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THE STATE OF THE UNITED STATES ECONOMY AND FINANCIAL MARKETS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

THE STATE OF THE UNITED STATES ECONOMY AND FINANCIAL MARKETS

THURSDAY, FEBRUARY 14, 2008

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THURSDAY, FEBRUARY 14, 2008

WITNESSES

Additional Material Supplied for the Record

THE STATE OF THE UNITED STATES ECONOMY AND FINANCIAL MARKETS

THURSDAY, FEBRUARY 14, 2008

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

The Committee met at 10:10 a.m., in room SR–325, Russell Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. Good morning. Let me first of all welcome everyone here this morning to this hearing on the state of the economy and capital markets. A couple of things, if I may.

What I would like to do this morning, given the limited amount of time—we have got a couple of hours. The Secretary has, I know, an appointment at noon, or thereafter, and I am confident the other two witnesses probably do as well. Normally what we would do is allow everyone here to make opening statements. Needless to say, the simple math, it would probably eat up the 2 hours. I see smiles now appearing on the witnesses' faces at the prospect of listening here for 2 hours to all of us make statements about the state of the economy.

What I would like to suggest—and it is merely a suggestion here—is that I make an opening statement, Senator Shelby make an opening statement, and then we will get right to the statements of our witnesses, and then go to questions and use the question period to make any comments you would like to, as well as engage in the questions you would like to ask of our witnesses. That may allow us to move along in that period, which I think is probably the most interest to most Members.

Second, when we end up with a quorum here, I want to apologize to my colleagues, but we need to re-vote the ILC bill yesterday. Under the rules of this Committee, if there is not a majority of the majority present at the time the vote occurs, then the vote does not count in the sense. We had only 12 people here. It was a 6–6 vote. And so we have to re-vote the issue under the rules, and I apologize to my colleagues. We did not have 13 Members, so we did not have a majority of the majority on that issue present at the time. As soon as a majority arrives, we will do that. All statements, by the way, will be included in the record. If people have any opening statements or information you want to include in the record, I will make sure that is all included.

With that, let me proceed with some opening comments quickly, turn to my colleague Senator Shelby, and then we will get right to our witnesses this morning.

This is a historic room, of course. We were talking outside; there have been many historic hearings that have been held in this room. I remember as a child being here watching my father actually chair hearings on violence in television back in the late 1950s, early 1960s. President Kennedy and Robert Kennedy announced their candidacies for the Presidency in this room. The Watergate hearings, Teapot Dome, the McCarthy hearings—this is a historic room, so maybe some historic suggestions this morning here from our witnesses might be an appropriate response.

Anyway, today the Committee meets to discuss the state of our Nation's economy and capital markets. We are very pleased to welcome before the Committee three of the country's leading economic figures: Secretary of the Treasury Hank Paulson, Federal Reserve Chairman Ben Bernanke, and Securities and Exchange Commission Chairman Chris Cox. And we welcome all three of you.

Gentlemen, thank you for coming before us today, and I want to note that the last time the heads of all three of these agencies appeared jointly before this Committee to discuss the state of our Nation's economy was in the immediate aftermath of the tragic attacks of September 11, 2001. And while the challenges that the Nation's economy faces today are very different from those we faced then, today's economic challenges are, unfortunately, no less serious. I think we would all agree on that.

The current economic situation is more than merely a slowdown, in my view, or a downturn. It is more even than a mere recession—or near recession, I might add. Instead it is a crisis of confidence, I feel, among consumers and investors. Consumers are fearful of borrowing and spending. Investors are fearful of lending. Financial transactions which generate new businesses and new jobs are shrinking in number and in size.

The incoming economic data shows how serious the problem is. The Nation's economy slowed to a near standstill in the fourth quarter of last year, with overall GDP growth by less than 1 percent, and private sector GDP growing only one-tenth of 1 percent. The country had a net loss of jobs in January, the first time we have had a loss of jobs of that nature in over 4 years. Incoming data on retail sales have been very weak, and most projections for economic growth this year have been revised down sharply. Credit card delinquencies are on the rise, as consumers find themselves increasingly unable to tap the equity in their homes to pay down credit card debt and other bills.

