose of relatively simple assets that were taken over by the Government. That works in that context, and there are ways to do that.

The situation we have now is unique and new. It involves not failing institutions—although we have had a few failures. Where we had failures, we dealt with them in a very tough way. You know, we have insisted on, you know, bringing the shareholder value down close to zero, imposing tough terms and so on. But the firms we are dealing with now are not necessarily failing, but they are contracting, they are de-leveraging, they are pulling back. And they will be unwilling to make credit available as long as these market conditions are in the condition they are.

So, in order to address the illiquidity of the market and how to deal with these complex securities in the hands of going concerns, the methods used to resolve failed institutions in other contexts are not really appropriate because that would involve, I think, a great deal of concern on the part of other potential investors that if they invest in a bank that the Government is going to come in and take away their value. So I think that we are better off trying to address the root cause of the problem.

Senator SHELBY. What banks would be eligible to participate in this plan, assuming Congress adopted it as you proposed it, in selling their nonperforming assets to the Treasury or to an entity? And what size banks would be eligible to participate in that plan?

Secretary PAULSON. Senator, thank you for that question, because that is where I think there have been broad misunderstandings, and maybe we did not communicate this properly. But what we are seeking to address with this is we are seeking to address—first of all, we are dealing with complicated securities, mortgage and mortgage related, and we have got various asset classes here, and we need different approaches for different asset classes. But when we use the market mechanisms, we want—we are looking at thousands, you know, of institutions. Because to make this run properly, we need to deal with big banks, small banks, S&Ls, credit unions, because what we are trying to do here—and I think we will be successful—is to develop mechanisms where we get values out there, and where there is some value that the market can look at, then private capital will come in.

Senator SHELBY. Are you planning to buy assets of foreign banks doing business in the United States? And if so, why? And how do you rationalize that the American taxpayer?

Secretary PAULSON. The answer is yes, and it is very easy to rationalize it to the American people.

Senator SHELBY. I need your help here.

Secretary PAULSON. OK. Here is how I want to—this is all about the American taxpayer. That is all we care about. And so any business, any banking operation in the United States that is doing business here and dealing with the American public is important. They are all important to keeping our markets open, keeping credit flowing. The American public, when they are dealing with the financial system, does not know who owns that bank. What they care about is how is the system working. And so we are doing this to protect the system, and it is about keeping credit flowing, protecting savings, making it possible to have car loans, student loans, mortgages.

And, again, if you have operations in the United States and you are doing business with the American people, that is what we are focused on. But let me also say to you we have a global financial system, and when I was on the phone a number of times, and most recently Monday morning, talking with central bankers and finance ministers around the world, I urged them all to put in place where it is necessary similar programs with similar objectives.

Senator SHELBY. What do you say to people that ask us, or at least ask me—and I am sure others—how do you rationalize or justify bailing out banks and so forth that cause, are the root cause of a lot of this problem where they will be made whole with capital, at least it will strengthen them? And I understand that strengthens the economy, but they will profit dearly from this, more than likely.

Secretary PAULSON. Senator Shelby, I share your frustration, so I hate to be on this side of the table, because this is not something that I ever wanted to ask for.

Senator SHELBY. I know.

Secretary PAULSON. But it is much better than the alternative. So what I do is I start off saying I am not only concerned, I am angry by the things that got us here. OK? But the greatest protection for the American taxpayer, by far the greatest protection is

having this program work and having it be effective, because the consequences if it does not are worse.

When the credit markets—you asked Chairman Bernanke about what would happen if it did not work. I looked at the——

Senator SHELBY. Worst-case scenario under your plan. What if it does not work? You know, you assume it will work, but you cannot assure us that you know it is going to work because you thought some of the other plans would work.

Secretary PAULSON. Well, let me say this: With all due respect, Senator, I believe that Freddie and Fannie worked the way it was supposed to work. We stabilized that. And in terms of the other actions, I would very respectfully submit, if the Federal Reserve had not stepped in on AIG, we would have been facing a major calamity. So, again, I do not think any—this problem has been growing for a long time.

But to get to your question about this plan working, it gets to the root cause—housing; deals with illiquid assets; it is going to free up the balance sheets, let capital flow; and it will lead to price discovery, private capital coming in, and injecting confidence in the markets.

Senator SHELBY. What does it do to the homeowner who is losing their home? And thank you, Senator Dodd, for your——

Secretary PAULSON. I would say, regrettably, there is not every homeowner that is going to save their home. As you well know, even in normal times, in good times, there are many foreclosures. There are some people that cannot afford to stay in their home. But there is a huge effort being made so that everyone that can afford to stay in the home and want to stay in the home stays in the home.

But what this plan will do is make financing available. And I do not think there is anything more important. Lenders have got to keep lending. If they are not lending and there is not capital available, homeowners are not going to be able to stay in the home.

Chairman DODD. Thank you very much.

Senator JOHNSON. And let me just remind my colleagues, we want to try to keep to the time. We are going over, and I want to give everybody a chance to ask some questions.

Senator JOHNSON. Secretary Paulson, the Treasury proposal, it seems to me, rewards the bad actors. Those financial institutions that engage in irresponsible lending have bad assets on their books and need help from the Government to stay afloat. What punitive actions are being taken against these companies and their CEOs?

Secretary PAULSON. Senator, thank you for the comment. The first thing I wanted to say is this plan is broad based and it is dealing with the root cause. And when we have needed to come in and do something to save a failing institution, there have been very harsh consequences. And when we deal with one-off situations, I think there always should be very significant consequences. That is No. 1.

No. 2, in terms of what needs to be done to fix the system, we could have a long conversation about that, and you are going to be busy for a long time, and you are going to be busy after I am gone doing that. I have given you my suggestions, and they are sugges-

tions that have to do with a totally outmoded and insufficient regulatory structure.

When I got down here and after about several months on the job, I was shocked, absolutely shocked, to find it was not deregulation or too much regulation or too little regulation. It was just a flawed regulatory structure. It was built for a different model, for a different financial system. The financial system changed. The regulatory system did not change. And so that clearly has to be corrected.

When you look at these mortgages, the vast majority of the mortgages that were originated with very, very shoddy procedures were regulated at the State level. OK? You cannot come down here, come down to Washington at Treasury Secretary and fix all that. We made a proposal that I think is the right proposal for this mortgage origination commission, which would be a Federal commission not to invalidate State regulation but to make sure there are common standards enforcement.

So there are a lot of things that need to be done, and in terms of the compensation issue, there are a lot of things that need to be done there. But I would respectfully submit that we cannot do those as quickly as it takes to get this system up and running, because that is what you care about. You care about the constituents in your State, the average people, and Americans in terms of what the impact is going to be on them. And, unfortunately—and it may make you angry; it makes me angry—when you ask about the taxpayers being on the hook, guess what? They are already on the hook. They got put on the hook by the system we have, the system we all let happen, the system that Congress, the administration, future administrations let exist. And so if this system is not stabilized, they are going to bear the costs. The Chairman explained that. I have explained it. So the best thing we can do for all of them is to stabilize the financial markets so that people can continue to get loans, small businesses can get loans, small farmers in your States can get loans, big farmers in your States can get loans. And then go to work to make sure that this does not happen again, and that is going to take a longer period of time.

Senator JOHNSON. Given what occurred with AIG, should the Federal Government regulate some or all insurance companies? Would an optional Federal charter model be appropriate?

Secretary PAULSON. Well, in the regulatory blueprint that we put forward to there—we put it forward well before we were in the midst of this crisis, something we had been working on for a long time. There were a series of recommendations. One was that the Federal Reserve play the role of macro stability regulator to look for excesses and problems throughout the economy. Another was there should be a Federal charter for insurance companies. I strongly believe that. There is a lot of debate on both sides of the aisle here. That will take, in my judgment, a good deal of time to sort out. But that would be my judgment on that one.

Senator JOHNSON. Chairman Cox, last week, you issued several emergency orders regarding short selling. How did the SEC determine which firms to include? And what happens when the orders' 10-day period expires?

Mr. COX. Senator, this is not a step that we took lightly. With the support of the Federal Reserve and the Treasury and a unanimous Commission, we took temporary emergency action directed at financial stocks for the purpose of stabilizing the market at a time when Congress is considering important legislation that may deal in a broader way with these problems.

The financial sector is defined according to standards that the SEC has provided to the exchanges. The exchanges themselves are making the particular determinations of whether their listing companies fall within those categories.

When the order expires, which it will because it is an emergency order, we will segue into sturdy protections against naked short selling. We already have permanent rule changes that have just taken place in the last week to make even stronger the existing ban against naked short selling.

Senator JOHNSON. Mr. Lockhart, what will the GSEs look like when they come out of conservatorship? And how long do you plan on having them in conservatorship?

Mr. LOCKHART. We will certainly be working with the two companies and their new management teams to rehabilitate themselves and work through the issues. The time period will depend a lot on what is happening in the housing market and their ability to raise capital in the future. That may take a year or even longer. How they will look, to a large extent, may depend on where Congress wants to go.

The legislation that was passed in July—and I thank you for passing that legislation—does create a much stronger regulator with the kinds of tools that would be needed to regulate these companies going forward.

Chairman DODD. Thank you, Senator.

Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

Chairman Cox, I would like to spend time with you on the short selling issue. As you know, I have spent a lot of effort pursuing that, and I want to thank you for the diligence with which you have pursued that.

Having said that, I am driven by the conversation to concentrate on Secretary Paulson and Mr. Bernanke, so do not take my passing over it as a symbol that I am not still intensely interested, because I am, and that I am not supportive of what you have done, because I am. I think you have done an excellent job, and I appreciate that.

Chairman Bernanke, you ran us through a tutorial, true to your college professor background, which I found very helpful, talking about the difference in hold-to-maturity prices and fire-sale prices. And there is going to be an auction, presumably, to determine what the fire-sale price is or what the hold-to-maturity price is. What are people going to be bidding on, do you think?

Mr. BERNANKE. Well, we know more or less what the fire-sale prices are. Those are the marks that a lot of companies have.

You know, there are a lot of different ways—auctions, auctions combined with expert evaluations and so on—to try to determine the hold-to-maturity price. So, for example, if the Government tries to acquire a substantial portion of a security, the marginal seller would be somebody who has a hold-to-maturity interest in it, for

example. So I think there are methods to determine that hold-to-maturity price.

Senator BENNETT. OK. Well, the best place to determine a price, obviously, is willing buyer and willing seller. But this is not going to be your ordinary auction because the Treasury is going to be there with a \$700 billion checkbook. And the question that arises in my mind is: Who is going to bid against the Treasury? Against whom is the Treasury bidding? And what effect will that have on the price?

Mr. BERNANKE. It is a reverse auction, which means that there will be many bidders holding these securities who will be bidding the lowest price in order to sell them to the Treasury, which is the reason why you do not want to limit participation—

Senator BENNETT. So that is an offer, not a bid?

Mr. BERNANKE. Sorry?

Senator BENNETT. That is an offer price, not a bid.

Mr. BERNANKE. Well, it is a reverse auction so that people are bidding in order to sell rather than to buy.

Senator BENNETT. OK. Secretary Paulson, do you anticipate that this might attract some outside capital into this auction and say that looks like a pretty good price and I would like to own it at that price?

Secretary PAULSON. Not exactly that way, but here is—and, again, let me come back and say to you the reason we asked for broad flexibilities—and the Chairman said it earlier—is that we are dealing with complex securities. We are dealing with many classes of securities. We are going to need to use different approaches in different situations. So the reason we have been general and talked about market mechanisms, we are going to have to involve experts, we are going to have to use different approaches. The Chairman said, you know, Treasury, we are going to need to get some really good asset managers, we are going to—we will do a certain amount of experimentation. But if this works the way it should work, that once there is a, you know, bid from Treasury and there is more learned about these securities, the thought would be that then it is easier for private capital to come into the market; and that there will be some price discovery mechanism.

Now, again, the—

Senator BENNETT. Let me just comment on that. The price discovery mechanism in a simple world—and you are describing a very complex, un-simple world—has to do with the cash-flow the underlying asset will produce. And I would think the problem here is determining what that cash-flow is. Is that what you are bringing all these experts to determine what—

Secretary PAULSON. I wish it were that simple because—and even that would not be easy. But what the Chairman said, when he presented, he said no one has been faced with this situation before. We spent a lot of time thinking about it, and there are different types of asset classes—mortgage derivatives, mortgage-backed securities. There are different whole loans. And so when you look at dealing with this, we are going to have to use different approaches in different situations, and there will be market-based approaches, and that is all—even I cannot sit here and figure out

what the auction technique should be and how to use it and in what situations to use it.

So what we asked for was broad-based authority to use a series of market-based approaches, and we will be dealing in different approaches in different situations. We cannot sit here and say here is the reverse auction we are going to use in every situation. So we need flexibility.

Senator BENNETT. My time is up. I understand that. My time is up. I just wanted to leave this last comment. This is the whole core of what you are trying to accomplish, and this is the whole problem with our giving you blank-check authority to accomplish it, because in theory it is easy to describe and it will work, but if you end up paying too little to these institutions, which mark-to-market accounting might drive you to, you are not giving them the support that they need. If you end up paying too much, then there is no upside potential for the taxpayer when the time comes for you to liquidate these, and the details of how you find the right balance here are the ones that all of us need—you, but certainly as much as we—all of us need to understand better as we make our determination whether or not to support your proposal.

Secretary PAULSON. You are right, and you have defined the problem, and the problem is easier to define than to solve. And we believe that we are going to get the right group of experts and we are going to come up with a solution, and it will be different with different asset classes and in different situations. And as I said, this should not be confused—and some people have confused it—for instances where you need to go in and, you know, do things that are extraordinary things to save an institution. So those are two different actions.

But for the system to work the way it needs to work, we need a broad group of institutions—banks and S&Ls—to want to participate, and we need them to participate, not just those that are under immediate pressure. And so for this to be effective, it has got to be designed to have it work that way.

Senator BENNETT. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator Reed.

Senator REED. Thank you very much, Mr. Chairman.

Chairman Bernanke, the equity participation rights which were a central part of the AIG arrangement, were they punitive in nature?

Mr. BERNANKE. Well, they are 80-percent participation.

Senator REED. Well, no, was that a way to punish—

Mr. BERNANKE. Our terms included, besides 79.9 percent, an interest rate, which is currently over 11 percent and essentially a super lien on most of the assets of the company. So I think that it is a very tough deal that we struck. We did that because we wanted to protect the taxpayer. At the same time, we were concerned about the implications for the markets of the failure of this large company.

I would like to say, I think we do have a serious “too big to fail problem” in this economy. It is much worse than we thought it was coming into this crisis. And as we go forward, we need to develop methodologies to reduce that “too big to fail” issue.

Senator REED. But why wouldn't equity participation rights work in this arrangement to protect the taxpayers and reimburse the taxpayers, particularly with the difficult problems of pricing these securities, the different arrangements that Secretary Paulson suggested might be undertaken, and the need, really, to assure the public that this is not a one-way salvation for Wall Street at the expense of taxpayers?

Mr. BERNANKE. The reason is that when we dealt with Bear Stearns or AIG or Fannie and Freddie, those were situations where the company was about to fail, had no option. We came in to prevent failure for systemic reasons. In those situations, it is appropriate to knock the share values down low to reduce the moral hazard for subsequent events. But if we are dealing with going concerns, companies that, you know, are still operating, have reasonable business prospects, we do not want to threaten the companies with reducing their share values to zero because that will obviously—

Senator REED. Well, no one is suggesting that you reduce their share values to zero. But I think in that context of going companies, this program will be strictly voluntary. There will have to be a business judgment made by the managers of that company whether it is worth it to them to enter into this transaction to rid their balance sheets of toxic assets. Right now the price of admission is zero. I think it is not inconceivable or inappropriate to demand in that calculation they recognize if they will benefit from this transaction in the future—and that is the notion of participation in the future—that they will share that benefit with the taxpayers who made the benefits possible.

Mr. BERNANKE. We just would note that if you leave the risk on the balance sheet in that way, you really have not accomplished anything.

Senator REED. Well, if a company is willing to accept that risk, manage those risks themselves, they do not need a bailout. If they are unwilling to do that or cannot do that, then they should pay for it, at least in a contingent fashion, which is the essence of this whole issue of participation rights or warrants or whatever you would like to call it.

Secretary PAULSON. Let me approach it this way. This is a huge—

Chairman DODD. Turn on your microphone so we can hear you, Mr. Secretary.

Secretary PAULSON. Approach it this way. When you talk about what the companies need, this is not about the companies. This is about the American people. We need something to work. And for something to work here, rather than going to a group of troubled institutions that need to sell and saying here we are, sell to us, you know, here are all the things we want from you in turn for that, we need—and we want for this to work—a broad range of institutions to willingly—not that we have to go and sign them up, but to willingly participate because we are trying to find value and we are trying to get markets working, because we do not want to have to deal with a failure.

RTC is about failure. Putting capital in institutions is about failure. This is about success.

Senator REED. Mr. Secretary, you are suggesting that these very brilliant financial people who run these companies would risk the failure of their enterprise by not participating in this function because now we have imposed a contingent reimbursement to taxpayers.

Secretary PAULSON. Let me just say one more time. I am as frustrated as you are about compensation—

Senator REED. This is not about compensation, Mr. Secretary. This is not about what they get paid. This is about when they do well, and if they don't do well, the value of those warrants are zero.

Secretary PAULSON. Here is what I am saying: that if this—when we protect the taxpayer, the right way is to have the program work and have the assets appreciate when the economy appreciates. I am saying that the model you are looking at is a model where we go to people that absolutely need to sell and say, If you want to sell, give us something. The model we are looking at—and what we believe it takes to be successful here—is to go to a broad group of institutions, a very, very wide range of institutions that own these assets and have them participate. And if we deal with it selectively, as we deal with situations where there is serious trouble, to use a different approach.

But, anyway, I appreciate your comments.

Senator REED. Well, Mr. Secretary, the one other way to describe what you just said is to go to some institutions that do not need help and we give them help for free. But let me change the subject, if I may, and I am indulging the Chairman's time.

In this reverse auction, it is a very difficult set to price, but one of the principles—would one of the principles be that someone cannot sell to you or bid to you at a price higher than what they paid for? Because today there are firms that are collecting distressed assets at discount prices. If you do not have some protection like that, they will walk in and they could very well sell you something that they paid much less for.

Secretary PAULSON. Well, first of all, Senator, we are going to be dealing and our intent is to be dealing with regulated financial institutions. OK? That is No. 1.

And, No. 2, the reason we want to deal with it on a broader basis is so we do not get into that situation.

But, third, let's not focus on one reverse auction. That is one way of doing it. There will be a number of market mechanisms. I think a reverse auction—and there are different forms of that.

Chairman DODD. It is not regulated.

Senator REED. Mr. Secretary, then you would not oppose language in legislation that would restrict this to regulated financial institutions.

Secretary PAULSON. What I would like—rather than negotiating language here, what I would like is I would like as much flexibility, but the intend would be to deal with regulated financial institutions with business operations in the United States.

Senator REED. Thank you.

Chairman DODD. That is a very important point, the definition of a financial institution and whether or not you would limit it to regulated financial institutions.

Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman, and I appreciate the questions that Senator Reed had. I had a number of those, too, on equity sharing and future assessments. Actually, all the questions that I have, I would like everybody to answer them, but we do not have time to do that. So I will ask them of one person, and I would hope that you would have your staffs get together and answer for me later, but not very late.

One of the things that follows up on Senator Reed's question is what happens if Treasury cannot price the assets accurately. This is for Secretary Paulson. Shouldn't we have the process designed before we do \$700 billion in an experiment? Treasury has to set the perfect market for the assets, and I am not sure that I have faith in the ability of the Federal Government to emulate the free market. How can an artificial market drive a real market for these assets?

Secretary PAULSON. In terms of that, I would say you have pointed to the complexity and the difficulty. I would very respectfully say that if the Federal Government tried to legislate a prescriptive solution, it almost certainly would not work when you are getting into the market mechanisms.

Again, you are asking me about free markets and how the Government is going to work better than free markets, and, listen, I have never been a proponent of intervention. And I just think we have an unprecedented situation here, and it calls for unprecedented action. And there is no way to stabilize the markets and deal with the situation other than through Government intervention. And so what we are going to do, we have put forward something we have thought about for a long time in terms of the issue and different ways of dealing with the issue. And so what we are asking for is some broad powers with some good, strong oversight, and we think that is the best way to protect the taxpayer. That is our view.

Senator ENZI. I want to get into something a bit more specific on that because I am concerned about the small banks in this reverse auction situation. A lot of the details are left out. As you say, you do not want it to be prescriptive. But the reverse auction that you described in your testimony—

Secretary PAULSON. We are not just recommending a reverse auction. That would be one way of handling it.

Senator ENZI. OK, but just on the reverse auction part of this, I mean, we are going to have questions on all parts of it, but I think it will help the big banks to sell their toxic debt. But what about the smaller banks? How are they going to be able to compete with the Citigroups in the world to sell their assets? Economies of scale suggest to me that the plan will bail out the big banks, and our community institutions might be left holding the bag. What kind of consideration has been given to that?

Secretary PAULSON. Well, that, we are very focused on that—very focused—because to have this work right we are going to have to go broadly, because only by going broadly in a number of these asset classes and these securities are we able to really deal with the market. And so that is something that we have very much in mind. And if this were just about going to a few big banks, we

would have designed an entirely different program with a different structure.

Senator ENZI. Thank you.

Chairman Cox, I am always interested in the accounting aspects of all of these things and the effect that they can have on it. And I have been looking at getting some authority to suspend the mark-to-market accounting. I know that writing regulations takes a long time, but sometimes if it is included in congressional language, it can short-circuit that and make it possible.

Another area that I have gotten a lot of comment from, the small banks that hold the GSE stock, they prefer that that be considered a loss to the bank rather than—a loan loss rather than a stock loss. Some implications like that, I hope that you are taking a look at them. I know that we have talked about this being a fire and wanting to put the fire out before we address the fire code. But I am hoping that we will take a look at all tools and make sure that this proposal has all the tools possible so that we are not throwing water on an electrical fire.

Have you given consideration to whether Congress would need to act on some of these accounting things or whether you have enough authority to do that?

Mr. COX. Senator, both the United States and international accounting standard setters are very focused on the need to provide timely guidance on the fair value issues that several of you have raised here this morning and this afternoon. In fact, today the FASB's Valuation Resource Group is meeting to address these very application issues in the context of U.S. generally accepted accounting principles, with a goal of providing timely guidance to companies.

Senator ENZI. Thank you. My time has expired. I will have additional questions.

Chairman DODD. Thank you very much, Senator.

Senator SCHUMER.

Senator SCHUMER. Thank you, Mr. Chairman, and I thank all the witnesses. This is not an easy day.

One of the things that I mentioned I want to focus on is taxpayers, and so I have a couple of questions in that regard, first to Secretary Paulson.

One of the things I have thought about is whether we shouldn't create an insurance fund, similar to the FDIC, for the whole financial system. All firms over a certain size would pay, not small little community banks but everything else. They would pay a fee, not too onerous or too large, but over time it could help defray the costs of any losses we might suffer. It is the financial system that has the trouble and the taxpayers are bailing it out, as you say, in part because it will help the taxpayers. But why do the taxpayers have to do the whole thing?

What would be your initial reaction—I am not asking for a commitment here—of some kind of broad FDIC that would help pay for some of these losses from financial institutions, as I said, above a certain size, whether they participate in the program or not?

Secretary PAULSON. One thing that both the Chairman and I have talked about a lot, have spoken with the Chairman and Senator Shelby about, is that we were not left with the authorities we

needed fully to protect the system and the taxpayer because we have wind-down authorities with insurance for, you know, savings depositors, FDIC insurance. In 75 years, you know, we have not had a saver with FDIC insurance lose a penny.

Senator SCHUMER. It works. Yes.

Secretary PAULSON. You know, for \$100,000. So what you need is if—but if a non-bank or for someone without deposit insurance fails, in many cases there is just bankruptcy, and that throws the system into disarray. So—

Senator SCHUMER. But this would be different, the FDIC—

Secretary PAULSON. That is right. And so I am saying so if you had wind-down authority, then you have got to say, OK, how do you pay for it? And there are various ways to pay for it, and one way, as you have mentioned, would be some kind of broader industry-wide tax. But that is something we did not have, so—

Senator SCHUMER. You would be open to it, in other words.

Secretary PAULSON. Yes.

Senator SCHUMER. And would you think it might be a good idea, Mr. Chairman?

Mr. BERNANKE. Potentially, yes. But I think it is more important—

Senator SCHUMER. Well, I think I am going to cut you off right there.

Mr. BERNANKE. It is more important to—

[Laughter.]

Mr. BERNANKE. It is very important to try to address this “too big to fail” problem. It is a big problem.

Senator SCHUMER. Understood, but I think this—on the second question, again about protecting the taxpayers, I think in some of our informal discussions when we ask why \$700 billion and over how long a period of time, one of you, I think—somebody mentioned it would cost about—we would probably use about \$50 billion a month. If that is the case—and you are certainly not going to use all \$700 billion immediately. And as you can see, there are a lot of questions about whether this would work. We understand you have done your best, you think this would work best. But, clearly, we are in uncharted waters with Scylla and Charybdis around. What about doing this in tranches? Why couldn't you ask us for \$150 billion and on January 15th or January 20th we would come back, we would assess how this worked, and grant some more money if it is really working? Maybe, you know, the markets will have stabilized, and you actually will have made money. Why ask for the full \$700 billion? I never thought I would think that \$150 billion is a low sum of money, but compared to \$700 billion it is. And I think it would make people sit—not easily, but at least a little easier.

Secretary PAULSON. I will give you my answer, Senator. I think you got at it when you said when we come back in January, because what we need to do is we need to stabilize the system, and we need to—this is based on market—we need market confidence, and we need the tools to work with.

Now, of course, we plan to do this in tranches, and, again, as a number of people have said, this is not an expenditure. I know that

this does not fit into your outlay system in Congress. The taxpayer is on the hook.

Senator SCHUMER. Yes, yes.

Secretary PAULSON. But, again, it is purchasing assets. They will be held. They will be resold. Money will come back in.

Senator SCHUMER. Understood.

Secretary PAULSON. But to your basic question, we think we need the 440 for that size to do the job and stabilize the market.

Senator SCHUMER. Could you live with less?

Secretary PAULSON. That does not mean—that does not mean that it is going to be invested—be spent between now and January. We are going to—

Senator SCHUMER. Could you live with less? I think people would feel better if it were—if we did this and we could come back and reassess it. As I said, it is uncharted waters, so I am not asking you to support it now. But, again, could the system work if we put in the legislation, say, this is the first tranche and by January 15th, say—just pick a date—Congress will come back and reexamine?

Secretary PAULSON. I think that would be a grave mistake.

Senator SCHUMER. And why?

Secretary PAULSON. Because I think what this is about is about market confidence and having the tools to do the job. We are going to do this in tranches, but I am wondering, when Congress is gone and if we need—if we need this, what it is we do. And so, again—

Senator SCHUMER. Well, the President, if there is an emergency of any type, if this does not work over the next 2 months and the cataclysm that Chairman Bernanke has talked about, you are going to have to call us back into session if you need some other type of authority.

I have to tell you, I would ask you to think about this. I know ideally you would like to just have as much as possible. But you are not going to use \$700 billion in these 3 months. It is a huge sum of money, even \$150 billion. And the confidence in the markets will be determined by how well it works initially, not by how much money you have in your pocket next to your bazooka.

Secretary PAULSON. Well, I would say with all due respect, Senator, you are going to have to decide. The two of us have made the recommendation of what is required. As you said, this will not be spent or invested right away. It is going to be done in tranches. And all we are doing is giving you a—again, I do not like to be in this position asking for things and, you know, answering to the American taxpayer on this. I think this is—it is a sad story, but the American taxpayer, as I said, is already on the hook.

You know, here is the other thing I want to say to you, because it is so important. This is not about big financial institutions. Every American employer depends on money flowing through our financial system every day, not just to create new jobs, but to sustain and keep existing jobs. What we are playing with here is very important, and, again, give us the tools we need to make this work.

Senator SCHUMER. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Schumer, very much.

Senator Hagel.

Senator HAGEL. Thank you, Mr. Chairman.

Secretary Paulson, you have addressed a number of questions regarding reverse auction elements and how it would work. If you could explain to the Committee your concept of the implementation of the plan, focusing first on a framework of oversight, which you noted in your remarks why that was important. How do you conceptualize this working? Who would be the oversight? How would it work? I know Chairman Dodd has laid some ideas down. And then take us down from that, the oversight structure and then the implementation of the plan. You have noted, I think, in your words, the right group of experts that you would bring in on valuating equities and so on. Walk us through that.

Secretary PAULSON. First of all, in terms of—and this is what we are working through right now with your Committee and with others. We need to have transparency here. We clearly need protections. There has to be oversight. And we are going to work with you on that group. And we have to be effective and efficient, and we cannot get slowed down to the point we cannot do the job. And so this is a balance we are going to need to work on together.

And, again, as I said, in terms of the market mechanisms, we can spend—and I know our staffs have spent time together on this. But, again, there are so many different asset classes, some held by a very broad range of institutions, that what we are going to do is look to use market mechanisms and bringing in some of the very best asset managers and others to work with our people getting help from within the Government, help from, obviously, the Fed, other talent we have here, to make this work. But this is not a situation where we can come up and say, “Here is what we want to do, here is how we want to price it, here is exactly how the reverse auction will work.”

Senator HAGEL. I understand that, but that is not really the question. You understand, as does everyone on this panel, why these hearings are so valuable. They are valuable, in my opinion, first because they allow you to educate and inform the American people and the Committee as to how these kinds of things work. And there is a tremendous amount of misunderstanding, as you know—and as has been reflected by comments this morning—about how does this work. Are we just putting \$700 billion of taxpayers’ money out here with no oversight, with no structure?

So what I want to bring you back to is: Are you envisioning an oversight board, once-a-month meetings? Or just walk me through in very layman’s terms so someone could understand how are you going to do this. How are you going to implement it? Also, does the Treasury have the capacity and the capability to administer something this big?

Secretary PAULSON. Well, those are very good questions, and let me answer them.

First of all, we need an oversight board. OK? We need and we want it. OK? And so what—and the way I envision this working is with great transparency so that the board clearly knows what we are doing. We can explain this to the American people, as complicated as it is. Again, the process which we are looking at doing, which I think has been misunderstood, is something that would be broad based and—to a large extent, broad based. There may be

some parts of it that need to be more narrowly focused, and then we will deal with that and use different methodologies and different approaches to deal with that.

And so it would be something that, as we went along and as we started, we would probably start with a simpler set of securities, something simple like mortgage-backed securities as opposed to something more complicated. And we would go out, and we would do it—the first tranche would be, obviously, a smaller tranche, not a significant part of the \$700 billion. And we would get it out quickly into the market. And we would be very clear to people what it is we have done.

So that is as much right now as I can say to the American people other than that the key thing for the American people is that if this works the way it should work, with the assets, this is not an expenditure. This is an investment, and as the economy grows, as housing corrects, these assets should appreciate in value. The cost to the taxpayer will be far below what is invested in the assets. Some people have mentioned that under certain circumstances you could actually make money. We are not committing that. We are saying the taxpayer is at risk. And we have also said very up front that there is going to need to be some experimentation because we are dealing with things that have not been dealt with before. And so there will be experimentation in terms of experts. We are able to attract and we have attracted a variety of experts, and we are going to continue to bring them in. We want the best and brightest working this as we go through this.

Senator HAGEL. Mr. Chairman, thank you.

Chairman DODD. Thank you, Senator Hagel. Very much.

We turn now to Senator Carper.

Senator CARPER. Thank you very much.

First of all, a question for Chairman Cox, if I could. I have been out of the hearing for a while chairing a hearing on the census. The census has had its share of problems in the last year or two as well, and I think we are getting that resolved. I told the Director of the Census if we can finish getting the census ready, we might bring him in and help address this issue, and he offered his assistance.

A question for Chairman Cox. We talked a little bit earlier this week about short selling and the role that that has played in getting us into the jam that we are in today. And I know you have not just some thoughts but have taken a number of steps. Just a little bit of a Short Selling 101 for us, and what role do you believe it is playing, it has played in getting us to where we are today?

Mr. COX. Senator, the decision to intervene in market rules in this way was highly unusual and a very difficult one for the Commission. It is not a step that was taken lightly. It was taken with the support of and in coordination with the Secretary of the Treasury, the Chairman of the Federal Reserve, but also, importantly, international regulators. As you notice, the U.K. took this step, and we worked very closely to coordinate our actions with them. We have been in contact with our counterpart regulators around the world who are taking related actions in the current circumstances, narrowly focused on financial stocks. And the reason is based on the connection between the share price, which we have seen, and

confidence in the institution itself. We have got healthy institutions, or at least all institutions—perhaps there are none healthy anywhere, but if that is the case, we have the kind of problem that the Congress is here to address—that are put at risk if there is a downward spiral based not on normal information but on fear.

And so in this climate, we want to make sure that decisions in the market are going to be made in a way that protects the overall market and investors in it. But we also want to get out as quickly as possible. That is why this is an emergency order. It is very narrowly tailored, and it is time limited.

Senator CARPER. All right. Thank you.

I do not know if you all have gotten into this today. Let me just ask you this. The proposal offered by Senator Dodd includes the creation of a Special Inspector General. I believe my understanding from the House bill is they do not create an Inspector General, but they do call on the General Accounting Office, the Comptroller General, to play a role with respect to accountability going forward. And my question is for each of you.

I am going to start with Mr. Lockhart. I do not know if you have fielded a lot of questions today, but we are going to make sure you earn your keep here. We will turn to you first. What are your thoughts on the creation of an Inspector General to oversee this program? I am just going to come right down the line, if you will.

Mr. LOCKHART. Thank you, Senator. Actually, we are getting an Inspector General as part of the new legislation that was just passed. Inspector Generals are a useful part of the government process. I have found them useful, and I have certainly found working with GAO useful in my career as well.

Senator CARPER. All right. Thank you.

Mr. Cox, Chairman Cox.

Mr. COX. I would support it.

Senator CARPER. All right.

Mr. Chairman, Chairman Bernanke.

Mr. BERNANKE. I think that you have to have rigorous oversight, and OIGs—the Federal Reserve has an OIG, as do many other agencies, and they are very effective.

Senator CARPER. All right. Thank you.

Secretary Paulson.

Secretary PAULSON. I would say the same thing, but I do not think we can sort of design it here today, but we clearly want—to protect the American taxpayer and for all our protections, we want oversight.

Senator CARPER. Another question that kind of relates to the one I just asked, but with respect to conflicts of interest or the potential for conflicts of interest going forward, the Treasury plan calls for, as I understand, private sector portfolio managers to basically run the day-to-day management of the assets that would be purchased by the Treasury. And while this may be more efficient than creating a Government entity, my first thought is to be supportive of what you are asking for, but it also does create some possibilities for conflicts of interest.

Let me just ask, what safeguards need to be put in place to minimize, in your view, any potential conflicts of interest?

Secretary PAULSON. Well, I would say we cannot design these here, but we have been very conscious of this. And when we have dealt with advisors before, we have been very careful about how we do it.

But I just cannot emphasize enough to you how important it is that we have experts available to begin working quickly, because this is about market confidence, effectiveness, and so we need to balance. OK? We need to balance the need to go quickly with the protections we build in. And I want strong oversight, strong protections, great transparency. And as this develops, I am sure it will evolve. And it may evolve in various different ways, but right now we need to get up and running and deal with the market as it exists.

Senator CARPER. Thank you for that response. My time has expired, and I am not going to ask another question. But I do want to make a statement, just to follow up on what others have said, Mr. Chairman, and what I said earlier during my opening statement.

I went back in time, and I asked us to recall the Chrysler bailout where the Federal Government did not take an equity position in Chrysler. The Federal Government did not actually make a loan to Chrysler. The Federal Government actually guaranteed loans, and ultimately our guarantee was never exercised. We did not actually have to use the guarantee, although it was out there. But at the end of the day, we made money. The Federal Government and taxpayers made money, recovered money on behalf of our citizens.

And the Resolution Trust Corporation, when it was established, my recollection is the Resolution Trust Corporation did not go in there and take an equity position in savings and loans. The Resolution Trust Corporation took off the hands of the S&Ls the nonperforming loans, and a lot of them were actually good investments—shopping centers, apartment complexes, and on and on. And because of the condition of the market, they had fallen in value. They were actually taken off the books of the S&Ls, held for a period of time, and as the economy recovered and as property values recovered, the Resolution Trust Corporation was actually able to recover a fair amount of money for the Treasury.

We need that kind of thinking. We need to be entrepreneurial. And I do not know at the end of the day if the Federal Government ought to have an equity position in these companies, but at the end of the day, I do not want to go home unless we can say to the taxpayers in my State, “We have come as far as we can, as close as we can to recovering every dime we put into these companies.” And, last, we will be able to look them in the eye and say, “We have made, to the best we can, every effort to ensure that no bad behavior is being rewarded.” And the people who should not be rewarded in this financially, they are not going to get rewarded.

Thank you very much.

Chairman DODD. Thank you, Senator, very much.

I just briefly wanted to make a point because I think this is something we have missed a little bit. If we were to move forward with this, the idea of giving the Treasury, with all of the oversight and accountability built in, is the authority to deal with this. What I think needs to be said, Mr. Secretary, unless you are going to tell

me this would not be allowed under your plan, is that if you discover along the way that there is some better idea or some variations of these ideas that would work better—and there are a lot of ideas we are all hearing about from people from the world from which you come—that there is nothing in here that would prohibit you from using the flexible notions and thoughts out there on how a better approach might work, an equity infusion, for instance.

Secretary PAULSON. Mr. Chairman, you said it better than I did, and this is—I am not looking and I did not want to find myself in this position. I did not want to find myself in the position of being here asking for these authorities. But under the circumstances, I think they are better than the alternative. This is something we will work on together. And as we learn if there are better ways of doing things, clearly, as we get in the markets, we are going to learn, and our whole objective here is going to be to minimize the ultimate cost to the taxpayer.

Chairman DODD. Senator Dole.

Senator DOLE. I would like to ask Secretary Paulson, Chairman Bernanke, and Chairman Cox the following question: According to the Wall Street Journal, the market for credit default swaps has reached \$62 trillion, up from \$144 billion as of 10 years ago. The issue of credit default swaps, as I mentioned earlier in my opening comments, is one that I have consistently raised throughout the year, beginning with Bear Stearns in March: the transparency of this market and what regulators have been doing to improve oversight of these securities. Chris Cox has spoken today to the regulatory issue.

At the time, though, the Treasury Department, Federal Reserve and SEC all testified that these CDS securities did not play a major role in the situation at Bear Stearns. Now Americans come to learn that these same securities—credit default swaps—played a role in the collapse at Lehman Brothers and the Government intervention of AIG. Simply put, what has changed? And given that we now know they played a significant role in the demise of AIG and Lehman Brothers, will the Treasury Department plan on purchasing some of these illiquid CDSs?

Secretary PAULSON. Senator, there is some confusion here. Let me explain. This is a huge market, and we have all, from the day I came down here, my very first meeting—as a matter of fact, my first meeting with the President talked about these issues. We have been working with the Fed because there is this huge market, and the most important thing that needed to be done was to build the protocols, to build the infrastructure to handle this.

And so we have all known the risks. As a matter of fact, the fact is that the reason—one of the major reasons that the Government helped out in the Bear Stearns situation was to avoid throwing it into bankruptcy with all the credit default swaps and not having the infrastructure.

One of the reasons the Chairman has said to Senator Schumer, even more important than the wind-down in the insurance, is the “too big to fail,” and part of the reason for the “too big to fail” is the lack of all the infrastructure and protocols and discipline around over-the-counter derivatives market. But it is not as simple as to just say let’s just regulate it.

This is a market that regulators, led by the New York Fed, have been making huge inroads in with the industry, and there is a lot more that needs to be done on this market. So it is a big problem. We have been focused on it for a long time. How it got here is another story. But we have been dealing with it.

Mr. BERNANKE. Senator Dole, this is an instrument that has grown extraordinarily rapidly, as you point out, more quickly than the infrastructure that supports it. And the Federal Reserve, particularly the New York Federal Reserve Bank, have been extremely active in working with market participants to improve the transparency, the clarity of those trades, to develop protocols in case there is a failure, how to deal with that, and to move toward a central counterparty that will help make this a safer market.

So we are working on that and making a lot of progress. It is part of a broader plan to try to make the system more resilient, more transparent, so that when we have crisis conditions that, you know, those problems will be much less severe.

So we understand your concern, and we have been working very hard to try to make that market better.

Senator DOLE. Yes.

Mr. COX. Senator, I think that there are several issues here. One is the infrastructure issue that the SEC is working on with the Fed, and the Treasury, of course, and the President's Working Group are very aware of this, and this has been a leadership effort for some time. It is important to have an OTC derivatives clearance and settlement infrastructure that works much better. It is important to have a central counterparty.

It is also important to note that legislation has expressly excluded CDS from regulation even of the most modest kind, such as disclosure. And the lack of disclosure, the lack of transparency around this market is one of the reasons that we as a law enforcement agency but also market participants are very, very concerned about this.

We have seen what happens with these regulatory holes. We have got a big regulatory hole around investment banking supervision. We now have right in focus—and we can see how this works—a bit regulatory hole around CDS.

Holding a credit default swap is ordinarily effectively taking a short position in the underlying. But CDS buyers do not have to own the underlying. They do not have to own the bond or the debt instrument upon which the credit default swap is based. So they can effectively naked short it. This is a problem that we have been dealing with with our international regulatory counterparts around the world with straight equities, and it is a big problem in a market that has no transparency and people do not know where the risk lies.

The opportunity, therefore, for fraud and manipulation in this market can lead to market distortions, market disruption, and damage to the companies themselves. And it is just vitally important, as we consider reform of the financial system in the current crisis, that we regulate this so that we can have disclosure, so that we can have transparency in this market.

Senator DOLE. Thank you, Mr. Chairman. My time has expired.

Chairman DODD. Thank you very much. I was just asking staff as to whether or not this is something—I would ask Chairman Bernanke or Secretary Paulson, is this something we ought to be thinking about as including in some proposal given the language of the Chairman of the SEC?