Last, inflation increased by 4.1 percent last year, the largest increase in 17 years, driven mainly by the rise in costs of energy, food, and health care. Industrial production is falling, and we have been hemorrhaging jobs in the construction and manufacturing sector. This decline has been reflected in falling stock prices and increased volatility in the securities markets. Our economy is clearly in trouble, in my view, and the most important thing we can do right now is restore that consumer and investor confidence, which is absolutely critical if we are going to get back on our feet again.

To that end, I want to commend Fed Chairman Bernanke for taking an active role in addressing the weakness in our economy, for injecting much needed liquidity, and cutting interest rates. I am also pleased that the administration and the Congress have been able to reach agreement on a stimulus package that provides some support for working families who are bearing the brunt of these difficult times. However, more needs to be done, in my view, to address the root cause of our economic problems, and I say respectfully that includes by the three agencies led by our witnesses here this morning.

The catalyst of the current economic crisis in my view is the housing crisis. The housing starts are at their lowest levels in a quarter of a century. The inventory of existing home sales is nearly at 4 million units—almost double the number in January of 2005. This is equal to about 10 months of supply. And while many of us have experienced home price drops in our own States and regions, overall 2007 was the first year since data has been kept that the United States had an annual decline nationwide in home and housing prices. A recent Moody's report forecasts that home sales will drop in 2008 by as much as 10 to 15 percent—in fact, even in 2009 an additional drop. Others are predicting similar declines in 2009, as I just mentioned. This will be the first time since the Great Depression that national home prices will have dropped in 2 consecutive years.

If the catalyst of the current economic crisis is the housing crisis, then the catalyst of the housing crisis is the foreclosure crisis. This foreclosure crisis was triggered by what Secretary Paulson himself has called "bad lending practices," and I commend him for making that statement. These are lending practices that no sensible banker would ever engage in. Reckless, careless, and sometimes unscrupulous actors in the mortgage lending industry essentially allowed loans to be made that they knew hard-working, law-abiding borrowers would not be able to repay. And they engaged in practices that the Federal Reserve in previous years under different leadership under the Bush administration had absolutely nothing—did nothing effectively to stop, in my view.

The problems were compounded by inaccurate and misleading corporate disclosures and asset valuations, inflated credit ratings, and poor risk management, so investors could not act as a check on these problems. As a result of failures throughout the chain of mortgage finance from origination to securitization, foreclosures are at record levels. There are 1.5 million homes that are seriously delinquent or in foreclosure right now. And what we have seen—and we have not seen the worst of it.

Economist Mark Zandi estimates that 3 million homes will default between 2007 and mid-2009, and 2 million of those homes will end up in foreclosure. This crisis affects more than families who lose their homes. Property values for each home located within one-eighth of a square mile of a foreclosed home will drop by an average of $5,000. This will affect somewhere between 44 and 50 million homes.

The foreclosure crisis could result or will result in an increased demand for social services, obviously, police and fire and further services to ameliorate the impact of increases in foreclosures and abandoned property. Yet State and local governments will have fewer resources with which to meet these demands as property values and tax collections drop. Localities could lose as much as $4.5 to $5 billion in property taxes and other revenues due to this wave of foreclosures.

Any serious effort to address our economic woes must include, in my view, an effort to take on the foreclosure crisis. That is a crucial step toward restoring the confidence of consumers and investors in our economy.

We on this Committee have already taken several steps to address these problems, and I want to thank Senator Shelby and Members of the Committee for their efforts. We worked to reform the FHA program and passed FHA modernization legislation through the U.S. Senate by a vote of 93–1. Now we need to make sure that this becomes law. We have appropriated close to $200 million to facilitate foreclosure prevention efforts by borrowers and lenders. In addition, the recently enacted stimulus package includes a temporary increase in the conforming loan limits for GSEs to try and address the problems that have spread throughout the credit market into the jumbo mortgage market. While this is helpful, we still need to implement broad-based GSE reform, and I am committed to doing just that. As I have told the Secretary and others. Certainly Senator Shelby and Members of this Committee I have mentioned that to as well. And I have spoken about my belief in the need for additional steps to mitigate the foreclosure crisis in a reasonable manner. These steps include targeting community development block grants to communities struggling to counter the impact of foreclosed and abandoned properties within their communities, and they include establishing a temporary homeownership loan initiative, either using existing platforms or a new entity that can facilitate mortgage refinancing.