Mr. BERNANKE. You mean in part of a reform?

Chairman DODD. I understand the logic, but I am talking about more immediately.

Secretary PAULSON. You cannot deal with this immediately. This is a huge market that has built up over a long period of time. It has also been extraordinarily useful in avoiding collapses and problems, letting institutions hedge themselves, as we went through—I could just go through situation after situation where, you know, Enron failed at great cost and human suffering, but the markets held up.

So these are really valuable tools. It is a case where they grew too quickly, and when I talked earlier about we had a regulatory system that was static and did not change with the marketplace. And so the first work that has been done—and I think it would have to be done before you could regulate anyway—is all the work that Tim Geithner at the New York Fed has been leading with the industry to work out the transparencies and the protocols and the discipline in this market. And so—

Chairman DODD. The only reason I asked the question is because, Chairman Cox, there was an urgency in your comments. Just quickly, do you disagree with the Secretary?

Mr. COX. Well, I think the Secretary is absolutely right when he says that these instruments provide a lot of important support for liquidity in the markets. And so we ought not to view regulation as somehow going to stamp out credit default swaps or the derivatives markets or all the functions they perform. But at the same—

Chairman DODD. But you are not recommending that as the amount of this package we are talking about—

Mr. COX. Well, there is an urgency to what I am saying, but I do not want to get in the way of your consideration of what you have before you. On the other hand, giving regulators authority does not mean that it will be used in ways that disrupt the market.

Chairman DODD. I hear you. Senator Menendez—

Secretary PAULSON. And I think what the Chairman was talking about was law enforcement, which you urgently—

Mr. COX. Well, we have already got the antifraud authority. What we need is—

Chairman DODD. There is a statutory gap.

Mr. COX. Yes, we have a big—somebody in the Government needs to be able to look at this.

Chairman DODD. Senator Menendez.

Senator MENENDEZ. Thank you. Thank you, Mr. Chairman.

As I listen here for a while, I get the sense that while you have given this a lot of thought, by the same token I get some sense that we are flying by the seat of our pants and that in that respect, you know, that you want to come in strong and have the cavalry be there, but you are not quite sure what the cavalry does once it arrives. And that is part of my concern here.

The trouble is that these assets are so intertwined and complex that no one seems to be able to figure out what they are worth. And, hence, no one has been willing to buy them, which is why, Mr. Chairman, as you described, they have been in a lockdown mode.

But you talked about the maturity price, and I just wonder how, in fact, since they are impossible to value as instruments at this point in time, how does one actually achieve that? If the Secretary pays the market rate, presumably if that was enough to be able to achieve the sale, that would be enough to persuade banks to sell already, so they would have sold. For that plan to work, then it would almost seem that you have to pay some type of a premium. And if that is the case—and I have heard the Secretary say many times we are going to look toward market mechanisms. Well, you know, some of us are concerned that market mechanisms have brought us to where we are today.

So how do you know—how do any of these institutions even know how to bid, for example, in the reverse auction, if, in fact, they could not in the first place determine what the value is? And, therefore, how do we make the determination of what, in fact, the hold-to-maturity price is so that the taxpayers do not get left holding the bag?

Mr. BERNANKE. The holders have a view of what they think it is worth. The trouble is it is difficult for those outside to know what it is worth. And I think that there are combinations—and I want to be clear. I have not, you know, specified a specific mechanism, and this is an important thing to be looking at. But I do believe that there are combinations of market-based type auction procedures with expert input that would reveal—just as when you sell a painting at Sotheby's, you do not know—nobody knows what it is worth until the auction is over. Then people know what it is worth. I think it is the same thing here. If you have an appropriate auction mechanism together with other types of inputs, with flexibility to address different assets in different ways, I think what you will do is you will restart this market, and then you will get a sense of what the more fundamental value is.

Senator MENENDEZ. In essence, what you are going to do is a massive—ultimately, you create a massive repricing, right?

Mr. BERNANKE. On the grounds that the prices that we now see are what I called fire-sale prices, prices that are seen when you sell into an illiquid market.

Secretary PAULSON. There is no doubt that we are saying Government intervention. There is no doubt about it. And I would just add it is not just market mechanisms that have got us where we are today. It is also a hopelessly failed and outmoded and outdated regulatory structure that has helped get us where we are today also.

Senator MENENDEZ. Well, I would add to that, even within the regulatory structure you have, a lack of pursuing some of the regulations that we have aggressively in doing that.

Let me ask you, what in this process do you envision not having the market try to manipulate the process in doing so? For example, what makes you believe that the institutions will not sell the very worst of the assets that they have in order to unload them and, in essence, be able to do that?

Secretary PAULSON. What we are going to do is we are going to do this focusing on one asset class at a time. So we will start off with maybe simpler asset classes, and it may be that one of the things we are going to want to do over time is buy some of the most illiquid asset classes and pay for them appropriately in order to preserve the system and do all the things you have heard me emphasize before to protect the taxpayer.

Senator MENENDEZ. Well, let me ask you, Chairman or Mr. Secretary, you said the institutions believe there is a value. They think that there is a value. The question is: When you have it in the reverse auction, what if they ultimately offer a value you do not think is appropriate?

Mr. BERNANKE. This is one of the reasons, you know, in response to Senator Bennett, you know, if we narrow—if we keep the range of participants too narrow, only failing institutions, for example, then we will not have a robust, competitive auction. The more participants we have, the more people who are involved in offering these assets, we will have a competition. And auctions are good at producing, you know, relevant prices, even if individuals have an incentive to underprice.

Senator MENENDEZ. Well, let me ask you this: I have heard you both make statements today and in the past that would lead one to believe that, at the end of the day, there is minimal risk to the taxpayers here. And, in fact, I have heard you say that there are some who argue that, in fact, we could make money.

Can you both look at me in the eye and tell me that, as we increase the debt limit of the United States by \$700 billion, which basically means about \$2,333 for every man, woman, and child in this country, that this will not cost the taxpayers anything if we pursue what you want us to do?

Mr. BERNANKE. I never made any guarantees like that. There is going to be risk involved for sure.

Senator MENENDEZ. Can you quantify the risk then?

Mr. BERNANKE. No. We are going to have to look at it. But I think that what is clear is that the \$700 billion is not an expenditure. There is going to be a substantial amount of recovery. Whether it is the full amount is hard to know.

Secretary PAULSON. Senator, I think what you heard me say today is that, unfortunately, there is great risk to the taxpayer today with what we have. The taxpayer is already on the hook, through no fault of his or her own. And now the taxpayer is on the hook because if the system does not work the way it needs to work, people are not going to get the loans they need, small businesses are not going to get the capital they need, farmers are not going to get the loans they need. So there is risk to the taxpayer.

Now, in terms of what we are doing here, you have not heard me say that there is not risk to the taxpayer. You have heard me say there is less risk to the taxpayer in this course versus not doing it.

Senator MENENDEZ. Can you give us any quantification what that risk is?

Secretary PAULSON. I cannot give you a quantification because—and I will explain why. We are not making an expenditure. We are buying the assets, we are holding the assets, and we are reselling

assets. And what the cost to the taxpayer will ultimately be will depend upon how the economy recovers, what happens in the housing markets, and how we execute this program.

And so I wish there were a simple answer. I do not like being in this position. But I need to tell you the truth. And I certainly have not told you there is no risk to the taxpayer.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Menendez.

Senator CRAPO.

Senator CRAPO. Thank you very much, Mr. Chairman.

I want to go first to you, Chris, and talk about the short sell rule. Could you give the rationale for why you felt it was necessary to implement a ban on short selling?

Mr. COX. Yes, Senator. The decision was taken by the Commission after a great deal of careful thought, albeit in urgent circumstances. We consulted very closely with the Secretary of the Treasury, the Chairman of the Federal Reserve, the President of the New York Fed, and it was the considered view and recommendation of all that we take this course, as well as international regulators—the U.K. Financial Services Authority, in fact, took this action slightly ahead of the United States, as have regulators in markets in Europe and Asia. This has been the subject of a G-7 statement. And the purpose of it is to ensure that in circumstances that we have seen where there is panic and fear in the markets, that that does not lead, because of the close correlation that we have seen between equity prices and confidence in the institutions, to a run on the bank. That would affect the entire financial sector, and that is why this is restricted to financial institutions. But it is also time limited. The emergency nature of this makes it time limited. It is not something we would want to do on a permanent basis.

And what we were looking to accomplish is to give the Congress an opportunity to consider this legislation in an environment of relative calm and to segue away from this emergency order as quickly as possible.

Senator CRAPO. But you do deem it to be short term and limited.

Mr. COX. It is short term, limited, and focused on the financial sector.

Senator CRAPO. I want to go on to another issue, and I have short time, so I will get into this with you privately. But as you know, I am very concerned that the way we have implemented the rule needs to make necessary exceptions for the kinds of proper short sales that are important for our markets to work well. But we can discuss that at a later time.

I want to get to, which Chairman Bernanke and Secretary Paulson, the question of the run on the bank issue in the context of the actions that were taken to protect our money market funds. Could you explain to me just quickly what was done and what authority was used there?

Secretary PAULSON. Yes, Senator, let me explain the authorities the Treasury used and why we used them, and then the Chairman can explain what they did to support the commercial paper market.

We have talked generally about the stresses in the capital markets when they froze up and when banks stopped lending to each

other and things really slowed down. We have millions of Americans that have savings in money market funds. We have institutions that have savings in money market funds. And we had some of that money start to leave. We had an institution or two halt redemptions, you know, break the buck in a case. And there was great concern about this. And so this was not a normal circumstance.

And so what we did was, at the same time we came to Congress Thursday night and said we want to address the root cause, which is housing and capital and we had this big plan, we also had some tactical steps. And one of the things we did at Treasury was we have an exchange stabilization fund, and in our judgment—and we got strong legal opinions that what happened in the money markets really gets to the stability of our system and, you know, to our currency and so on. So on this emergency basis, what we did was guaranteed all investors in money market funds, and we did it all funds that were there as of the date. So we did not want to create an uneven playing field going forward, but what we wanted to do was come up with this guarantee, and that is what we did. And then individual institutions will be—as they opt into this, we are working out the arrangements and the fee.

Senator CRAPO. And this is emergency. Do you contemplate that it needs to be temporary, or does the legislation need to authorize this?

Secretary PAULSON. No, we did this. It is in place for a year, and we do not think that this is something that needs to be codified because I do not believe this is something that needs to be done permanently. And it is something you can look at as you are looking at broader reform issues.

Senator CRAPO. All right. In the limited time that I have left, I would like to get back once again to the issue that you have already talked about a number of times here, which is why we do not look at an approach of obtaining equity for the taxpayer. And I understand the points you have been making about the fact that this is different from a failed institution that we are stepping in to fix and that you are trying to get broader participation.

What I do not understand is, even given the fact that you are looking for broader participation, why we could not achieve that. Or maybe said another way, is it really necessary for us to go to the level of \$700 billion to get more broadly out into the economy to institutions that are not facing the kinds of pressures that would require this kind of an emergency response by Congress? Why aren't we focusing simply on those firms and those portions of our market that really do need to have the recapitalization occur quickly?

Secretary PAULSON. Well, I will answer it and then let the Chairman answer it. There were two possible approaches, and this is by far the best in our judgment. One is to come up with something that is aimed solely at propping up a relatively small number of bigger institutions if and when they need it. OK?

And the other approach, you know—and, again, we have flexibilities to deal with individual's situations as they arise. But the approach we thought was the better approach was to focus on the securities themselves and the markets of the securities themselves,

looking at various security tranches and asset classes, and by establishing markets, working to establish values and markets here, to then induce the flow of private capital. And, again, when you look at all of our financial institutions, when people say why not recapitalize them, one of the reasons that capital is not coming into these institutions is they do not know—investors do not understand the value of some of these securities, and we need more transparency.

So that is the approach, and it is—one is an approach to deal with failure, and the other is to try to make the system—to get to the system in advance of that.

Mr. BERNANKE. Senator, as the Secretary said, those distressed firms have been a big problem. We have seen a number of cases, and in those cases, injecting equity and so on has been the right approach. But this is a systemwide problem. Even banks that are relatively healthy are contracting their balance sheets, refusing to lend, not able to raise more capital, and it is that contraction, even in the absence of failures, that is creating the pressure in the U.S. economy.

So by trying to address this as a market phenomenon rather than an institution-by-institution phenomenon and getting wide participation, we have a much better chance of having a beneficial effect on credit and on the economy. So I do believe that is a better approach.

And I will not take your time, but the Fed has done a number of things to try to help out on the money market mutual funds as well, trying to avoid—helping them not liquidate in such a disorderly way.

Senator CRAPO. Thank you. My time is up.

Senator BAYH [presiding]. Resisting the temptation as the temporary Chairman to jump the line, I will recognize Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

I do not think a single call to my office on this proposal has been positive. I do not believe I have gotten one yet of the literally thousands of e-mails and calls we are getting. Part of this reflects outrage by taxpayers making \$30,000, \$40,000, \$50,000, \$75,000, \$100,000 a year, bailing out people whose country club memberships cost many times that. Part of it is, I think, an attitude. Wall Street to most people in my State, I think—certainly to many of them—Wall Street did not care one bit what it was doing to neighborhoods in Cleveland and Dayton and Toledo. It did not see the devastation. It did not feel the pain. And my question for each of you is: Do you think Wall Street owes the American people an apology?

Mr. BERNANKE. Wall Street made a lot of mistakes; regulators made a lot of mistakes. We are going to have to go through all that. But let me just say this: People on Main Street who think that Wall Street is somewhere far away and whatever happens there has no implications for their lives are just misinformed, because if Wall Street, if the markets freeze up—

Senator BROWN. Mr. Chairman, people know that what happens on Wall Street has an effect on their lives. That is not the question. The question is: Does Wall Street owe the American people an apology?

Mr. BERNANKE. Wall Street itself is an abstraction. There are many people who made big mistakes and many regulators who made mistakes, and we need to figure out what those were and make sure they do not happen again.

Senator BROWN. Secretary Paulson.

Secretary PAULSON. You know, I share the outrage that people have. It is embarrassing to look at this, and I think it is embarrassing for the United States of America. There is a lot of blame to go around. A lot of blame. And a lot of blame with the big financial institutions that engaged in—that is where I started with this—irresponsible lending, the overly complicated and complex securities that no one understood as well as they should, and it turns out they did not understand them themselves; the rating agencies that rated those securities; blame to the people that made loans they should not have made to some people that took out loans they should not have taken out; to regulators.

So there is no doubt about that, but what we are focused on now is—and what I think your constituents want to hear, is let's fix the problem in the way that is going to have the least negative impact on them, and then let's go out and deal with all these problems and figure out how to make sure that we minimize the likelihood that it will happen again.

Senator BROWN. No disrespect, Mr. Secretary, but they understand much of that. They do want a solution. But they do not want the same people that have helped to inflict this pain on the American people to get the opportunity, because of our reluctance on executive compensation and our reluctance to do accountability, to inflict more pain. And I think that is—well, let me move on from that. I apologize for interrupting.

Senator Bennett raised a good question about troubled assets, and, Mr. Secretary, how would you determine the price of a troubled asset if not by a transparent method like an auction? I am not asking you to commit to a certain way, but give me an example or two how you could determine the price of a troubled asset outside of an auction and do it in a transparent way?

Secretary PAULSON. In terms of—when I am talking about trans, I am talking about how we report to the American people, how we report to the oversight board. If you are looking for transparency and being able to explain to you here today or anyone how some of these securities are valued and the issues surrounding them, I wish I could tell you, because we do not have—part of the problem that has gotten us here is excess complexity. And so we have very complex, illiquid securities, some tranches are more illiquid than others. And all I can say to you is we are going to need to use a variety of mechanisms, market-driven mechanisms as much as possible, bring together bright people from different backgrounds to work through this and do it with the main objective of protecting the taxpayer.

Senator BROWN. Thank you for that. Let me offer an idea, and you said part of the reason we got into this was the complexity. Part of the reason we got into this, too, is that the various actors had so little or no stake in the ultimate success of the mortgages. It was like a game of musical chairs. The appraiser got a fee, the

broker got a fee, the investment bank got a fee, until the music stopped and somebody did not have a chair in some sense.

Have you given any thought—both Chairman Bernanke and Secretary Paulson, have you given any thought to creating a system where the seller determines the price but must retain a good fraction of the asset, live with the consequences, and indemnify the Government if it was wrong on the high side?

Mr. BERNANKE. I am sorry. I thought you were talking about securitization processes. Are you talking about this operation—

Senator BROWN. I am talking about when we buy these troubled assets if there is—

Secretary PAULSON. We did not give thought to that, because I do not think that would be—I do not think that that would be a successful way to deal with something systemically.

Senator BROWN. Why not?

Secretary PAULSON. Because what we are looking to deal with is, as I said, the asset classes broadly and market-based solutions and getting—reaching out to many institutions to do that. And so that is—I recognize that there are a lot of ideas, and I have heard a lot of them. We spent a lot of time over the last number of months talking through these issues. I have heard in the last couple days all kinds of ideas that have come forward. And what we need to do here, I think, is move quickly and have some flexibility to—we have got some very good ideas and I think some approaches we spent a lot of time on. But we are going to have to spend time learning as we go along also.

Senator BROWN. If we subscribe to sort of the theory of the ownership society, which your administration kind of stands for, doesn't an idea like that, where there is some ownership of the asset by the seller to make the price perhaps more real or more fair to taxpayers, make some sense?

Secretary PAULSON. Well, again, I will let the Chairman respond from his standpoint, but given what we are trying to do to the system—and, again, the fairness to taxpayers, I am defining fairness to taxpayers as what is going to create the least cost to taxpayers, what is going to protect the taxpayers to the greatest extent. And I believe that by far the most important thing is addressing the questions that Richard Shelby and some others have asked: How do we make this work? How do we make this work so it is going to be effective, keep our economy going, keep capital flowing, and do something systemically? And to do something systemically the way we need to do that, I do not think that is the right way to go.

Mr. BERNANKE. Let me just—there are many different mechanisms for trying to establish value. There are different ways. Some involve various kinds of copay type arrangements like you are describing. I think we need to go to experts. I have received a number of e-mails from world leading auction experts saying, "We want to come work with you on this." The thing I would ask you to do is not to put in the legislation precisely how these mechanisms would work, because that would prevent us from using the advice of experts and the benefit of experience in this very novel type of situation to learn the best way to do it.

Senator BROWN. Thank you.

Thank you, Mr. Chairman.

Chairman DODD [presiding]. Good questions. Thank you very much, Senator.

Senator MARTINEZ.

Senator MARTINEZ. Thank you, Mr. Chairman.

This is for Mr. Lockhart and Secretary Paulson, if we could, Director Lockhart. When Fannie and Freddie were put into the conservatorship, one of the impacts that it has had has to do with the asset quality or the equity capital of America's banks. And I am talking now about Main Street; I am talking about community banks. Apparently, about 11 percent of their core equity capital was involved in these types of equities even as a result of the conservatorship, because of this situation, maybe about—it is believed about \$36 billion in value of the preferred shares has been essentially wiped out.

The question really—and, apparently, the impact on small and community banks, everyday banks in our towns and our cities and in Florida towns and cities that are making the loans to the small business guy, to the car purchasers and so forth are being impacted by this in a much greater way than was initially anticipated.

So the question is: How could we restore the value of these assets to these banks? And when would dividend payments begin again? And how do we deal with this unintended consequence of the conservatorship?

Mr. LOCKHART. Fannie and Freddie had about \$35 billion of preferred outstanding. It was held across the board, but there was a concentration in banks, and sometimes in smaller banks. It was something that was considered at the time, and the view was that we needed to conserve Freddie and Fannie and those dividend payments were going to be excessive. So, a decision was made to stop the dividends.

The preferreds are still in place. If the companies come out of conservatorship, there is potentially an opportunity some time in the future for dividends to be restored but not in the near term.

Mr. BERNANKE. Senator, the Federal Reserve and the other Federal regulators are very aware of this situation. We understand it is an unusual situation. It wasn't brought about by bad lending, for example. And we are going to be working with banks to try to find solutions for them.

Senator MARTINEZ. Good deal. Thank you.

And in the situation that brings us here today, Mr. Secretary, today, I have heard you say that you welcome oversight, so as we try to narrow differences and begin to work in a bipartisan way to find a way of getting to a solution to this problem, which is not just about Wall Street but is directly related to what is happening in Miami and Orlando and Tampa and the small cities across America, so therefore, we have the idea that you have asked for a blank check or that Congress would give you a blank check or that Congress—I mean, we can remove that from the debate. You are not asking for a blank check. We are not going to give you a blank check. There will be oversight. And you accept and understand that that is part of what we have to do?

Secretary PAULSON. I accept and understand it. I welcome it. And as I said earlier, I was told by Congress, by your Chairman, let us work together. Please don't work out all the details. So we

sent up a simple outline of a bill expecting to work on an oversight and then I read that I didn't want oversight. So clearly, the position I am in, I want—I welcome oversight, protection, transparency, all of that, but we need to work together to do it and make this effective and very efficient.

Senator MARTINEZ. And likewise, there needs to be and there will be transparency in the way in which this is executed in terms of how you are going to move ahead and whether it is an auction or reverse auction or exactly how these securities are going to be valued.

Secretary PAULSON. Yes. We will—as I said, there are going to be various methodologies. We are going to do the things we think make most sense and with a lot of experts, and then that is something we are going to need to explain to an oversight body, and we are, again, going to need to be transparent and I totally accept that and agree with it. And we all need to understand this is something that hasn't been done before. It is something that Congress had never welcomed, authority, intervention of this size. We weren't recommending it in this size months ago. We have—we are, again, dealing with a market situation where we need to move quickly and we need to move quickly to protect the American taxpayer. And so this will be—this is something we are going to be working through very carefully as we go forward here.

Senator MARTINEZ. That issue, quickly, is something that as we—we first discussed this on Friday, I believe, some of us. We now are moving down the road to try to get something done, and obviously it needs to be done right more than it needs to be done fast. But do you still—and this is also to Chairman Bernanke—do you both continue to feel the sense of urgency that was present when we first spoke about this on Friday?

Secretary PAULSON. I feel at least as great an urgency because I believe that what calmed the markets was the understanding that we were going to do this, and we stood—or I had a press conference with the leaders of both Houses saying we are all going to work together to get this done quickly. And so I feel great urgency and I believe it has got to be done this week or before you leave.

Senator MARTINEZ. Mr. Chairman?

Mr. BERNANKE. I agree with that. I think it is necessary, at a minimum, to give a very strong indication of exactly what is happening and very soon so that markets will understand what is happening. Yes, I do see that urgency.

Senator MARTINEZ. And Mr. Chairman, while we are on that, you do agree that this is the best and the only way forward that you know of at this time?

Mr. BERNANKE. Well, we haven't specified all the details, obviously, but the only other model which we have is sort of the failed bank model we have seen in the S&Ls and other cases and that just doesn't apply to this particular situation. So yes, I do believe this is our best shot.

Senator MARTINEZ. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Secretary PAULSON. Not only our best shot, it is—we are going to make it work.

Chairman DODD. Thank you, Senator.

Senator Casey.

Senator CASEY. Mr. Chairman, thank you very much for this hearing and for the way you have conducted it.

I guess my first question will be directed mostly at Secretary Paulson and also Chairman Bernanke. Both of you have said today and on numerous occasions that the root cause of this, of course, is housing, and you have taken steps, both of you and others here today have taken steps to deal with that over time, and I think a lot of the strategies that have been employed have helped. I think we should enlarge them, especially at this time when we have an opportunity to do so.

You know the numbers about foreclosures per day. It is approaching now, by one estimate, 10,000 per day. The Center for Responsible Lending is predicting that 6.5 million foreclosures over the next couple of years. And I know that both Chairman Bernanke and Secretary Paulson today, especially Chairman Bernanke, have spoken about both fire sale prices and hold-to-maturity prices. But I believe, and I think the evidence is compelling, that foreclosure itself forces fire sale prices of homes. And isn't it true that if these foreclosures occur, then all home values are going to drop and drop to the fire sale price and that that forces the hold-to-maturity price to fall to the fire sale price.

So in essence, what I am asking in a long way is why does this proposal have this, what I would argue is a gaping hole in it, with no specific provisions that deal with foreclosure prevention?

Mr. BERNANKE. Well, I certainly agree that we should—every preventable foreclosure that we can, we should prevent, and we have a number of actions in that direction, including the bill that Congress just passed, for example. And I think that we ought to keep working in that direction.

One of the things that will help will be increased jobs, stronger income, better credit availability. That is essentially what we are trying to achieve here. It is not a substitute for other things, including working with servicers to develop better methods, insisting the banks work effectively with their borrowers, using the FHA in the way that we have been doing through the HELP for Homeowners, HOPE for Homeowners that the Federal Reserve is part of. So those things need to go together. But certainly, housing is not going to do well in an economy which is not growing in which credit is not available.

Senator CASEY. And I understand the point that you have made and Secretary Paulson has made about there is a direct connection between what is happening in a proposal, or what we hope happens as a result of the implementation of this proposal between helping financial institutions and what happens on Main Street or in the American economy. I get that and I think we need to say that more.

But what I don't understand is even though we made progress on HOPE for Homeowners in July—we can help 400,000 homeowners—why not use this opportunity to take another shot at that and expand that 400,000 to a million or to a million-and-a-half or two million, whatever it takes to, in two words, stop foreclosures as best we can? And I don't know whether, Secretary Paulson, you have some thoughts on that.

Secretary PAULSON. Again, I think you know, Senator, that we have spent a lot of time on this and the HOPE Now Alliance has helped about 200,000 people a month avoid preventable foreclosures. And our big focus, one of the things—as you said, housing is at the root of this. What we are doing with Fannie and Freddie and what we are doing with this action should help. And I have also said, and I know the Chairman and I have talked about this, that with some of the securities we own, we will have much more leverage to get things done to avoid preventable foreclosures. But we very much hear your concern and we understand it and there is no doubt that foreclosures are a significant problem.

Senator CASEY. Because I think when people are looking at this proposal and they see elements like that and like transparency, like oversight, like executive compensation, the warrant question, when they see those missing, I think it gives further credence to the idea that this is very narrowly tailored to financial institutions, even though you have made the case that that has a connection to the larger economy.

I do want to move to the question of how we modify the mortgage agreement between a lender and a borrower. One of the ways that has been proposed, and we voted on it before and I think we should return to it, is the question of bankruptcy. Can we use bankruptcy procedures, the bankruptcy law, to have a—to help modify some of these mortgages, in some ways, frankly, to force people to sit down to do it? I want to get your perspective on that, because I know it is a source of convention in our ability to not just come to a resolution on this proposal, but also on the foreclosure issue itself.

Secretary PAULSON. Senator, I will give a quick view and I am sure the Chairman will. From a policy perspective, you have heard me express disapproval. I think that that is—although many people have considered it and advocate it, I very respectfully think it is a mistake, and when I look at what we are trying to do here, is to get lending going again and increase lending, I think this really mitigates against that and it is in contradiction with what we are trying to do, is to get lenders to do more if we do these bankruptcy modifications or cram-downs. But I understand there are differences of opinion and I respect the other view. I just think it is a mistake.

Senator CASEY. Chairman Bernanke.

Mr. BERNANKE. It is hard to know which way that would go, whether putting things into courts is a way of facilitating this or not. The Fed didn't take a position on bankruptcy reform last—a few years ago. We have just basically not taken a position on this one.

Senator CASEY. Well, I would respectfully urge you to reconsider that, because I think we need a voice like yours, the voice of the Fed, on something this, I think, essential to the debate.

I know I might have a minute left, if that. My last question is in terms of real contention here, obviously, executive compensation is a huge issue and I think the American people, even though I think most understand that the dollar amounts for executive compensation may not impact or compare to the dollar amounts we are talking about overall here, whether it is \$700 billion or whatever number it ends up being, but I think the message sent by a failure

to address the executive compensation question in a reasonable way, in a way that we can have bipartisan forces come together, I think would send the wrong signal.

And in terms of confidence, we are concerned about market confidence, but we also—I think part and parcel of that is the confidence the American people have in us, all of us, to be able to deal with an essential question of fairness and equity and real justice. And I guess I want to have you to reiterate your position on the issue of executive compensation and if there is any way we can come together on that by providing some reasonable limits on it, especially with regard to severance after the fact, after there is a problem.

Secretary PAULSON. Again, I will—

Chairman DODD. Try to be brief in your answer, because we have got other members here.

Secretary PAULSON. I will be very brief, because I understand how serious the problem is. I just got—and how great the concern is and the outrage. You know, I hear it everywhere. But I can just say to you the most important thing by far, the most important thing is to have something that works, works well, and works effectively.

Senator CASEY. Thank you.

Chairman DODD. I would just say, almost any plan we are going to talk about is going to deal with executive compensation. Count on it. Just count on that one. We will figure it out, but it is going to be here.

Senator Bunning, I missed, and I apologize—

Senator BUNNING. That is all right. Thank you. I was absent for a while and I understand.

We are trying to get at the housing problem, is that correct? Secretary Paulson? The problem that the housing mess has created and spilled over into the rest of our economy and worldwide.

Secretary PAULSON. I would say that is a major cause. I have called it the root cause, the housing correction.

Senator BUNNING. OK. Then why did I read in the paper this morning that we are now going to include student loans and credit card debt? How does that fit the housing?

Secretary PAULSON. I would say to you, that is certainly not my proposal, is to—I think the vast bulk of our effort needs to be aimed at mortgage-related securities. We asked for broad authorities and various kinds of securities because again, what we need to do is to free up the—

Senator BUNNING. I think you have made that perfectly clear, Mr. Secretary—

Secretary PAULSON [continuing]. So what I am saying, so that is—that that—

Senator BUNNING. Then how are we getting in other things that are non-related? This is something that—is that untrue?

Secretary PAULSON. I would say the reason we want flexibility to, if we need to, buy some other classes of assets would be that if the banks—if capital starts to—as capital flows more freely, it will help the housing, because the fact that the financial system is gummed up and there is illiquidity hurts it and it may be that to deal with—

Senator BUNNING. Student loans and then credit card debt are messing up the housing?

Secretary PAULSON. That is—I certainly, sir, did not say we are going to focus on this and that that was going to be the major focus—

Senator BUNNING. I didn't say you said it. I said I read it.

Secretary PAULSON. OK. OK. Well, I am not sure what you read.

Senator BUNNING. I read that included because someone insisted on it, that you were dealing with—included that we were going to deal with credit card debt and student loan debt.

Secretary PAULSON. I—

Senator BUNNING. It is untrue?

Secretary PAULSON. I don't know what you are talking about. What we have said, though, is we have asked for broad authorities to deal with a variety of securities if we need to, and a variety of asset classes. But the focus here, the major focus will be dealing with mortgage and mortgage-related.

Senator BUNNING. This is unrelated, but it is essential for me to get a handle on some prior statement you made earlier today. How long were you the CEO of Goldman Sachs?

Secretary PAULSON. I was the CEO of Goldman Sachs from May 1999 until I left to come down here at the middle of 2006.

Senator BUNNING. Now, that is not what I want—I don't need help from the audience. I can ask the questions on my own. Then you said in an earlier statement that you didn't realize the maze of regulatory problems that we have here on the Hill and that you and other companies like you were CEO of were dealing with here. You made that statement to us all sitting at this table.

Secretary PAULSON. I said, you have to get down here, look at the people, look at the plumbing, look at the inadequacies. I was not studying—

Senator BUNNING. You were dealing with it on a daily basis.

Secretary PAULSON. I was dealing with all of the best regulators. So I guess what I said is that you have got to see it up close and personal and then step back and look at it and think about it and say, how does this make sense, and that was my statement, yes, sir.

Senator BUNNING. In other words, you didn't know or somebody in your firm other than you was dealing with the regulatory burdens that were placed on your firm?

Secretary PAULSON. Well, I was dealing with—very well with the regulatory burdens on my firm, but to look back and say—look at the broader economy, to look at some of the holes in the regulatory system as it relates to other institutions, yes, that is it.

Senator BUNNING. Mr. Secretary, do you know if large Treasury debt holders such as foreign official investors, Commonwealth Fund, Bank of China, whatever it might be, are going to go along with a massive debt issue? Have you heard from any such investors who are complaining about the close to one trillion or more dollars of debt increase we are looking at between the GSE plan and the new debt to finance the Fed activities?

Secretary PAULSON. I would say to you, sir, when we had—when I have had a discussion with central banks and finance ministers from around the world, their primary concern was that we deal

with this situation and they were very complimentary of this action. And I believe from the conversations that I have had with central bankers, China, Japan, around the world, their first and foremost concern was stabilizing our financial system because it is so integrated with the rest of the world.

Senator BUNNING. OK. I guess maybe I am the only one that has a problem with this, but one of the big problems I am having dealing with your plan and Chairman Bernanke's and others to address this issue is that you are not going to be here after January 20 of 2009, and I am going to have to answer to the 4.2 million people in Kentucky and all these other Senators up here are going to have to answer to their constituents if this plan does not work. And I am frightful to the point of almost panic that I don't see a solution in your plan to address this financial crisis that we are in.

Secretary PAULSON. Senator, all I can say to you is I got here 2 years ago. I am going to—I have been trained all my life to run toward problems. I have had some big problems to have to run toward. And I have worked very closely with the Chairman of the Fed, with the Chairman of the SEC, the President of the New York Fed, my colleagues, Congress, to address these issues as they have come up and I believe that this is my plan to deal with these set of circumstances which are unprecedented. And so that is what I can say to you.

Senator BUNNING. This is my last question. This is for Chairman Bernanke, also. Your predecessor came up to the Hill today and said that the \$700 billion in this plan is chicken feed and it won't take care of the problem. I don't necessarily agree with your predecessor on many things, as you might well know. And I happen to think that he is wrong here, also. But what happens if it doesn't? Are you going to come back to us and say, by the way, the \$700 billion is insufficient and now we have to open the taxpayers' box and bring more money to the table to get this mess straightened out? Chairman Bernanke, would you like to—

Mr. BERNANKE. Well, Senator, I can't predict the future and I have been wrong quite a few times now. But we may—we don't know exactly what is going to happen, but I think this is a very powerful program and that the amount of money is enormous, of course. There is a chance we may come back and say we didn't need it all, but it is very hard to know. But I think this is a very substantial effort by the Congress to address what is indeed a very large and serious problem.

Senator BUNNING. Thank you, Senator.

Chairman DODD. Thank you. Thank you, Senator Bunning.

Senator Bayh.

Senator BAYH. Thank you, Mr. Chairman, and thank you, gentlemen.

Some of this ground has been gone over before, and I apologize, but I would like to follow up a little bit. Secretary Paulson, I would like to begin with you. Many of us would feel a little bit better if we were convinced that private sector-based solutions had been exhausted in this, or if at least there were some private sector participation in this to validate the decisions that the public entities will be making.

For example, I mean, you said that you have been bombarded with a variety of suggestions. One I heard was that we require a 10-percent private sector participation along with the purchases the government will be making in these options. Another would be, and one of my colleagues floated this idea, some sort of guarantee of private sector purchases. That historically has worked fairly well. It would allow the private sector companies to—purchasers to purchase closer to the hold-to-maturity value. Why are those sorts of things not viable? Why is this the optimal solution to this problem?

Secretary PAULSON. Well, we have thought a lot about it. We need a systemic approach, and again, I think it is—I have described the systemic approach. I have also heard conversations about taking equity stakes, various other things, and I just believe very strongly if you impose these kinds of conditions, if you impose any kind of punitive conditions, this program won't work and we will all lose. And—

Senator BAYH. This wouldn't be punitive. This is including the private sector along with the public sector in answering the problem and—

Secretary PAULSON. Yes—

Senator BAYH [continuing]. They would be validating the decisions—

Secretary PAULSON. Well, I would say in terms of bringing in the private sector, OK, along with it, I think we have looked at a number of initiatives. We started off, actually, with some initiatives with the private sector, some that got off the ground and others that didn't. I would say with the private sector as frozen as it is and as concerned as it is and with the overall system as fragile as it is, now is the time that we need to do something very strong as a government, and so that is why we have come up with this plan.

Senator BAYH. Chairman Bernanke, many of my colleagues, Senator Reed foremost among them, have asked, and I think you put your finger on the essential point here, and that is how do we go about valuing the hold-to-maturity price versus the fire sale price, and I think you would acknowledge—you have acknowledged it is an inexact science at best. So the taxpayers do—there is some downside risk here. What do they get in exchange for bearing that downside risk? Why should they not be allowed to participate in the potential upside, and then that gets to the question once again of possible equity participation.

Mr. BERNANKE. Well, first, to go back to your—

Senator BAYH. And I understood your answer about the difference between failed institutions and contracting institutions. It seems to me these are different points on the same continuum and I struggle for a principal differentiation. I mean, this is a market intervention. The taxpayers are bearing risk. Aren't they entitled to something in exchange for that risk if things work out well?

Mr. BERNANKE. Well, first, to go back to your earlier point, as I mentioned earlier, there are various mechanisms for auctions and for valuation that do involve private sector participation. I think, you know, that experts ought to look at that. You know, the bad bank model, for example, is one approach that we have actually—the Secretary has actually tried. I guess my just concern is it not

be written into the legislation because we have to work and see what is going to be most effective.

I am just concerned that we not do anything that limits participation, because one of the issues with valuation is, as I mentioned earlier, is to get wide participation in the auction process. If you are auctioning a—if you only have one seller, then there is essentially no way to figure out what the thing is worth—

Senator BAYH. Compensating the taxpayers for the risk they are bearing would disincite others from participating?

Mr. BERNANKE. No, but if you make it a condition of participation in the valuation process, that is going to—that is essentially going to cause some not to participate when they would otherwise be part of the competitive valuation process.

Secretary PAULSON. I would say it this way. If we have to grant—have companies grant equity stakes, grant options, that would render this ineffective because it just—broadly, because our approach, as I said, there is different approaches, and if we dealt with people and institutions that were very fragile and needed to do something in order to prevent failure, then I think we have had a really strong record of getting equity stakes. I think you will see us continue to do that under those circumstances. But what we want here is a broad array of institutions to participate and so that just makes it—this would make this program ineffective if we approached it that way.

Senator BAYH. I would appreciate at another time when you are not quite as busy some further explanation about why such a thing would disincite further participation, because as you can see, that is a common concern that we have.

Secretary PAULSON. Yes.

Senator BAYH. You don't need to answer me further, Mr. Secretary.

I did have one final thing. I found—Senator Shelby raised this point, and Secretary, I don't know whether it was you or the Chairman addressed it, about the participation about foreign domiciled entities participating in this, and I must be candid. I found the explanation to be somewhat unpersuasive and I think many of the American people will probably have a similar reaction. Forget all that for a moment.

You say you are going to be going to the central banks of other countries to ask them to help out in dealing with this problem. Why should it not be a prerequisite for participation in this that the central banks of the countries in which these foreign institutions are domiciled agree to participate?

Secretary PAULSON. I am leaning on them to participate—not to participate, but to come up with programs that make sense in their countries. But we need to go back to what we are saying here. What we are saying is that institutions that do business in the U.S., employ people of the U.S., are part of the financial system of the U.S. They are there to benefit the American taxpayer. If they have problems, they are our problems. If they work the way they are supposed to work, they help get the economy growing.

And so the focus here, although we are clearly dealing with this and communicating in very strong terms with other governments, our first concern is the American people, and for the American peo-

ple, if any institution has got a major office here, regulating institution, doing business that is very important to the American people, those are the—that is the universe we want to deal with.

Senator BAYH. Well, my time has expired, Mr. Chairman. I would only say that if this works well, which we all hope that it does, this will restore balance sheets for these institutions. Share prices will rise. They will benefit. I think the American people will find it to be odd, to say the least, if our government cared more about the financial integrity of these institutions than the home countries of these institutions.

Mr. BERNANKE. They would. What we are aiming at, of course, is the market, and it is not just those who participate who benefit or don't benefit. If prices go up generally, that will help the entire system. In fact, it will help the global system, you know, which strengthens financial conditions generally.

Senator BAYH. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and Chairman Bernanke, I am heartened by your comments regarding the openness and hopefully desire to look at some of the accounting standards as it relates to banks that have held—not the banks we are talking about here, but the banks throughout the country that have held Fannie and Freddie and now need some transitional help in accounting. I hope Chairman Cox and others involved will join in that effort and make it happen.

Mr. Secretary, I don't normally tweak people, especially someone I respect like you. I noticed in your comments you ad hoc-ed, if you will, regarding a bazooka comment. I do want to remind you that the theory behind the bazooka was that if you have a bazooka in your pocket and the markets know that you have it, you will never have to use it. And I would like to point out that you not only pulled that out of your pocket and used it, huge amounts of ammunition was pulled out of the taxpayer arsenal to solve that. I think you have done some very deft things, and I compliment you on that, but the point is that things don't always work out the way people and their best efforts think they are going to work out.

And I have to tell you, if we were part of a venture board, if you will, up here, listening to what is really today a concept—this is not really a deal—I think most of us in dealing with our own money would say, you know, come back and talk to us when you can put a little meat on the bones, OK. At the same time, I understand where you are and I understand the severity of the situation which puts some balance in that.

I guess the concern that I have, especially listening to Chairman Bernanke talking about valuing these in a hold-to-maturity basis, that would automatically give me the impression, based on what I know about these securities, is that we are going to actually be paying above what these securities are marked to market now in many cases. Do you have any concern that with you being the only player and with private capital being on the sidelines that you are crowding out private capital by, in fact, handling it on this basis?

Mr. BERNANKE. I would say I have a number of concerns. That is clearly not the biggest one, because the private capital has come

in two or three times during this difficult period, this turmoil in the markets, and each time, it has been overwhelmed by the leverage in the system, and so private capital isn't coming into the system.

And I would also say to you that these securities—we never said that under certain circumstances, they wouldn't—you wouldn't do things where we pay above the mark. We are doing—because these securities are marked with different marks and different types of institutions. So this is a very complicated process and so—and it is going to be difficult to get our arms around valuation, but that is why it is so important that we cast our net broadly.