But it is not just the Congress that needs to do more. The administration, including the agencies represented here this morning, I think need to do more as well—much more. Almost a year ago, I convened, with Senator Shelby, a summit of leading lenders and servicers. The attendees at that summit agreed to a set of principles that requires them to create a permanent, affordable solution, wherever possible, for at-risk borrowers. Unfortunately, the administration has been working, in my view, at cross purposes with us. Instead of helping us hold leaders and servicers to the commitments that they made back in the spring of 2007, they have, in essence, sanctioned backsliding from the kind of aggressive, broad-based effort that is more urgently required by the day. The latest administration effort, dubbed "Lifeline," is a lifeline more to lenders than to borrowers, in my view, and the Treasury Department, HUD, and others in the administration need to do more.

Similarly, the Federal Reserve as the lead financial regulator needs to break with its past and become more vigilant about policing indefensible lending practices. Now, I want to commend the Chairman of the Federal Reserve when last year the Fed finally accepted its duty under the Homeownership and Equity Protection Act to protect consumers from unfair and deceptive lending practices, and there were many steps taken and recommendations made in those regulations which I strongly agree with. The Chairman and I have talked about this. We have some disagreements about some of those suggestions, and I applaud the efforts, but my hope is that they will strengthen them in the coming days so that we can deal with some of these problems that have persisted and caused, as the Secretary of the Treasury has pointed out, bad lending practices that led us to this situation we are in today.

As for the SEC, I want to commend Chairman Cox—Chris—for the oversight and credit rating agencies and for enforcement efforts related to subprime-related cases. But here, again, I think greater vigilance is urgently needed. The SEC needs to help restore investor confidence in the markets by more vigorous enforcement, by more comprehensive regulation of credit rating agencies, and increased accountability and transparency of publicly traded companies that are engaged in the mortgage finance system.

Despite these unprecedented challenges, I remain confident in the future of the American economy. We may need to change some of our policies, regulations, and priorities. But the ingenuity, productivity, and capability of the American worker and entrepreneur ought to never be underestimated. I look forward, of course, to working with the Ranking Member, Senator Shelby, and other Members of this Committee so we can move forward on some of these critical issues, as well as working with the administration, the Department of the Treasury, obviously the Federal Reserve, and the SEC to restore that sense of confidence and optimism that is so critical to economic growth and prosperity in our country.

With that, let me turn to Senator Shelby for some opening comments, and then we will turn to our witnesses.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you. Thank you, Chairman Dodd, for calling today's hearing on our financial system and economy. This is an opportune time to discuss the challenges that our economy faces in our housing and financial sectors. We have a distinguished panel here today to provide us with their perspectives regarding the current and future economic conditions.

Mr. Chairman, one thing that is now clear to all of us is that the subprime problems are not contained. Sectors of the global financial system have lost confidence largely due to the subprime mortgage problem. Financial institutions in the U.S. and abroad have lost billions of dollars and have had to raise new capital as a result. Concerns about the valuation of assets have led financial institutions to become reluctant to borrow or lend money within the system.

We are seeing signs of an economic slowdown. After several years of rapid expansion, the housing sector is now paying the price. Residential investments have declined for eight straight quarters. The most recent Blue Chip Economic Survey forecasts growth for this year at 1.7 percent when just a month ago they forecasted a 2.2-percent growth. The blue chip forecasters now see the recession's odds at almost 50 percent, although the majority of them continue to say a recession will be avoided.

The administration and our financial regulators have taken a variety of actions intended to address the weakness in the housing sector and the slowdown in our overall economy. The Congress has already enacted and the President has signed an economic stimulus package. Even if every consumer spends their rebate check, I believe the impact to the overall economy will be negligible. I have equated it to pouring a glass of water in the ocean and expecting it to make a difference. I hope I am wrong.

It will have one effect that is undeniable, however. It will put more debt on our children and grandchildren because we are borrowing the money to pay for it. And, yes, a year from now it is going to help balloon our deficits. Unfortunately, we may never know whether the benefit was worth the cost.