Senator CORKER. Let me pick up on that comment. I know you have said several times how excessively complex this is. We talk about these auctions as if we are auctioning off securities that are like one another when, in fact, they are not. I mean, these securities are very different. The collateral that backs them up is very different. And so to talk about the due diligence—and I am going to lead up to something, if I could—the due diligence that one would have to go about to actually even buy these at anywhere close to an appropriate rate is going to be massive. Is that true? Would you say yes or no to that? And that is why you are employing another—

Secretary PAULSON. It is, but I want to correct maybe a misperception we have left you with. We believe, for the reasons you outlined, the way to deal with this is to deal with it by—with similar securities, to deal with it, you know, looking at the CUSIP numbers, looking at different tranches of the same security broadly, rather than saying let us have an auction and put any security you would like into it. But your point is still the same.

Senator CORKER. Tremendous due diligence.

Secretary PAULSON. Right.

Senator CORKER. OK. And Chairman Bernanke, I heard you say, and I don't know whether you were being somewhat politic and trying to help someone with a foreclosure process, but you mentioned we were going to be buying second liens. Surely we are not going to be buying second liens with taxpayer money. Would you expand on that?

Mr. BERNANKE. Well, second liens are selling for a few cents on the dollar and I wouldn't expect them to be worth much more than that. But I was only pointing out that—I know this from Governor Duke, who is on the HOPE for Homeowners Board, that the problem of second liens is a big issue right now because it prevents renegotiations of the first mortgage. So I was just saying that a side effect, if we do buy them at a market value, a few cents on the dollar, would be to help free up this other issue.

Senator CORKER. I know my time is up. I can see the light, I guess, on the timer. I just want to close by saying there have been a number of concepts thrown out regarding getting the private sector involved. I actually think that has not been explored to the length that it should. I know there have been some thoughts put forth about maybe a levy on the industry. It is a huge industry, a \$2.5 trillion industry, and that maybe a levy on the industry to help, if you will, cash-flow this process until some of the yields can come back to the taxpayers would be interesting.

But I just want to close by saying, following up on Senator Schumer's comments, we had a meeting Sunday, and I appreciate again so much your time. I am struck by the fact that, again, this is a concept and you want \$700 billion to deal with this concept that no one can explain how it is going to work, and I am certainly not asking you to do that and you can't do that today. It seems that what he said makes a tremendous amount of sense.

You are going to have to figure out a way to do this, if we agree to do it. It is going to take you—it is not going to be happening in 14 days. There are going to have to be some guidelines. People are going to have to be hired with instructions, the institutions that help support this.

It is very difficult for me, knowing that we really don't know what this is going to do, it is very difficult for me to understand why we don't pass legislation that says something like, we have a goal of \$700 billion, but that you are going to put in place the processes and expand a tranche or two, \$50 billion, \$100 billion, maybe \$150 billion, and you are going to get this put together in a thoughtful way and we are going to know who the Treasury Secretary really is and that you bring back to us a fully baked concept with the markets knowing that is what you are working through and that we have something intelligent and well-constructed to actually certify to go to the lengths that you are talking about doing now.

It seems to me that is very workable, and you would be sending a signal to the markets. And in fact, over the next 60 to 90 days, you would know which of these things is working and which is not. That just seems to me to be prudent. And I can't imagine why that is not acceptable to you, even though—I just can't imagine that.

Secretary PAULSON. Let me comment that under normal circumstances, that would be a good way to go. These are extraordinary circumstances. We have been moving quickly already to get ready to be in the position where we could implement within weeks something with some of the simpler things after you all act.

I think what I would come back to you and say, I believe and the Chairman believes, and we have talked about this a lot, this is what we need here to deal with this market situation. We will be going out in a methodical way. There will be plenty of time to review what is done. There will be plenty of time to add to transparency over time. We are going to put in strong protections. And you will have an opportunity to work with the new Treasury Secretary. We will have flexibilities. We will have flexibilities to involve the private sector. We will have flexibilities to move this to another area. But this is—we know how unusual it was to ask for this, but we have asked for it because we think it is the best way to protect the taxpayer.

So we both want to do the same thing, sir. You want to protect the taxpayer. I want to protect them. I am thinking the best way to protect the taxpayer, and you have a very strong view of that, is to do something that has got the maximum chances of working in this marketplace to calm the market, and so that is our view.

Chairman DODD. I thank Senator Corker.

Just an editorial comment here. Senator Shelby and I were talking. Senator Shelby is a young-old appropriator and sometimes we do things that—

Senator SHELBY. Together, we are.

Chairman DODD [continuing]. But there are times, I would say to Senator Corker, when we have appropriated funds and then fenced funds. So they have been appropriated, so it is not just a goal, and what you then can set up, some conditionality.

I would say, Mr. Secretary, I appreciate your point, but this is not—we are not going to try and draft legislation here, but I would leave that door open a little bit. If we are looking to build the kind of consensus up here to move forward quickly and thoughtfully and responsibly, I think it is very important to not reject some of these ideas as a way of getting something done, and I appreciate very much the spirit in which Senator Corker has raised an issue as maybe we can begin to talk about as how we move forward in an expeditious fashion, but a careful one, as well. So I thank him very much for that thought.

Senator Akaka.

Senator AKAKA. Thank you very much, Mr. Chairman.

This is an historic time in our nation and I want to commend all of you, the administration as well as the Congress, for using this spirit of working together to try and find the best way to work ourselves out of the disaster we are in. Historically, we have just been through a disaster that is natural and now we are in a manmade disaster. But we are using this period of working together to try to make a difference.

Chairman Bernanke, this economic downturn and credit crisis have produced great public concern, and it has been expressed here many times. My question to you has to do with human capital concern. What effect will this troubled assets program have on the supervisory duties, the supervisory duties of the Federal Reserve?

Mr. BERNANKE. Well, we will continue to evaluate. For those institutions that we supervise, we will continue to evaluate their positions, their capital, their risk management, and so on. But I think this will obviously be helpful in removing some risk from their balance sheet and allowing them to expand their lending. So I don't see any problem from this, but we will certainly keep close track of what is going on.

Senator AKAKA. I am also concerned about the statutory as well as regulatory aspects that what we are trying to do will affect us. So Chairman Bernanke, the Federal Reserve's statutory responsibilities focus on monetary policy to promote maximum employment, stable prices, and moderate long-term interest rates. My question is, to what extent will the injection of this \$700 billion affect your ability to meet these goals?

Mr. BERNANKE. Well, if the program works, it will be extremely helpful because we are in a situation now with financial markets freezing up and it is very difficult for us to achieve the objective of full employment in a situation where credit is not available and the financial markets are so unstable. So I think we have taken the view—we have been working very hard over the last year using a variety of tools to try and promote financial stability. That was, in fact, the historic purpose of the Federal Reserve. But I view it as

essential to the other objectives you just mentioned. Without financial stability, you are not going to have full employment and price stability. So we think that is very important and we have been working together with the Treasury Secretary very intensely in trying to promote stability in our financial markets.

Senator AKAKA. Chairman Bernanke, should we worry about the Treasury being given the ability to move \$700 billion in and out of the economy and the potential impact that this could have on monetary policy, and also the political independence of the Federal Reserve?

Mr. BERNANKE. I don't see any problem in terms of macroeconomics, only a positive effect in terms of stabilizing the financial system. The Federal Reserve would like to get out of dealing with some of these crises we have been dealing with because there is no broader authority, no broader support, and we prefer to get back to monetary policy, which is our function, our key mission.

Senator AKAKA. Mr. Secretary, you mentioned about needing the right group of experts to help in this huge effort. Has there been any consideration, Mr. Secretary, given to specifically what parts of the Federal Acquisition Regulations would need to be waived to get contractors and consultants to establish this program?

Secretary PAULSON. Yes. We have given a lot of thought to that and we have worked it through very carefully with our General Counsel.

Senator AKAKA. Do you plan to have competitive bidding, and if not, why not?

Secretary PAULSON. Well, we have procedures that are designed to mitigate against conflicts, but we need to move very quickly here and so we can't go through all of the normal processes or it won't work for the markets.

Senator AKAKA. Chairman Cox, do you need additional statutory authority to properly regulate brokerage holding companies? If not, why not?

Mr. COX. Senator, the regulatory hole that I have referred to that still exists gives no regulators the authority or the responsibility to regulate investment bank holding companies. The marketplace has dealt with this in the context of the current market turmoil by investment banks opting to become or merging or combining to become bank holding companies. But the problem remains, and if there are to be other investment, pure investment banks in the future, there is no statutory responsibility.

The SEC, for its part, does not have legal authority over the entire investment banking firm. It doesn't have the authority to require that it maintain capital levels or liquidity or what have you. We have had a voluntary program that was put in place 1 year before I arrived. Senator Shelby referred to our view of that early in the year, prior to Bear Stearns in March, the trial by fire for this voluntary program. It was very clear that it was broken and it did not serve the purpose. Certainly, it did not serve the purpose of looking at systemic risk, something that the SEC is not assigned to do in statute.

And so I think with respect to this question, we have now an MOU that we signed up with the Federal Reserve immediately in the wake of Bear Stearns so that we could take a look at informa-

tion about regulated investment banks' subsidiaries, or I should say, regulated broker-dealer subsidiaries of bank holding companies and the Fed could take a look at the same information for investment bank holding companies. That is working very well, or was working very well, to broaden our reach, but the fundamental flaw was that it was voluntary. And so I think, yes, that needs to be taken care of.

I also mentioned the other regulatory hole, which I think is urgent in the current circumstances, and that is CDS. We are looking at effects of short selling, but those same effects, and indeed greater opportunities for manipulation exist in the CDS market. No regulator has authority except anti-fraud authority with respect to credit default swaps.

Chairman DODD. Thank you, Senator, very much.

Senator AKAKA. Thank you, Mr. Chairman.

Chairman DODD. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman. I should request that we could have gotten this hearing over a lot quicker if you had just called my name first.

[Laughter.]

We have been at this about four-and-a-half hours. I want to thank you fellows for being here. I really appreciate it.

My first question is going to be with Secretary Paulson and Chairman Bernanke. When you were at the last hearing that I was at—it was on July 15—asking for some sweeping powers to provide taxpayer equity into the two housing GSEs, I asked you then if this could in any way affect the credit rating of the U.S. Treasury. You both at that point in time said no. That decision is starting to look like a minimum of about \$200 billion commitment, followed by \$85 billion to AIG and another \$29 billion to Bear Stearns before now. We have an additional \$700 billion now on top of that. Could this threaten the credit rating of the U.S. Treasury?

Secretary PAULSON. Let me comment. First of all, you have heard why we did what we did—

Chairman DODD. You have got to get closer to that microphone—

Secretary PAULSON [continuing]. There were obligations, and that this—when you look at this, this authority is the authority to invest up to \$700 billion. It is not to invest all of \$700 billion. It is up to as much as needed and it will be investing, buying assets, and then we are selling those assets, and hopefully for a cost that is—we are buying the assets. We are not spending it. So it is difficult to determine what the ultimate cost will be.

Senator TESTER. But my question is that, as has been pointed out about bazookas in people's pockets and the last housing bill we sent out, I mean, we had the conversation on the phone. You said, we need it. If I have got it, I am probably not going to have to use it. You had to use it. I am not arguing that point.

What I am asking you is that we have got \$700 billion in spending authority. Is this—could this potentially affect our credit rating to our U.S. Treasury? And really, it is yes or no.

Secretary PAULSON. Well, obviously, everything we do in some way or other affects the credit rating. But what I am trying to ex-

plain here is that this is different from normal expenditures or outlays—

Senator TESTER. So you don't think it is going to affect the credit rating?

Secretary PAULSON. Anything we do, every expenditure, every investment has an impact. But we believe this is the right thing to do, and I will, Ben, let you—

Senator TESTER. OK.

Mr. BERNANKE. I don't know how they make those decisions. I don't know. But I do know that a weak economy means lower tax revenues. So if it goes either way, there is going to be a fiscal hit.

Senator TESTER. OK. I understand. So what you are saying is the increase in potential debt would not have an impact on U.S. Treasuries.

Mr. BERNANKE. I don't think so, but I don't know how that rating agency does its analysis.

Senator TESTER. Good enough. The "too big to fail" issues have been brought up here several times today, and this is for Chairman Bernanke. Both you and your predecessor have warned about the threat of systemic risk to financial markets when some companies are too big to fail, or we are talking about the whole system. Chairman Greenspan spoke most frequently about the systemic risk Fannie Mae and Freddie Mac posed. In response to the recent crisis, Secretary Paulson, if I can quote you, you said, "as we have worked through this period of market turmoil, we have acted on a case-by-case basis," which is accurate.

In that work, we have forced some marriages of some of Wall Street's biggest titans, Bear Stearns, AIG, Bank of America and Merrill Lynch, Morgan Chase, all those. So the question is, are we posing additional risks by this consolidation in the marketplace and how do we spread risk as long as this consolidation is going on, because it appears we are forcing some of this consolidation.

Mr. BERNANKE. Well, I think some consolidation is necessary in the industry. In particular, in the investment banking industry, there were real concerns about that model raised by the recent events, which is part of the reason why Morgan Stanley and Goldman Sachs have applied to become bank holding companies.

I think the "too big to fail" problem is a very serious problem, but I think we have to get through this period and then work through ways to mitigate that problem in the future, and I have made a number of suggestions along those lines which I think is very important. That is a very important issue.

Senator TESTER. When you have consolidation in any marketplace, it tends to result in less benefits for the consumer—this is my perspective, you may disagree—less benefits to the consumer and need for more regulation. Do you see both of those things occurring or needing to occur?

Mr. BERNANKE. Well, the financial supermarket approach has benefits and costs. It has some complementarities across different types of services. It has some market issues, like you are referring to. I think we need to look at the regulatory system very extensively, as I said earlier today.

Senator TESTER. OK. And the consolidation, do you see it having an impact, a greater impact on rural America than it does on urban America?

Mr. BERNANKE. I think one of the—in the medium-term, at least, one of the beneficiaries of these events will be smaller and community-type banks who have retained those relationships within their own towns and communities and didn't get into some of these problems.

Senator TESTER. My time has—this is the quickest time in the world. I cannot believe how fast this time has gone by, and I apologize. I will just tell you that there is—I am just going to make a real quick statement.

Chairman DODD. Senator, you have been patient. Why don't you take another couple of minutes if you want to?

Senator TESTER. I can?

Chairman DODD. Yes, you can.

Senator TESTER. Well, thank you, Mr. Chairman.

Chairman DODD. I will exercise—

Senator TESTER. I appreciate that.

Chairman DODD [continuing]. Imperial authority I have here.

Senator TESTER. Man, you are top flight. I will buy you a cup of coffee.

[Laughter.]

I want to talk a little bit about foreign entities and possible dollars going to them. It has been brought up several times. And I think in your testimony, I heard—and correct me if I am wrong—that you have been talking to the folks in the G-8 around the world about the United States's role in propping up our markets, and have you talked about their role in us propping up their markets?

Secretary PAULSON. Yes. Our system is integrated. We have clearly talked about their role. They have different policies. The U.K. had a significant policy action related to their banks and mortgages. There are actions being taken elsewhere. We are talking to them. We are urging them. But again, I just want you to understand that our motive here is not propping up foreign banks. Our motive here is—

Senator TESTER. I understand that, and it is well taken. But when the taxpayers see us propping up foreign banks, there are questions that are asked to me and then I ask you questions. That is the way this process works, I guess.

What is the financial condition worldwide? I mean, and where I am going with this, just so you know, we passed a bill here a couple of months ago that we funded a very, very important project for research that, quite honestly, we are going to be borrowing money from other countries to fund that project when other countries in the G-8 should have been putting in the same kind of money. That is a little convoluted. But what I am asking is where are the other countries at in this process, because I think that, unless their economy is—and you said it is totally integrated, so it is integrated down on us, too—why aren't they ponying up? Why aren't they stepping up to the table? Because if we go down, like you say we could go down, I can't imagine they are going to be in very good shape.

Secretary PAULSON. We didn't say we are going to go down. I certainly said what we need to do is protect the American people from a system—

Senator TESTER. Bad choice of words. I am sorry.

Secretary PAULSON. But I will say this, that all of them are dealing with their own economies. Economies are slowing down around the world. We have fragility in the markets around the world. We have equity markets declining in various parts of the world. So again, every one of these countries is dealing with their own situation.

Senator TESTER. And so you feel comfortable that they have stepped up to the plate in a commensurate way?

Secretary PAULSON. Well, do I feel comfortable they have all—I can't speak for every country and every—

Senator TESTER. Your assessment.

Secretary PAULSON [continuing]. And every—

Senator TESTER. Your assessment.

Secretary PAULSON. So I can't say that. I say that there are different approaches to dealing with this with different situations.

Senator TESTER. OK. And I don't want to miss the opportunity to follow up with Chairman Cox on the whole Bear Stearns investigation and what went on there and what transpired and all that. It is still in the back of my mind and hopefully we can take care of that.

I just, in very quick closing, I want to say this. I haven't been involved in government all that long, 10 years. I have been involved in public service at the local level a lot longer than that. But I can tell you that every time, every time that I can think of that we made a spur-of-the-moment decision, that we didn't do our due diligence on, and with the level of governments I have been involved in, it has been a wreck.

To quote Senator Menendez, I don't feel a lot of confidence. I mean, I am not sure we have got the whole sentence written, much less the "i"s dotted and the "t"s crossed. And I fully feel the urgency, and I know you guys are frustrated. I am frustrated. Everybody up here is frustrated. But the truth is that we have to be given the time to do this right or it is not going to work and we will be back here next year or in 2 years asking for another \$700 billion or more, and that is a real issue with me because my kids have got to pay for that.

Thank you. Thank you for being here. I appreciate your patience.

Chairman DODD. Senator, thank you very, very much.

Just a couple of points. Let me ask you something, if I can, Mr. Secretary, that hasn't come up here today. Section 8 of your proposal says the following: Decisions by the Secretary may not be reviewed by any court of law or any administrative—order in the room—by any court of law or any administrative agency. This is rather sweeping, to put it mildly. I am trying to recall any other example I can think of in my 28 years where a request has been made of us to basically immunize any agency from any review.

And it would seem to me that—and I understand, as I understand, the motivation behind it would be to sort of calm the markets. We are going to be able to make decisions and they are not going to be able to be challenged. I almost have the opposite reac-

tion. It would seem to me it would almost have the opposite reaction to me. The idea that you are going to have decisions made that are not subject to review by courts or agencies is so sweeping that it would be troubling to me, that you are not going to have that kind of tension that occurs when decisions are being challenged.

And so, one, I would just tell you, maybe I am speaking for myself here, there will be real problems with this kind of language. Now, I understand you want to do some things, but I have asked the Judiciary Committee and others who spend more time on this, this language, in my view, cannot last here.

Secretary PAULSON. I hear your comment that we need to work through this. We put this together. It was bare bones. But again, I will just say to you, this is not a position I wanted to be in. I didn't want to be in this position. I am the Treasury Secretary. We moved very quickly to deal with something and it is very easy to second-guess it and it is very easy for everyone to—everyone has got to do their job here.

Chairman DODD. Right.

Secretary PAULSON. But we need something that can have strong oversight. We have got to have the protections. We have got to have the transparency. You have heard me say that. Would I like to have months and months to put this together? Yes, I would. But I don't think that the situation calls for that. And so what we want to do is have the oversight, have the protections, but be able to move quickly to implement this.

Chairman DODD. I hear you.

Secretary PAULSON. And again, implementing it does not mean going out and investing \$700 billion immediately.

Chairman DODD. No, I understand that. But the rule of law is something that all of us up here, regardless of party, care deeply about. And the idea that you would ask for such sweeping authority here, to sweep that aside, I suspect maybe met with as much concern as I am expressing to you. So I just raise that with you here. It takes some work. This is a paragraph that is going to require some work, to put it mildly.

Let me turn to Senator Shelby and we will try to wrap up here.

Senator SHELBY. Thank you, Chairman Dodd.

Chairman Bernanke, have you ever known of any central bank of any country in the world bailing out foreign banks doing business in their country other than their own? In other words, have you ever known any central bank bailing out our banks or some other banks? I have never heard of it. Now, you are a student of economic history.

Mr. BERNANKE. Well, central banks have an important role as the lender of last resort—

Senator SHELBY. We know that.

Mr. BERNANKE [continuing]. To provide liquidity, and we provide liquidity to any bank that is within the—whose branches—or, sorry, whose subsidiary is within the boundaries of the United States and is regulated by U.S. regulators, and that has been our general policy.

Senator SHELBY. We understand that, basically providing liquidity. But in this, this would provide liquidity, but at a price. You are talking about buying toxic securities or securities that there is no

market for them from all the banks, our banks and foreign banks doing business in this country. I don't—I understand why you are doing that, but I think that is a bad, bad precedent.

Senator Dodd, I know we are getting toward the end of the hearing, and I think there are still significant unresolved issues here. You have brought up several. Foremost is the basic question regarding whether the plan will actually provide stability and greater liquidity. I think, as do many of my colleagues that it appears here today on the Banking Committee, that the pricing mechanism that we have talked about is the absolute key to whatever you are doing, assuming you are playing pass.

Too high and the private money does not return to the market. There are trillions of dollars—you know this—in the private market looking for an investment. But they won't return here if it is not done right. If the price is too low, firms will become insolvent, fail, and bring instability back to the market.

Consider this proposition. We spend hundreds of billions of dollars, maybe a trillion dollars. It leads to the collapse—I hope not, but it could—of more firms. We have to spend billions more to recapitalize, among other things, the Federal Deposit Insurance Fund. There is also the question, as I see it, Mr. Chairman, as to whether our efforts might be better directed—something to think about—if we targeted some resources at homeowners beyond these issues.

I think there are a broad range of questions that haven't been resolved here and can't be resolved in a short time, such as taxpayer protection—this goes to the heart of this—GAO oversight, conflicts of interest, and many others brought before us today. I think we need better answers and I think that before we really proceed on this—I don't believe Congress should just ratify what has been thrown up to them. I understand the situation is dire, but so is the condition of the taxpayer out there. And I believe we, as Senators, should consider this.

And my last statement regarding this, the market is overwhelmed. I believe some of you used that term, or somebody did. I think it is overwhelmed by greed, by mismanagement, by lack of regulatory reform in the past, regulatory oversight. And the bottom line, as I see it, you are visiting the taxpayer with it. I think that is shameful, myself. I know there are better ways. Would it be without pain? Oh, no. There is always pain. But the best—and Chairman Bernanke, I have heard you say this, or something to this effect—that the best disciplinary mechanism we have is the marketplace. The marketplace will discipline all of us. We are paying, but we learn. I am not sure people will learn if this goes through.

Thank you, Mr. Chairman.

Chairman DODD. I see—I know Senator Schumer wanted to ask one additional question. I presume he is on the way over. But let me ask Senator Dole if you have a quick question here, or Senator Corker.

Senator DOLE. Yes, just a couple of comments. I want to underscore, Chairman Dodd, your concerns about the power assault here, and I would like to ask Secretary Paulson, how did you or how will

you select these so-called unbiased asset managers? Won't there be a perception of Wall Street helping Wall Street?

Secretary PAULSON. I would say we will design the process that has as many protections around this as possible to bring in experts, and we will have the proper oversight. Senator, that is how we are going to work through this.

Senator DOLE. Publicly, you have stated that the long-term fate of Fannie and Freddie rests with the subsequent Congress and next administration. In addition, you have expressed that these GSEs are a relic of the past and burdened by various conflicts of interest. Given this, before leaving in January, will this administration commit to releasing its own recommendations as to what it believes should be the Federal Government's role in supporting the U.S. mortgage market?

Secretary PAULSON. Senator, I have said that in the weeks or months ahead, that I will express views on different ways to deal with these conflicts or these ambiguities and some very specific views.

Senator DOLE. Specific written recommendations?

Secretary PAULSON. I didn't say written, but I will certainly express views, because there are—there clearly are significant issues. There, we had to stabilize the situation to deal with it, have them continue to play the very important role they have to play in our economy and our housing markets. But there is no doubt that the big structural issues have yet to be dealt with, and there are structural flaws and there are solutions, in my judgment, to those structural flaws.

Senator DOLE. Thank you. Thank you, Mr. Chairman.

Chairman DODD. Senator Corker, did you have a—

Senator CORKER. I think since we are filibustering for Schumer, I will just—

[Laughter.]

Senator CORKER. I know they have to go, and I can't believe we can keep them unless we are filibustering, but I would just say to them that I do hope—

Secretary PAULSON. We do have to go.

Senator CORKER. That is fine.

Chairman DODD. I know you do.

Senator CORKER. Let us end it, then.

Chairman DODD. Well, let me just say, I just want to make a couple of quick concluding remarks.

First of all, I just want to—Senator Casey raised about some modifications to the bankruptcy provisions. We ought to talk about that, because that could help, I think, on the mortgage, not to end up in bankruptcy courts, but it is the incentive to try and do workouts so you don't end up in courts, but I will leave that for further discussion.

I hope our witnesses see the value of this. I know it has taken a lot of time, but it is very important. These are the people here, at least in this committee, we have been charged because of jurisdiction to deal with this. And so it is critically important that my colleagues have a chance to do this. And through us, the public gets a better understanding of what is going on. Your answers, I think, have been very good. They have been further explanation of

what needs to be done. Obviously, there were those who have other ideas, but I think it has a value and it is important that there be an appreciation of that.

And again, I can't speak for everyone here, but I think most of us recognize the gravity of the situation and that it is important we act. And we are going to need to try and figure out how to do that. The present system of how we legislate does not lend itself to a moment like this, where you normally have this body works, then the other body works, and we meet back and forth and try and come up with an answer over weeks, in some cases, months, in some cases.

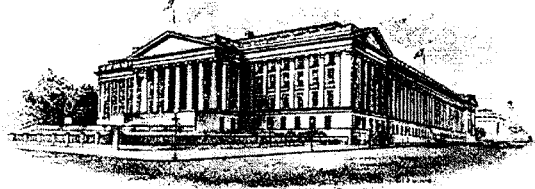
So I would hope the leadership of our respective bodies, and I think they are, are thinking about a mechanism by which we get together. It is not going to do any good just to have the Secretary negotiating with the House and then try and negotiate with the Senate. It seems to me we need a different system right now to begin to go through these ideas and put together a proposal that may then be adopted by both chambers and get us to move along. So I am going to recommend that we have some thought to how that can work.

But again, I think it is extremely important that we work together on this. And again, my desire here is to try and come up with something that can work. And so on behalf of all of us here, we thank you immensely for the time you have spent. It has been valuable, I think, for the country and valuable for this committee.

With that, this Committee will stand adjourned.

[Whereupon, at 2:25 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL, 10 a.m. (EDT), September 23, 2008
 CONTACT Brookly McLaughlin, (202) 622-2920

**TESTIMONY BY SECRETARY HENRY M. PAULSON, JR.
 BEFORE THE SENATE BANKING COMMITTEE
 ON TURMOIL IN U.S. CREDIT MARKETS: RECENT ACTIONS REGARDING GOVERNMENT
 SPONSORED ENTITIES, INVESTMENT BANKS AND OTHER FINANCIAL INSTITUTIONS**

Washington, DC—Chairman Dodd, Senator Shelby, members of the committee, thank you for the opportunity to appear before you today. I appreciate that this is a difficult period for the American people. I also appreciate that Congressional leaders and the Administration are working closely together so that we can help the American people by quickly enacting a program to stabilize our financial system.

We must do so in order to avoid a continuing series of financial institution failures and frozen credit markets that threaten American families' financial well-being, the viability of businesses both small and large, and the very health of our economy.

The events leading us here began many years ago, starting with bad lending practices by banks and financial institutions, and by borrowers taking out mortgages they couldn't afford. We've seen the results on homeowners – higher foreclosure rates affecting individuals and neighborhoods. And now we are seeing the impact on financial institutions. These bad loans have created a chain reaction and last week our credit markets froze – even some Main Street non-financial companies had trouble financing their normal business operations. If that situation were to persist, it would threaten all parts of our economy.

As we've worked through this period of market turmoil, we have acted on a case-by-case basis --- addressing problems at Fannie Mae and Freddie Mac, working with market participants to prepare for the failure of Lehman Brothers, and lending to AIG so it can sell some of its assets in an orderly manner. We have also taken a number of powerful tactical steps to increase confidence in the system, including a temporary guaranty program for the U.S. money market mutual fund industry. These steps have been necessary but not sufficient.

More is needed. We saw market turmoil reach a new level last week, and spill over into the rest of the economy. We must now take further, decisive action to fundamentally and comprehensively address the root cause of this turmoil.

And that root cause is the housing correction which has resulted in illiquid mortgage-related assets that are choking off the flow of credit which is so vitally important to our economy. We must address this underlying problem, and restore confidence in our financial markets and financial institutions so they can perform their mission of supporting future prosperity and growth.

We have proposed a program to remove troubled assets from the system. This troubled asset relief program has to be properly designed for immediate implementation and be sufficiently large to have maximum impact and restore market confidence. It must also protect the taxpayer to the maximum extent possible, and include provisions that ensure transparency and oversight while also ensuring the program can be implemented quickly and run effectively.

The market turmoil we are experiencing today poses great risk to US taxpayers. When the financial system doesn't work as it should, Americans' personal savings, and the ability of consumers and businesses to finance spending, investment and job creation are threatened.

The ultimate taxpayer protection will be the market stability provided as we remove the troubled assets from our financial system. I am convinced that this bold approach will cost American families far less than the alternative – a continuing series of financial institution failures and frozen credit markets unable to fund everyday needs and economic expansion.

Over these past days, it has become clear that there is bipartisan consensus for an urgent legislative solution. We need to build upon this spirit to enact this bill quickly and cleanly, and avoid slowing it down with other provisions that are unrelated or don't have broad support. This troubled asset purchase program on its own is the single most effective thing we can do to help homeowners, the American people and stimulate our economy.

Earlier this year, Congress and the Administration came together quickly and effectively to enact a stimulus package that has helped hard-working Americans and boosted our economy. We acted cooperatively and faster than anyone thought possible. Today we face a much more challenging situation that requires bipartisan discipline and urgency.

When we get through this difficult period, which we will, our next task must be to address the problems in our financial system through a reform program that fixes our outdated financial regulatory structure, and provides strong measures to address other flaws and excesses. I have already put forward my recommendations on this subject. Many of you also have strong views, based on your expertise. We must have that critical debate, but we must get through this period first.

Right now, all of us are focused on the immediate need to stabilize our financial system, and I believe we share the conviction that this is in the best interest of all Americans.

Thank you.

For release on delivery
9:30 a.m. EDT
September 23, 2008

Statement of
Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
before the
Committee on Banking, Housing, and Urban Affairs
United States Senate
September 23, 2008

Chairman Dodd, Senator Shelby, and members of the Committee, I appreciate this opportunity to discuss recent developments in financial markets and the economy. As you know, the U.S. economy continues to confront substantial challenges, including a weakening labor market and elevated inflation. Notably, stresses in financial markets have been high and have recently intensified significantly. If financial conditions fail to improve for a protracted period, the implications for the broader economy could be quite adverse.

The downturn in the housing market has been a key factor underlying both the strained condition of financial markets and the slowdown of the broader economy. In the financial sphere, falling home prices and rising mortgage delinquencies have led to major losses at many financial institutions, losses only partially replaced by the raising of new capital. Investor concerns about financial institutions increased over the summer, as mortgage-related assets deteriorated further and economic activity weakened. Among the firms under the greatest pressure were Fannie Mae and Freddie Mac, Lehman Brothers, and, more recently, American International Group (AIG). As investors lost confidence in them, these companies saw their access to liquidity and capital markets increasingly impaired and their stock prices drop sharply.

The Federal Reserve believes that, whenever possible, such difficulties should be addressed through private-sector arrangements--for example, by raising new equity capital, by negotiations leading to a merger or acquisition, or by an orderly wind-down. Government assistance should be given with the greatest of reluctance and only when the stability of the financial system, and, consequently, the health of the broader economy, is at risk. In the cases of Fannie Mae and Freddie Mac, however, capital raises of sufficient size appeared infeasible and the size and government-sponsored status of the two companies precluded a merger with or acquisition by another company. To avoid unacceptably large dislocations in the financial

sector, the housing market, and the economy as a whole, the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac into conservatorship, and the Treasury used its authority, granted by the Congress in July, to make available financial support to the two firms. The Federal Reserve, with which FHFA consulted on the conservatorship decision as specified in the July legislation, supported these steps as necessary and appropriate. We have seen benefits of this action in the form of lower mortgage rates, which should help the housing market.

The Federal Reserve and the Treasury attempted to identify private-sector approaches to avoid the imminent failures of AIG and Lehman Brothers, but none was forthcoming. In the case of AIG, the Federal Reserve, with the support of the Treasury, provided an emergency credit line to facilitate an orderly resolution. The Federal Reserve took this action because it judged that, in light of the prevailing market conditions and the size and composition of AIG's obligations, a disorderly failure of AIG would have severely threatened global financial stability and, consequently, the performance of the U.S. economy. To mitigate concerns that this action would exacerbate moral hazard and encourage inappropriate risk-taking in the future, the Federal Reserve ensured that the terms of the credit extended to AIG imposed significant costs and constraints on the firm's owners, managers, and creditors. The chief executive officer has been replaced. The collateral for the loan is the company itself, together with its subsidiaries.¹ (Insurance policyholders and holders of AIG investment products are, however, fully protected.) Interest will accrue on the outstanding balance of the loan at a rate of three-month Libor plus 850 basis points, implying a current interest rate over 11 percent. In addition, the U.S. government will receive equity participation rights corresponding to a 79.9 percent equity interest in AIG and

¹ Specifically, the loan is collateralized by all of the assets of the company and its primary non-regulated subsidiaries. These assets include the equity of substantially all of AIG's regulated subsidiaries.

has the right to veto the payment of dividends to common and preferred shareholders, among other things.

In the case of Lehman Brothers, a major investment bank, the Federal Reserve and the Treasury declined to commit public funds to support the institution. The failure of Lehman posed risks. But the troubles at Lehman had been well known for some time, and investors clearly recognized--as evidenced, for example, by the high cost of insuring Lehman's debt in the market for credit default swaps--that the failure of the firm was a significant possibility. Thus, we judged that investors and counterparties had had time to take precautionary measures.

While perhaps manageable in itself, Lehman's default was combined with the unexpectedly rapid collapse of AIG, which together contributed to the development last week of extraordinarily turbulent conditions in global financial markets. These conditions caused equity prices to fall sharply, the cost of short-term credit--where available--to spike upward, and liquidity to dry up in many markets. Losses at a large money market mutual fund sparked extensive withdrawals from a number of such funds. A marked increase in the demand for safe assets--a flight to quality--sent the yield on Treasury bills down to a few hundredths of a percent. By further reducing asset values and potentially restricting the flow of credit to households and businesses, these developments pose a direct threat to economic growth.

The Federal Reserve took a number of actions to increase liquidity and stabilize markets. Notably, to address dollar funding pressures worldwide, we announced a significant expansion of reciprocal currency arrangements with foreign central banks, including an approximate doubling of the existing swap lines with the European Central Bank and the Swiss National Bank and the authorization of new swap facilities with the Bank of Japan, the Bank of England, and the Bank of Canada. We will continue to work closely with colleagues at other central banks to address

ongoing liquidity pressures. The Federal Reserve also announced initiatives to assist money market mutual funds facing heavy redemptions and to increase liquidity in short-term credit markets.

Despite the efforts of the Federal Reserve, the Treasury, and other agencies, global financial markets remain under extraordinary stress. Action by the Congress is urgently required to stabilize the situation and avert what otherwise could be very serious consequences for our financial markets and for our economy. In this regard, the Federal Reserve supports the Treasury's proposal to buy illiquid assets from financial institutions. Purchasing impaired assets will create liquidity and promote price discovery in the markets for these assets, while reducing investor uncertainty about the current value and prospects of financial institutions. More generally, removing these assets from institutions' balance sheets will help to restore confidence in our financial markets and enable banks and other institutions to raise capital and to expand credit to support economic growth.

At this juncture, in light of the fast-moving developments in financial markets, it is essential to deal with the crisis at hand. Certainly, the shortcomings and weaknesses of our financial markets and regulatory system must be addressed if we are to avoid a repetition of what has transpired in our financial markets over the past year. However, the development of a comprehensive proposal for reform would require careful and extensive analysis that would be difficult to compress into a short legislative timeframe now available. Looking forward, the Federal Reserve is committed to working closely with the Congress, the Administration, other federal regulators, and other stakeholders in developing a stronger, more resilient, and better regulated financial system.



**TESTIMONY
OF**

**CHRISTOPHER COX, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION**

CONCERNING

**TURMOIL IN U.S. CREDIT MARKETS: RECENT ACTIONS
REGARDING GOVERNMENT SPONSORED ENTITIES,
INVESTMENT BANKS AND OTHER FINANCIAL
INSTITUTIONS**

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

SEPTEMBER 23, 2008

**U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549**

**Turmoil in U.S. Credit Markets: Recent Actions
Regarding
Government Sponsored Entities, Investment Banks
and Other Financial Institutions**

Testimony
Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

September 23, 2008

By
Christopher Cox
Chairman
U.S. Securities and Exchange Commission

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for inviting me here to today to discuss the turmoil in the U.S. credit markets and the efforts of the Securities and Exchange Commission, in concert with the Department of the Treasury, the Federal Reserve, and other regulators to protect investors and our markets. I should say at the outset that my testimony is on my own behalf as Chairman of the SEC, and does not necessarily represent the views of the Commission or individual Commissioners.

Last week, by unanimous decision of the Commission and with the support of the Secretary of the Treasury and the Federal Reserve, the SEC took temporary emergency action to ban short selling in financial securities. We took this action in close coordination with regulators around the world. At the same time, the Commission unanimously approved two additional measures to ease the crisis of confidence in the markets that threatened the viability of all financial firms, and which potentially threatened the ability of our markets to function in a fair and orderly manner. The first makes it easier for issuers to repurchase their own shares on the open market, which provides an important source of liquidity in times of market volatility. The second requires weekly reporting to the SEC by hedge funds and other large investment

managers of their daily short positions -- just as long positions are currently reported quarterly on Form 13F.

All of these actions relying upon the Commission's Emergency Authority under Section 12(k) of the Securities Exchange Act remain in effect until October 2, and are intended to stabilize the markets until the legislation you are crafting becomes law and takes effect.

The Commission's recent actions followed on the heels of new market-wide SEC rules that more strictly enforce the ban on abusive naked short selling contained in Regulation SHO. These new rules require a hard T+3 close-out; they eliminate the options market maker exception in Regulation SHO; and they have put in place a new anti-fraud rule expressly targeting fraudulent activity in short-selling transactions.

First and foremost, the SEC is a law enforcement agency, and we have devoted an extraordinary level of enforcement resources to hold accountable those whose violations of the law have contributed to the subprime crisis and the loss of confidence in our markets. We have over 50 pending law enforcement investigations in the subprime area. Our Office of Compliance Inspections and Examinations has initiated examinations of the effectiveness of broker-dealers' controls to prevent the spread of false information intended to manipulate securities prices. The Division of Enforcement has undertaken a sweeping investigation into market manipulation of financial institutions, focused on broker-dealers and institutional investors with significant trading activity in financial issuers and with positions in credit default swaps. The reason for this aggressive enforcement investigation is the significant opportunities that exist for manipulation in the \$58 trillion CDS market, which is completely lacking in transparency and completely unregulated.

Our subprime enforcement efforts fall primarily into three broad categories: first, subprime lenders; second, investment banks, credit rating agencies, insurers and others

involved in the securitization process; and third, banks and broker-dealers who sold mortgage-backed investments to the public.

We are investigating whether mortgage lenders properly accounted for the loans in their portfolios, and whether they established appropriate loan loss reserves. In connection with the sale of mortgage-backed securities and collateralized debt obligations, we are investigating the role of the various parties involved in the securitization process. Among other things, we are focused on whether lenders adequately disclosed the risk profiles of underlying loans, whether they valued their portfolios appropriately, and whether they made adequate risk disclosures to investors. We are also investigating whether investment banks and broker-dealers defrauded retail customers by making false representations, or by putting investors into unsuitable mortgage-backed investments.

Last month, the Enforcement Division, working with state regulators from around the country, entered into agreements that when finalized will be the largest settlements in the history of the SEC, in behalf of investors who bought auction rate securities from Merrill Lynch, Wachovia, UBS and Citigroup. The terms of these agreements would provide complete recovery for individual investors. Our Enforcement Division is continuing to investigate other firms.

Recently the Commission brought enforcement actions against two portfolio managers of Bear Stearns Asset Management, whose hedge funds collapsed in June of last year. We allege that they deceived their investors and institutional counterparties about the financial state of the hedge funds, and in particular the hedge funds' over-exposure to subprime mortgage-backed securities. The collapse of the funds caused investor losses of over \$1.8 billion.

The Commission is likewise using our regulatory authority to ensure that the market continues to function in a fair and orderly manner. Last week, the Commission's Office of Chief Accountant provided guidance to clarify the accounting treatment of

banks' efforts to support their money market mutual funds. The guidance clarified how banks should treat, for purposes of their balance sheets, the financial support they provide to money market funds within the same financial services complex. This will help assure banks that assistance to money market funds does not automatically trigger adverse accounting results. Clarity on this subject is important to protect investors in money market funds.

In the past week, the SEC, working with the Federal Reserve, oversaw the sale of substantially all of the assets of Lehman Brothers, Inc., to Barclays Capital. This quick result, following the Lehman bankruptcy, has brought immediate and significant benefits to Lehman's brokerage customers and the capital markets. The hundreds of thousands of Lehman's customer accounts can now be transferred, instead of going through a lengthy brokerage liquidation process that could take weeks and impair customer access to cash and securities. The transfer of most retail accounts, which hold over one hundred billion dollars in assets, is expected to be completed within days.

The problems that each of these actions has addressed have their roots in the subprime mortgage crisis -- which itself was caused by a failure of lending standards. The most recent dislocations have included the taxpayer rescues of Fannie Mae, Freddie Mac, and AIG, as well as the failure of Lehman Brothers and IndyMac. Financial institutions in every regulated sector have been damaged, and every one of those investment banks, traditional banks, and thrifts has been vulnerable to the effects of this toxic mortgage contagion.