Certainly, Mr. Chairman, the effects of these actions will take some time to work their way through the economy. I look forward to hearing from our witnesses this morning as to what factors they will be watching to judge the success of these efforts.

Mr. Chairman, as we consider what action we may take, my hope is that we will take the time to examine thoroughly all facets of market conditions. Any Federal intervention I believe should be carefully considered and targeted to encourage and reward the right behavior. The market is already punishing certain risky behaviors at all levels, and it is not necessarily the American taxpayers' responsibility to mitigate those risks.

I thank our witnesses for being here today, and I look forward to their views and other issues.

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

I will turn to you, Secretary Paulson. Thank you for being with us this morning.

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

Secretary PAULSON. Thank you, Chairman Dodd, Senator Shelby, Members of the Committee. Thank you very much for the opportunity to be here today. I am pleased to appear with my colleagues Chairman Bernanke and Chairman Cox. I appreciate their leadership on the challenges confronting our economy and capital markets and look forward to continued close, productive working relationships.

The U.S. economy is fundamentally strong, diverse, and resilient, yet after years of unsustainable home price appreciation, our economy is undergoing a significant and necessary housing correction. The housing correction, high energy prices, and capital market turmoil are weighing on current economic growth. I believe that our economy will continue to grow, although its pace in coming quarters will be slower than what we have seen in recent years.

Four weeks ago, recognizing the downside risks to our economy and that the short-term cost of doing nothing was too high, President Bush called for an economic growth package to provide a temporary boost to our economy as we weather the housing correction.

The Congress responded with bipartisanship, cooperation, and speed to pass an economic growth package that is temporary, broad-based, and will assist our economy quickly. We have demonstrated to the Nation and the world that we can come together to address the needs of the American people as we weather the housing downturn.

Yesterday, the President signed the economic package into law, and Treasury is already working to send payments out to more than 130 million American households. The IRS will manage the current tax filing season and simultaneously prepare to issue these additional payments starting in early May. Payments will be largely completed this summer, putting cash in the hands of millions of Americans at a time when our economy is experiencing slower growth. Together, the payments to individuals and the investment incentives for businesses will help create more than half a million jobs by the end of this year.

In addition to this growth plan, the Administration will continue to focus on aggressive action to try to provide alternative options to foreclosures. This includes encouraging the Hope Now Alliance, a coalition representing over 90 percent of the subprime servicing market, and nonprofit mortgage counseling organizations, trade associations, and investors.

This industry-wide effort employs multiple tools to reach and help struggling homeowners, including streamlining able subprime borrowers into refinancings and loan modifications.

The Hope Now effort is making progress. According to updated statistics, in the second half of 2007 the industry assisted 869,000 homeowners, including 545,000 subprime borrowers who received loan modifications and repayment plans. The progress rate is accelerating; the number of subprime modifications in the fourth quarter doubled over the rate in the third quarter. In Q4 alone, of the estimated 1.5 million homeowners of all types delinquent 60 or more days, over 470,000 received help from their servicer, and almost 30 percent of those received a loan modification.

I expect that this progress will accelerate in 2008. In January, the industry began implementing a new framework to streamline mortgage modifications for able but struggling subprime borrowers. As announced by the American Securitization Forum, this framework will greatly speed the financial evaluation process. Borrowers who have made their initial payments but cannot afford the interest rate reset may be fast-tracked for modification or refinance, allowing mortgage counselors and servicers to devote more time and resources to the more difficult cases.

Currently, I am focusing on two aspects of this effort: first, on ensuring that the ASF framework is adopted throughout the industry so that the industry is better prepared to deal with the rising volume of subprime mortgage resets; and, second, on ensuring that the Hope Now Alliance produces timely metrics so that policymakers and industry participants can evaluate progress and make adjustments as needed.