The SEC's own program of voluntary supervision for investment bank holding companies, the Consolidated Supervised Entity program, was put in place by the Commission in 2004. It borrowed capital and liquidity measurement approaches from the commercial banking world -- with unfortunate results similar to those experienced in the commercial bank sector. Within this framework, prior to the spring of 2008, neither commercial bank nor investment bank risk models contemplated the scenario of total

mortgage market meltdown that gave rise to, for example, the failure of Fannie Mae and Freddie Mac, as well as IndyMac and 11 other banks and thrifts this year.

The creators of the Consolidated Supervised Entity program in 2004 had designed it to operate on the well-established bank holding company model used by regulators not only in the United States but around the globe. They decided that the CSE rules would permit the parent holding company to calculate its capital adequacy using an approach consistent with either of the Basel standards, adopted by the Basel Committee on Banking Supervision. But the market-wide failure to appreciate and measure the risk of mortgage-related assets, including structured credit products, has shown that neither the Basel I nor Basel II standards as then in force were adequate. Each had serious need of improvement.

As a result, since March 2008, the SEC and other groups in which we participate have focused on improving standards for capital, liquidity, and risk management in both commercial and investment banking. Following the sale of Bear Stearns, groups such as the Senior Supervisors Group, the Financial Stability Forum, the International Organization of Securities Commissions, and the Basel Committee all pointed to the need to strengthen and improve these standards.

In the meantime, beginning immediately in the wake of the Bear Stearns sale to JPMorgan Chase, the Division of Trading and Markets, working with the Federal Reserve, implemented substantially more rigorous approaches to supervision of liquidity levels and liquidity risk management. They have developed scenarios that are of much shorter duration and that are much more severe, including denial of access to secured as well as unsecured funding. Those more stringent scenarios assume no access to the Fed's discount window or other liquidity facilities, although in fact such facilities are now available to the major investment banks. As a matter of prudence, investment banks are urged to maintain capital and liquidity at levels far above what would be required under the standards themselves.

But beyond highlighting the inadequacy of the pre-Bear Stearns CSE program capital and liquidity requirements, the last six months -- during which the SEC and the Federal Reserve have worked collaboratively with each of the CSE firms pursuant to our Memorandum of Understanding -- have made abundantly clear that voluntary regulation doesn't work. There is simply no provision in the law that authorizes the CSE program, or requires investment bank holding companies to compute capital measures or to maintain liquidity on a consolidated basis, or to submit to SEC requirements regarding leverage. This is a fundamental flaw in the statutory scheme that must be addressed, as I have reported to the Congress on prior occasions.

Because the SEC's direct statutory authority did not extend beyond the registered broker dealer to the rest of the enterprise, the CSE program was purely voluntary -- something an investment banking conglomerate could choose to do, or not, as it saw fit. With each of the remaining major investment banks now constituted within a bank holding company, it remains for the Congress to codify or amend as you see fit the Memorandum of Understanding between the SEC and the Federal Reserve, so that functional regulation can work.

The failure of the Gramm-Leach-Bliley Act to give regulatory authority over investment bank holding companies to any agency of government was, based on the experience of the last several months, a costly mistake. There is another similar regulatory hole that must be immediately addressed to avoid similar consequences. The \$58 trillion notional market in credit default swaps -- double the amount outstanding in 2006 -- is regulated by no one. Neither the SEC nor any regulator has authority over the CDS market, even to require minimal disclosure to the market. This is an area that our Enforcement Division is focused on using our antifraud authority, even though swaps are not defined as securities, because of concerns that CDS offer outsized incentives to market participants to see an issuer referenced in a CDS default or experience another credit event.

Economically, a CDS buyer is tantamount to a short seller of the bond underlying the CDS. Whereas a person who owns a bond profits when its issuer is in a position to repay the bond, a short seller profits when, among other things, the bond goes into default. Importantly, CDS buyers do not have to own the bond or other debt instrument upon which a CDS contract is based. This means CDS buyers can “naked short” the debt of companies without restriction. This potential for unfettered naked shorting and the lack of regulation in this market are cause for great concern. As the Congress considers fundamental reform of the financial system, I urge you to provide in statute the authority to regulate these products to enhance investor protection and ensure the operation of fair and orderly markets.

Mr. Chairman, I appreciate this opportunity to discuss the current market turmoil, the policy choices that Congress now faces, and the SEC’s actions to maintain orderly markets and protect investors in this crisis.

Statement of

The Honorable James B. Lockhart III, Director

Federal Housing Finance Agency

Before the Senate Committee on

Banking, Housing, and Urban Affairs

on the Appointment of FHFA as Conservator for

Fannie Mae and Freddie Mac

September 23, 2008

Chairman Dodd, Ranking Minority Member Shelby, and members of the Committee, thank you for the opportunity to testify on recent regulatory actions taken by the Federal Housing Finance Agency (FHFA) at Fannie Mae and Freddie Mac.

Fannie Mae and Freddie Mac share the critical mission of providing stability, liquidity, and affordability to the housing market. Between them, these Enterprises have \$5.3 trillion of guaranteed mortgage-backed securities (MBS) and debt outstanding, which is equal to the publicly held debt of the United States. Their market share of all new mortgages was 76 percent during the first half of this year.

During the turmoil that started last year, they have played a very important role in providing liquidity to the conforming mortgage market. That has required a careful and delicate balance of mission with safety and soundness. A key component of this balance has been their ability to raise and maintain capital. Because of recent market conditions, that balance was upset. Unfortunately, as house prices, earnings and capital have continued to deteriorate, their ability to fulfill their mission has deteriorated. In particular, the capacity to raise capital to absorb further losses without Treasury Department support vanished. That left both Enterprises unable to provide counter-cyclical support. Worse, it threatened to require substantial shedding of current positions with attendant further damage to mortgage and housing markets.

In retrospect and despite OFHEO's surplus capital requirements, portfolio caps, and repeated warnings about credit risk, the credit profile at both Enterprises followed the market down in 2006 and 2007 – without commensurate pricing for risk. They bought or guaranteed many more low documentation, low verification and non-standard ARM mortgages than they had in the past. For example, for the first half of 2007, roughly one-third of the Enterprises' new business was composed of Alt-A

(less than standard documentation), interest-only, or Option ARM products, and mortgages with layered (multiple) risk characteristics vs. 14 percent in 2005. For Fannie Mae, roughly 40 percent of new business in the first half of 2007 was in Alt-A and interest-only products versus 26 percent in 2005. The quality of their holdings of private-label mortgage securities (PLS) issued by others also deteriorated. The portfolio caps restrained the size of their PLS books, but maturing subprime and Alt-A PLS were replaced by PLS from the much riskier 2006 and 2007 origination years. As house prices turned down, delinquencies, foreclosures, real-estate owned, losses and reserves against future losses soared.

Over the last several years OFHEO, now FHFA, worked hard to encourage the Enterprises to rectify their accounting, internal controls systems and risk management issues. Both Enterprises and their dedicated managers and employees made good progress in many areas, but market conditions overwhelmed that progress. Their antiquated capital structures even with the OFHEO additional requirement were not adequate for this market.

The result was that the Enterprises were unable to provide needed stability to the market. They also found themselves unable to meet their affordable housing mission. Rather than letting these conditions fester and worsen and put the

mortgage and overall financial markets in further jeopardy, FHFA, after painstaking review, decided to take action. The goal of these dual conservatorship actions is to help restore confidence in Fannie Mae and Freddie Mac, enhance their capacity to fulfill their mission, and reduce the systemic risk that would have exacerbated the instability in the current market.

The Determination to Appoint a Conservator

FHFA based its determination that grounds existed to appoint a conservator for the Enterprises, and that it was necessary to do so, on five key areas, each of which worsened significantly over the past two months:

1. Accelerating safety and soundness weaknesses, especially with regard to credit risk, earnings outlook, and capitalization;
2. Continued and substantial deterioration in equity, debt, and MBS market conditions;
3. The current and projected financial performance and condition of each company as reflected in its second quarter financial reports and our ongoing examinations;

4. The inability of the companies to raise capital or to issue debt according to normal practices and prices; and
5. The critical importance of each company in supporting the country's residential mortgage market.

Over the last month I shared our growing concerns with the Chairman of the Federal Reserve Board, Ben Bernanke, who was made our consultant by the recent legislation, and with Secretary Paulson. After I presented my assessment of these developments to each of the companies with Chairman Bernanke and Secretary Paulson, their CEOs and boards consented to the appointment of a conservator. I would like to trace for you these developments and how, taken together, they led FHFA to this conclusion.

In August of last year, it became apparent that the boom in subprime and nontraditional lending was coming to an abrupt end. In particular, subprime loans originated in 2006 and 2007 have been found to be far less creditworthy than market participants had expected. The downturn in house prices in many markets across the nation accelerated the growing recognition of the poor credit quality of these loans.

Through the fall and then winter, the market continued to struggle as house price declines continued and delinquencies rose. Liquidity in PLS backed by subprime and Alt-A loans evaporated, and prices fell due to growing liquidity and credit concerns. In the fourth quarter, with our strong urging, Fannie Mae and Freddie Mac raised \$13.9 billion in preferred stock. As house prices continued to fall, concern spread from subprime to Alt-A mortgages, and then finally to prime mortgages. These concerns have been driven by the continued deterioration in house prices coupled with the alarming increase in mortgage delinquencies and defaults, even among prime mortgages.

In March, we announced with the Enterprises an initiative to increase mortgage market liquidity and market confidence. We reduced the OFHEO-directed capital requirements in return for their commitments to raise significant capital and to maintain overall capital levels well in excess of requirements. Fannie Mae raised \$7.4 billion in May, but Freddie Mac never fulfilled its commitment to raise capital.

As described in our April 2008 Annual Report to Congress, OFHEO continued to classify each company as a significant supervisory concern. In that report, we described the significant remediation progress that took place during 2007 but

pointed specifically to concerns with the deteriorating credit environment and the risks it posed to the companies. Over the summer, we intensified our focus on a full range of credit-related issues, including loan loss reserving, securities valuation, and the management of real-estate owned (REO) due to foreclosures.

It became apparent during this intense supervisory review that market conditions were deteriorating more quickly than the companies had anticipated and more quickly than they could respond to by adjusting their models and forecasts. After the late-July enactment of the Housing and Economic Recovery Act of 2008, and as provided by that act, we supplemented our own examination activity with consultations with senior mortgage credit examiners from the Federal Reserve and the Office of the Comptroller of the Currency. These examiners assisted and corroborated our own analysis of the deteriorating credit environment and its implications for the companies. It was clear that capital would be threatened by increasing loss reserves, impairments, counterparty risks and other accounting issues.

During the last part of July and in August, FHFA was completing its confidential semi-annual examination ratings. FHFA's rating system is called GSE Enterprise Risk or G-Seer. It stands for Governance, Solvency, Earnings and Enterprise Risk

which includes credit, market and operational risk. There were significant and critical weaknesses across the board, which continued to worsen after the end of the second quarter.

The Enterprises themselves disclosed how the rapidly changing credit environment was affecting their outlook. Notably, in its second quarter 10Q filing, Fannie Mae took the unusual step of providing a statement on post-closing developments, describing the effect that market events in July had on the company's outlook:

“In mid-July, following the close of the second quarter, liquidity and trading levels in the capital markets became extremely volatile, and the functioning of the markets was disrupted. The market value of our common stock dropped rapidly, to its lowest level since October 1990, and we experienced reduced demand for our unsecured debt and MBS products. This market disruption caused a significant increase in our cost of funding and a substantial increase in mark-to-market losses on our trading securities arising from a significant widening of credit spreads. In addition, during July, credit performance continued to deteriorate, and we recorded charge-offs and foreclosed property expenses that were higher than we had experienced in any month during the second quarter and higher than we

expected, driven by higher defaults and higher loan loss severities in markets most affected by the steep home price declines. Greater credit losses in July not only reduce our July net income through our actual realized losses, but also affect us as we expect that we will need to make further increases to our combined loss reserves in the second half of 2008 to incorporate our experience in July.” (FNMA Form 10-Q, August 8, 2008, pages 5-6)

Freddie Mac also announced adverse recent developments under “Recent Events” on page 1 of its 10-Q, including its expectation of a substantial dividend cut in the third quarter to conserve capital, a highly dilutive capital raise, and limitations on its ability to serve its mission as a result of efforts to conserve capital:

“Since mid-June 2008, there has been a substantial decline in the market price of our common stock. The market conditions that have contributed to this price decline are likely to affect our approach to raising new core capital including the timing, amount, type and mix of securities we may issue. We have committed to the Office of Federal Housing Enterprise Oversight, or OFHEO, to raise \$5.5 billion of new capital. We remain committed to raising this capital given appropriate market conditions and will evaluate

raising capital beyond this amount depending on our needs and as market conditions mandate.

“Our financial performance for the second quarter, while reflecting the challenges that face the industry, leaves us capitalized at a level greater than the 20% mandatory target capital surplus established by OFHEO and with a greater surplus above the statutory minimum capital requirement. Given the challenges facing the industry, we expect to take actions to maintain our capital position above the mandatory target capital surplus. Accordingly, subject to approval by our board of directors, we currently expect to reduce the dividend on our common stock in the third quarter of 2008 from \$0.25 to \$0.05 or less per share and to pay the full dividends at contractual rates on our preferred stock. In addition, we continue to review and consider other alternatives for managing our capital including issuing equity in amounts that could be substantial and materially dilutive to our existing shareholders, reducing or rebalancing risk, slowing purchases into our credit guarantee portfolio and limiting the growth or reducing the size of our retained portfolio by allowing the portfolio to run off and/or by selling securities classified as trading or carried at fair value ...” (FHLMC Form 10-Q, August 6, 2008, page 1)

As noted earlier, Freddie Mac never fulfilled its March 2008 commitment to raise capital. Its own projections as disclosed to analysts on August 6 showed that, in the absence of such a capital raise, it would be unable to meet its commitment to maintain capital in excess of regulatory requirements.

The internal supervisory reviews and market evidence just presented led us to conclude that the companies each presented critical safety and soundness concerns pertaining to credit risk and to continued deterioration in the market environment. Importantly, key developments in July and August demonstrated market recognition of these heightened credit concerns and the effect of the deteriorating market environment on the Enterprises. New equity capital in any meaningful size became unavailable, and yields on Enterprise debt and mortgage-backed securities rose relative to other benchmarks. These developments convinced us that the time to act was now, before the conditions of each Enterprise worsened, and before the markets for their securities became too unstable to permit normal business activity and potentially threatened the financial health of many other institutions. The following developments in July and August provide context to this conclusion:

- July 7 – A Lehman Brothers report speculating on the need for the Enterprises to raise substantial capital should a proposed accounting rule to put MBS currently off-balance sheet on balance sheet be adopted sends Enterprise common share prices into a tailspin.
- July 13 – Secretary Paulson announces a proposed package of assistance for the Enterprises in response to fears of a debt market run on Enterprise securities.
- July 15 – Moody’s cuts the bank financial strength rating from B to B- for Fannie Mae, from B+ to B- for Freddie Mac, and the preferred stock rating from Aa3 to A1 for both Enterprises.
- July 30 – President signs the Housing and Economic Recovery Act of 2008. Since I took the job as Director of OFHEO, I have been requesting regulatory reform legislation that would give the regulator much stronger, bank-like authorities, including expanded authority to set capital requirements and establish prudential safety and soundness standards. I am very grateful that Congress granted those authorities to FHFA, but regrettably they arrived too late to establish a strong capital regime in advance of this credit cycle. Going forward, we will be working towards creating a sounder capital structure for the Enterprises.

- August 6 – Freddie Mac files its 10-Q, reporting losses of \$0.8 billion and describing the deteriorating capital situation as noted above. The loss was Freddie Mac’s seventh quarterly loss over the past eight quarters.
- August 8 – Fannie Mae files its 10-Q, reporting losses of \$2.3 billion and describing its July results and credit deterioration as noted above. This marked the fourth consecutive quarter of losses for Fannie Mae.
- August 11, Standard and Poors cuts subordinated debt and preferred stock ratings for each GSE from AA- to A-; the risk-to-the-government rating from A+ to A for Fannie Mae and AA- to A for Freddie Mac.
- August 22, Moody’s cuts the bank financial strength rating from B- to D+ for each Enterprise and the preferred stock ratings from A1 to Baa3 for each.
- August 26, Standard and Poors cuts its subordinated debt rating from A- to BBB+, preferred stock from A- to BBB-, and risk to the government ratings from A to A- for each Enterprise.
- September 5 – The Mortgage Bankers Association reports new record highs for seasonally-adjusted total delinquencies, rate of foreclosure starts, and percentage of loans in foreclosures, consistent with the trends identified by our examination process.

- Throughout July and August other pressures were mounting that made it more and more difficult for Fannie Mae and Freddie Mac to fulfill their missions:
 - Increased headline risk led to increased scrutiny of GSE debt, including by foreign investors and their regulators.
 - Central banks ceased buying and began selling Enterprise securities; relatively small sales triggered large price moves.
 - Despite financing 30-year mortgages, the Enterprises had to rely on short-term discount notes, with only a few fixed-rate debt securities issued, none with maturity greater than three years. Yet they have \$89 billion in long-term debt maturing in the second half of 2008.
 - The spread between senior and subordinated Enterprise debt rose from less than 100 basis points in late June to as much as 500 basis points by late August.
 - The spread between preferred stock and Treasuries jumped in early July, settled back a bit after the July 13th Treasury Department announcement, and then spiked in August to roughly double the mid-July spread and four times the late June spread.

- Stock analysts substantially lowered their prices targets for Enterprise stock, in one case from \$45 to \$8 for Freddie Mac and in another from \$48 to \$10 for Fannie Mae.
- Press speculation of a government bailout became more frequent.
- After substantial effort and communication with market participants, each company reported to FHFA and to Treasury that it was unable to access capital markets to bolster its capital position without Treasury financing. FHFA's and Treasury's own discussions with investment bankers and investors corroborated this conclusion.
- In the absence of access to new capital, the only alternative left to the firms was to cease new business and shed assets in a weak market. That would have been disastrous for the mortgage markets as mortgage rates would have continued to move higher and, in turn, disastrous for the Enterprises as the prices of their securities would have fallen and credit losses would have increased.

Therefore, in order to restore the balance between safety and soundness and mission, FHFA placed Fannie Mae and Freddie Mac into conservatorship. That is a statutory process designed to stabilize a troubled institution with the objective of maintaining normal business operations and restoring its safety and soundness.

FHFA did not undertake this action lightly. We consulted with the Chairman of the Board of Governors of the Federal Reserve System, Ben Bernanke, who was made a consultant to FHFA under the new legislation. We also consulted with the Secretary of the Treasury, not only as an FHFA Oversight Board member, but also in line with his ability under the law to provide financing to the GSEs. They both concurred with me that conservatorship needed to be undertaken.

FHFA will act as the conservator to operate the Enterprises until they are stabilized. The Treasury's financial commitments, authorized by the new law, were critical to creating a workable conservatorship structure.

Operating the Enterprises in Conservatorship

Let me now turn to the conservatorships. Although it is very early, the first signs are that the conservatorships have had a very positive impact on mortgage markets. A lack of confidence had resulted in continued widening of the spread between yields of their MBS and yields of Treasury securities, which meant that virtually none of the large drop in Treasury interest rates over the past year had been passed on to the mortgage markets. On top of that, Freddie Mac and Fannie Mae, in order

to try to build capital, may have raised prices and tightened credit standards beyond what was necessary for sound underwriting. I am pleased to say early indications are that the Enterprises' funding costs have declined, as have spreads on mortgage securities, as denoted in the attached chart. This lower cost has been passed on to homebuyers, with 30-year fixed-rate mortgage rates below 6 percent for the first time since January.

There are several key components of this conservatorship:

On the first day of the conservatorship businesses opened as normal, only with stronger backing for the holders of MBS, senior debt and subordinated debt. Consistent with the terms of the Treasury's financial assistance, over the next 15 months we will allow each company to increase its portfolio, up to \$850 billion, before requiring gradual declines in the portfolios of 10 percent per year. That is less than their runoff rate. The Enterprises are allowed to grow their guarantee MBS books without volume limits.

As the conservator, FHFA assumed the power of the board and management. However, new Chief Executive Officers and Boards of Directors will have significant powers. I have selected Herb Allison to be the new CEO of Fannie

Mae and David Moffett the CEO of Freddie Mac. Herb has been the Vice Chairman of Merrill Lynch and for the last eight years chairman of TIAA-CREF. David was the Vice Chairman and CFO of US Bancorp. I appreciate the willingness of these two men to take on these tough jobs during these challenging times. Their compensation will be significantly lower than the outgoing CEOs.

Although it is not necessary in a conservatorship, new boards are being formed as a matter of good governance. New non-executive Chairmen were announced yesterday. Philip Laskawy, former Chairman and CEO of Ernst and Young, and a Director for Loews Corporation, General Motors, Henry Schein, Inc., and Discover Financial Services, has agreed to be the Chairman of Fannie Mae. John Koskinen, former President and CEO of Palmieri Company, a corporate turnaround management company, former Deputy Director for Management at OMB, and Director for American Capital Ltd., has agreed to be the Chairman of Freddie Mac.

The present CEOs will be leaving, but have agreed to stay on for a time to help with the transition. Consistent with the authorities granted in HERA, I have determined not to pay any golden parachute payments to either departing CEO.

FHFA worked with the new CEOs to establish employee retention programs. They agreed with me that it is very important to work with the current management teams and employees to encourage them to stay and to continue to make important improvements to the Enterprises.

All political activities -- including all lobbying -- were halted immediately. We will review the charitable activities to ensure that it reflects their mission and their conservatorship status.

In order to conserve over \$2 billion in capital every year, the common stock and preferred stock dividends were eliminated, but the common and all preferred stocks will continue to remain outstanding. I recognize that the loss of dividend income may have an adverse affect on some investors, including depository institutions. Before taking our action, we consulted with the bank regulators and I understand that they are working with individual institutions under their jurisdiction that may have capital invested in Enterprise preferred stock. As you know, any preferred stock is part of the issuing firm's equity account and is issued to absorb losses ahead of debt holders. Subordinated debt interest and principal payments will continue to be made, even if the capital test is breached.

Finally and very importantly, there are the liquidity, MBS investment, and senior preferred stock facilities with the U.S. Treasury, which Secretary Paulson discussed. We believe that these facilities will provide critically needed support to Freddie Mac and Fannie Mae to fulfill their mission, most importantly of which is the liquidity of the mortgage market. In light of Treasury's senior preferred stock facility, we will continue to closely monitor capital levels, but the existing regulatory capital requirements will not be binding during the conservatorship. The Senior Preferred facility supports all past and future debt and MBS issuances, until the terms of the facility are completely satisfied. As SEC registrants the Enterprises will continue to report their financial results quarterly.

The secured liquidity facility is not only for Fannie Mae and Freddie Mac, but also for the 12 Federal Home Loan Banks that FHFA also regulates. The Federal Home Loan Banks have performed remarkably well over the last year as they have a different business model than Fannie Mae and Freddie Mac and a different capital structure that grows as their lending activity grows. They are jointly and severally liable for the Bank System's debt obligations and all but one of the 12 are profitable. Therefore, it is very unlikely that they will use the facility.

Let me now bring you up-to-date on our actions since September 7. The new CEOs were introduced to Enterprise senior management at separate meetings at FHFA offices on Sunday, September 7. To reassure financial counterparties, later that day FHFA posted a statement on its website emphasizing that all existing contracts with the Enterprises remain in effect, that the Enterprises have the authority to enter into new contracts, and that the enforceability of such new contracts is not affected by the appointment of the conservator. I also sent a statement to employees at both Enterprises explaining the conservatorships, and that the purposes of the action are to help restore confidence in the Enterprises, enhance their ability to fulfill their mission, and mitigate systemic risk.

Since the Enterprises opened for business on September 8, FHFA examiners have been continuously on site, both at the Enterprises' headquarters and locations of other key operations, to ensure a smooth transition. FHFA examiners are there to reassure Enterprise employees about the business-as-usual objective of the conservatorship, to allay fears and dispel rumors, to provide information to employees, to support the needs of the new CEOs as they become familiar with their new organizations, and to communicate any questions and issues that need resolution back to me as FHFA Director.

During the conservatorship period, FHFA will continue to work expeditiously on the many regulations needed to implement the new law. Some of the key regulations will be minimum capital standards, prudential safety and soundness standards and portfolio limits. It is critical to complete these regulations so that any new investor will understand the investment proposition.

Affordable Housing and Mission

The new legislation, for the first time, adds affordable housing and mission enforcement to the responsibilities of the safety and soundness regulator. While FHFA has had these responsibilities for only a matter of weeks, they rank among our most immediate concerns in making the determination to place the Enterprises into conservatorship. In short, a key reason for moving quickly rather than waiting any longer was that the companies' abilities to serve their mission had been impaired. As I noted earlier, ceasing new business activity and shedding assets was not acceptable, especially given the Enterprises' public purpose.

As the companies operate in conservatorship, I have already instructed each new CEO to examine the underwriting standards and pricing. They have begun to do

so, and I expect any changes to reflect both safe and sound business strategy and attentiveness to the Enterprise's mission.

Fannie Mae and Freddie Mac are important to the secondary market for multifamily loans, and multifamily lending is critical to the affordable housing mission of the Enterprises. I am determined to ensure that, in conservatorship, both Enterprises remain dedicated to, and actively involved in, multifamily lending. I released a statement to this effect last Friday so that market participants may have assurance that the Enterprises will continue to be a source of underwriting and financing for multifamily loans.

The new legislation established a Housing Trust Fund to increase and preserve the supply of rental housing for extremely low and very low income families, including homeless families, and to increase homeownership for extremely low and very low income families. I recognize the importance of the Housing Trust Fund to many members of Congress. In the near-term, these funds will be used to fund a key component of the new law, the FHA HOPE for Homeowners Program, which will be funded by Treasury if the Enterprises do not.

Congress required that the FHFA Director consider annually circumstances in which such allocations would be suspended. Accordingly, I intend to make that determination only after a careful and thorough review of existing conditions.

Enforcement of the affordable housing goals established for the Enterprises by the Congress, once HUD's responsibility, is now up to FHFA. While ensuring liquidity in the mortgage marketplace has necessarily been a primary focus in recent weeks and months, ensuring that low and moderate income persons and underserved areas have ready access to affordable mortgage loans remains a critical responsibility of the Enterprises. In the near-term, the Enterprises are charged with meeting the very ambitious goals set by HUD back in 2004, a year in which the mortgage marketplace looked far, far different than it does today. In 2007, they missed two subgoals. Based on our discussions with the Enterprises, the miss will be larger in 2008. With the Enterprises now in conservatorship, even if some or all of these goals are found to be unattainable, I will expect each Enterprise to develop and implement ambitious plans to support the borrowers and markets targeted by the goals.

If we are to address the problem of mortgage delinquencies, a systematic approach to loan modification is essential. Well before last week's actions, we had already asked the Enterprises to facilitate the loan modification program the FDIC has undertaken with IndyMac Federal. I expect the ongoing work on loan modifications being done there, and with other seller servicers, to continue to be a high priority for the conservatorships, both as a matter of good business and as a matter of supporting the Enterprises' mission.

Finally, I am pleased to report that FHFA expects to have a regulation in place by October 1 to implement Section 1218 of HERA, which provides temporary authority for the Federal Home Loan Banks to use a portion of the subsidy money in Affordable Housing Program to refinance mortgages for families at or below 80 percent of area median income. In broad terms, we intend to issue a regulation implementing this program so that it supports the refinance program in HERA's Hope for Homeowners program by permitting AHP funding of additional principal write-downs or payment of closing costs. We've discussed this initiative with the FHA, which is very supportive of the prospect of added support on this initiative.

Conclusion

The decision to appoint a conservator for each Enterprise was a tough one for the FHFA team members who as they have worked so hard to help the Enterprises remain strong suppliers of support to the secondary mortgage markets. Unfortunately, all the good and hard work put in by the FHFA teams and the Enterprises' managers and employees was not sufficient to offset the consequences of the antiquated capital requirements and the turmoil in housing markets. Conservatorship will give the Enterprises the time to build on progress already made, to address more recently developing concerns, and ultimately, to restore the balances between safety and soundness and affordable housing market stability and liquidity. I want to thank the FHFA employees for their work during this intense regulatory process. They represent the best in public service.

I also recognize that many employees at each company have been working extremely hard through years of remediation and through the past year of market volatility. Employees have lost personal savings as a result of the plummet in their company's stock price and they have been working, and continue to work, long hours in the face of uncertainty. To them, I say thank you and pledge that, as conservator, we share the common goal of stabilizing your company while ensuring it continues to serve its public purpose of providing stability, liquidity, and affordability to the mortgage market.

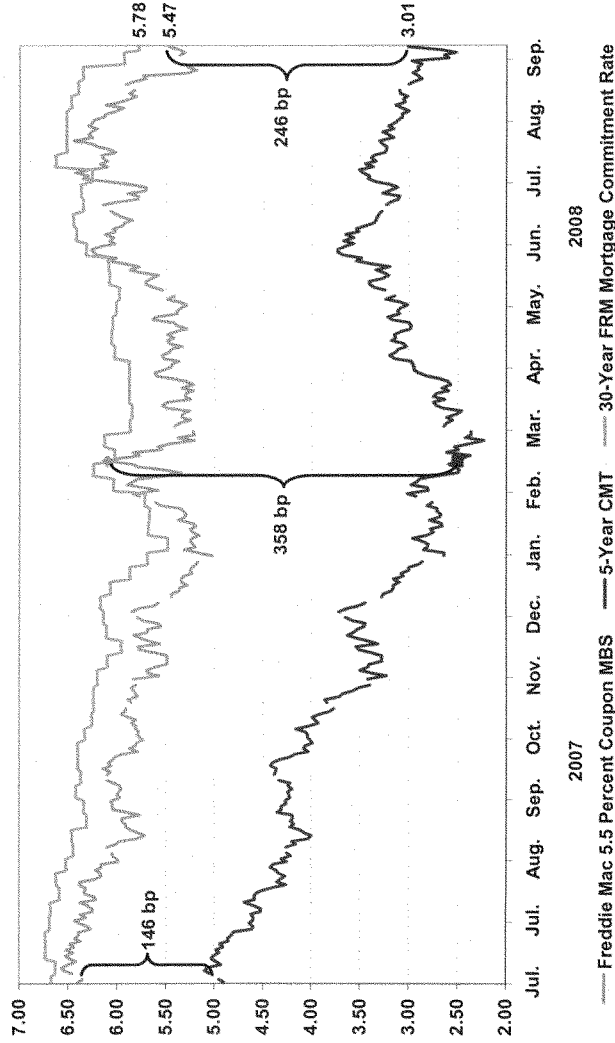
Working together we can finish the job of restoring confidence in the Enterprises and with the new legislation build a stronger and safer future for the mortgage markets, homeowners and renters in America.

Thank you. I would be pleased to answer any questions you may have.

Mortgage Rates Are Finally Starting to Fall with Treasuries



30-Year FRM Mortgage Commitment Rates and Yields on Freddie Mac MBS and 5-Year Treasury



Sources: Bloomberg Financial LP, Freddie Mac, and Federal Reserve Board H15.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED
FROM JAMES B. LOCKHART III**

Q.1. Director Lockhart, I was pleased to see your recent statement affirming your support for the multifamily lending programs of Fannie Mae and Freddie Mac, and your intention not to sell the low income housing tax credit interests at either institution. As you know, Fannie and Freddie are the single most important sources of financing for affordable multifamily rental housing, vital to hundreds of thousands of low income families across the country. The GSEs provide valuable stability to multi-family rental housing by being active in this market all the time. Do you agree that this part of the enterprises' business is fulfilling their liquidity and stability missions, and that you will continue to support their financing of this housing, which overwhelmingly serves people below 100 percent of area median income, and is a significant contributor to Fannie Mae and Freddie Mac's regulatory housing goals?

A.1. Yes. Fannie Mae and Freddie Mac historically have provided valuable stability to the multifamily market by maintaining a regular presence in the financing of such housing, and they should continue to do so. Such a presence, however, requires an innovative and market-oriented approach that reflects the current financial condition of the Enterprises themselves and the actual needs of the multifamily market.

Q.2. Given the serious dislocation of the Low Income Tax Credit market in the absence of Fannie and Freddie investments, are you planning to permit the companies to reopen that business line as soon as practicable?

A.2. While we recognize that LIHTC investments have provided significant assistance to affordable housing markets in the past, new investments in LIHTC are not economically attractive for the Enterprises when they are reporting losses. In their most recent quarterly financial statements, both Enterprises established valuation allowances for their deferred tax assets, which are indicative of their potential inability to realize future tax benefits associated with LIHTC investments.

Part of what needs to be done to assist the LIHTC market is to broaden participation. Accordingly, FHFA has been working very hard with the Enterprises to determine how they can play a key role in achieving that goal. That involves the Enterprises looking at creative transaction structures, in consultation with FHFA, as well as conducting outreach to stakeholders, including housing advocates, lenders, and state and local housing finance agencies, with the goal of expanding the universe of these credits. FHFA's meetings with such groups have been regular, extensive, and productive, and are ongoing.

Q.3. Last year HUD declared the regulatory housing goals "infeasible" for both enterprises because of market conditions. Since then, Congress has adopted a new approach to the calculation and measurement of the companies' housing goals, as well as added new "duties to serve" specific populations and markets. I'm sure you agree that given the current market and the companies' situation it is vitally important to reaffirm and clarify their housing goals requirements. What is your plan to quickly issue new regulations to exe-

cute these new provisions and ensure that both companies have clear direction in meeting these important requirements, and to publish clear guidance on what FHFA considers to be the important additional “duties to serve” under the statute?

A.3. Given current market conditions, it is vitally important to reaffirm and clarify the Enterprises’ requirements with respect to housing goals. FHFA has begun the process of reviewing housing goals for 2009 and will issue proposed goals for public comment in the first quarter of 2009. In addition, FHFA has begun the process of implementing regulations to establish new housing goals, as well as new “duty to serve” requirements, for 2010. We expect to issue a proposed regulation for public comment by the second quarter of 2009 and to issue a final regulation by the fourth quarter.

Q.4. Over the years the GSEs have provided important services to populations that are especially hard to serve, such as Native Americans living on trust lands, and people with special needs. Fannie Mae also has provided lines of credit and equity and equity-like investment to community loan funds and community development lenders. These investments provide community-oriented lenders with more capital to support revitalization projects in some of America’s hardest hit communities. They also have developed products such as Community Express and Modernization Express that help public agencies finance important public investments in housing. Do you agree that these specialized lending products are important extensions of their mission to serve low and moderate income people and underserved communities, and what role do you anticipate these specialized and targeted products will play in their future business?

A.4. Specialized and targeting lending products have made a significant contribution to the Enterprises’ achievement of their affordable housing mission. FHFA expects that Fannie Mae and Freddie Mac will continue to develop and market such products to fulfill that mission in the future, consistent with safe and sound management of credit risk and maintenance of adequate capital.

Q.5. Much has been said about the GSEs’ affordable housing mission. Specifically, their mission includes providing “ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.” (12 § U.S.C. 1716 and 12 U.S.C. § 1451) The statute specifically recognizes the need to provide affordable housing for low- and moderate-income families. It seems to me that the Affordable Housing Fund and the Capital Magnet Fund will help ensure that the enterprises fulfill this mission. Do you agree? Why or why not?

A.5. Section 1337 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended, requires each Enterprise to set aside an amount equal to 4.2 basis points for each dollar of the unpaid principal balance of its total new business purchases as funding for the Housing Trust Fund and Capital Magnet Fund. Each Enterprise’s contributions to those funds will further

its mission of supporting affordable housing. Section 1337 also authorizes FHFA to suspend the contributions on a temporary basis. After reviewing the Enterprises' 3Q 2008 financial results, FHFA exercised that authority on November 13, 2008, by directing each Enterprise, until further notice, not to set aside or allocate funds for the contributions.

Q.6. Director Lockhart, an article in the September 8, 2008 Wall Street Journal stated as follows: "At both Fannie and Freddie, so-called Alt-A loans, a category between prime and subprime, amounted for roughly 50% of credit losses in the second quarter, even though such loans accounted for only about 10% of the companies' business. Alt-A mortgages include loans made with less than full documentation of borrowers' income or assets." Is it true that a disproportionate share of Fannie and Freddie's credit losses are related to mortgage loans that were made without anyone checking the borrower's income? If so, do you think it would be prudent, especially now that the American taxpayer is responsible for insuring loans held by Fannie and Freddie, for the FHFA to require that Fannie and Freddie purchase only those mortgage loans for which income verification has been performed?

A.6. A disproportionate share of each Enterprise's credit losses have been on Alternative-A (Alt A) single-family mortgages, which are loans made to borrowers who generally have limited verification of income or assets or no employer. Fannie Mae and Freddie have greatly curtailed their purchases of Alt-A and other low documentation loans in 2008. Beginning in 2009, neither Enterprise will purchase any such mortgages on a flow basis (where loans are delivered pursuant to pre-negotiated contracts and pricing). Acquisitions of pools of such loans on a negotiated basis will occur only after adequate due diligence and with appropriate pricing.

Q.7. As I understand it, part of the strategy of the entire mortgage lending crisis is that it would have been so simple to verify consumers' incomes. In her April 6, 2008, New York Times column, Gretchen Morgenson wrote about the IRS 4506-T form, which is a request for tax transcripts, and how lenders could have used that form to avoid a considerable part of the subprime mortgage mess. According to Morgenson's sources, approximately 90 percent of borrowers signed the form, but lenders used the form to obtain tax transcripts only 3 to 5 percent of the time—and usually after the loan had closed. Tax transcripts are prepared by the IRS with data contained in tax returns, and are therefore unlikely to contain exaggerated amounts of income. Given that the 4506-T process is cheap and efficient, do you think IRS tax transcripts should be utilized to protect the GSEs and therefore the American taxpayer from bearing the losses for inappropriate mortgages?

Another reason for requiring tax transcripts is that they provide an easy means for identifying fraud. Section 1379 E of the Housing and Economic Recovery Act of 2008 contains the following report requirement:

The Director shall require a regulated entity to submit to the Director a timely report upon discovery by the regulated entity that it has purchased or sold a fraudulent loan or financial instrument, or suspects a possible fraud relating to the purchase or sale of any loan or financial instrument. The Director shall require each

regulated entity to establish and maintain procedures designed to discover any such transactions.

A.7. The income verification processes at Fannie Mae and Freddie Mac have been subject to increased scrutiny by FHFA and these processes have tightened considerably. Working with FHFA, the Enterprises have explored the use of a variety of tools, including IRS forms 4506 and 4506-T, to better verify and document borrower income. Considering the pros and cons of those various approaches, the Enterprises have decided to reduce significantly their purchases of Alt-A mortgages and other lower documentation loans in 2009 and beyond.

Given the volume of loans Fannie Mae and Freddie Mac guarantee, it is not operationally feasible for them to individually review every loan; instead, they rely on lenders to verify borrower income and assets and other necessary information. The lenders represent and warrant that mortgages are eligible for Enterprise purchase; if an Enterprise identifies a misrepresentation, it requires the lender to repurchase the questionable loan. Both Fannie Mae and Freddie Mac now require lenders to verify borrower income, have increased their quality control reviews, and are issuing repurchase requests in cases where nonconforming loans are identified. Such repurchases discourage poor underwriting practices, including the use of unverified income to establish borrower eligibility.

Q.8. The FDIC's summer 2007 issue of Supervisory Insights cites an April 2006 Mortgage Asset Research Institute report for the fact that "90 percent of stated incomes [on mortgage loan application] were exaggerated by 5 percent or more, and 60 percent of stated incomes were inflated by more than 50 percent." Given these statistics, do you plan to institute, as part of your anti-fraud program, a rule requiring Fannie and Freddie to purchase, re-sell, or otherwise back only loans for which income verification has been executed and what method will you recommend for verification?

A.8. Fannie Mae and Freddie Mac are subject to a mortgage fraud reporting regulation promulgated by the Office of Federal Housing Enterprise Oversight (OFHEO), one of the predecessor agencies to FHFA, as set forth in Title 12, Chapter 17, Part 1731 of the Code of Federal Regulations (CFR). That regulation requires each Enterprise to establish adequate and efficient internal controls and procedures and an operational training program to assure an effective system to detect and report mortgage fraud or possible mortgage fraud. The regulation defines mortgage fraud broadly in order to give the Enterprises the flexibility to adapt their internal controls and procedures to fraudulent practices that may emerge over time within the industry. FHFA's ongoing examinations include evaluations of the extent to which the internal policies, procedures, and training programs of the Enterprises minimize risks from mortgage fraud and mortgage fraud or possible mortgage fraud is consistently reported to FHFA.

Fannie Mae and Freddie Mac have also increased quality control reviews to identify cases of exaggerated income. The Enterprises are actively requiring lenders to repurchase such loans. As mentioned in the previous answer, working with FHFA the Enterprises have decided to significantly reduce the use of stated income going

forward. Any change to that standard will also require a safety-and-soundness review by FHFA.

Q.9. The 4506-T process for IRS tax transcripts has a proven track recorded and is currently being utilized by the FDIC in their efforts to modify loans as the conservator for IndyMac. In Housing and Economic Recovery Act of 2008, Congress enacted a requirement pursuant to the HOPE for Homeowners Program that mortgagors' income be checked via tax transcripts or tax returns. In the Bankruptcy Reform Act of 2005, Congress provided debtors the option of producing a transcript of their tax returns via a 4506-T form in lieu of providing their actual tax returns to the court. This was to provide consumers additional privacy protections as well as speed of service. And, as Housing and Urban Development Secretary Preston well knows because he used to be the Administration of the Small Business Administration, the SBA requires a 4506-T form for its loan applications. Given that this process has been adopted and recognized so pervasively, do you see any reason that Fannie and Freddie should not require its use for the loans they purchase, re-sell, or otherwise deal with?

A.9. As indicated above, Fannie Mae and Freddie Mac have decided to reduce significantly the use of stated income loans going forward. The Enterprises give lenders several options for verifying income, including using tax records for self-employed individuals. Enterprise lenders use forms 4506 and 4506-T to obtain borrower permission to request tax transcripts from the IRS.