I appreciate this Committee's leadership and specific efforts to address issues that have arisen during the housing downturn. Finalizing the FHA modernization bill will provide additional tools to help homeowners, and I encourage you and the House to reach consensus as soon as possible. Enactment of GSE regulatory reform is also a very high priority for Treasury and the Administration, and I commend the Chairman and the Committee Members for your willingness to move forward promptly. While not under this Committee's jurisdiction, the Administration has also proposed legislation that will allow States to issue tax-exempt bonds for innovative refinancing programs. This tax proposal is in addition to that signed into law in December, which provides temporary tax relief for homeowners facing increased taxes due to forgiven mortgage debt. All of these initiatives may help mitigate the housing headwinds, and we remain open to other good ideas as we move forward.

Treasury continues to monitor capital markets closely and to advocate strong market discipline and robust risk management. While we are in a difficult transition period as markets reassess and re-price risk, I have confidence in our markets. They have recovered from stressful periods in the past, and they will do so again.

Working through the current stress is our first concern. Through the President's Working Group on Financial Markets, we are also reviewing underlying issues ranging from enhancing risk management to market infrastructure, to reporting and disclosure, to ratings and investor practices. We know a short-term boost to our economy is needed. We also know that it is just as important to get the long-term policy response right.

Thank you and I look forward to taking your questions later.

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

Chairman Bernanke, thank you for being with us.

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

Mr. BERNANKE. Thank you. Chairman Dodd, Senator Shelby, and other Members of the Committee, I am pleased to be here to offer my views on financial conditions, the near-term economic outlook, and related issues.

As you know, financial markets in the United States and in a number of other industrialized countries have been under considerable strain since last summer. Heightened investor concerns about the credit quality of mortgages, especially subprime mortgages with adjustable interest rates, triggered the financial turmoil. However, other factors, including a broader retrenchment in the willingness of investors to bear risk, difficulties in valuing complex or illiquid financial products, uncertainties about the exposures of major financial institutions to credit losses, and concerns about the weaker outlook for the economy, have also roiled the financial markets in recent months.

As the concerns of investors increased, money center banks and other large financial institutions have come under significant pressure to take onto their own balance sheets the assets of some of the off-balance-sheet investments that they had sponsored. Bank balance sheets have swollen further as a consequence of the sharp reduction in investor willingness to buy securitized credits, which has forced banks to retain a substantially higher share of previously committed and new loans in their own portfolios. Banks have also reported large losses, reflecting marked declines in the market prices of mortgages and other assets that they hold. Recently, deterioration in the financial condition of some bond insurers has led some commercial and investment banks to take further markdowns and has added to strains in the financial markets.

The banking system has been highly profitable in recent years and entered this episode with strong capital positions. Some institutions have responded to their recent losses by raising additional capital. Notwithstanding these positive factors, the unexpected losses and the increased pressure on their balance sheets have prompted banks to become protctive of their liquidity and balance sheet capacity and, thus, to become less willing to provide funding to other market participants, including other banks.

Banks have also become more restrictive in their lending to firms and households. For example, in the latest Senior Loan Officer Opinion Survey conducted by the Federal Reserve, banks reported having further tightened their lending standards and terms for a broad range of loan types over the past 3 months. More expensive and less available credit seems likely to continue to be a source of restraint on economic growth.

In part as the result of the developments in financial markets, the outlook for the economy has worsened in recent months, and the downside risks to growth have increased. To date, the largest economic effects of the financial turmoil appear to have been on the housing market, which, as you know, has deteriorated significantly over the past 2 years or so. The virtual shutdown of the subprime mortgage market and a widening of spreads on jumbo mortgage loans have further reduced the demand for housing while foreclosures are adding to the already elevated inventory of unsold homes. Further cuts in home building and related activities are likely.

Conditions in the labor market have also softened. Payroll employment, after increasing about 95,000 on average per month in the fourth quarter, declined by an estimated 17,000 jobs in January. Employment in the construction and manufacturing sectors has continued to fall while the pace of job gains in the service industries has slowed. The softer labor market together with factors including higher energy prices, lower equity prices, and declining home value seem likely to weigh on consumer spending in the near term.

On the other hand, growth in U.S. exports should continue to provide some offset to softening in domestic demand, and the recently approved fiscal package should help to support household and business spending during the second half of this year and into the first part of next year.

On the inflation front, a key development over the past year has been the steep run-up in the price of oil. Last year, food prices also increased exceptionally rapidly by recent standards, and the foreign exchange value of the dollar weakened. All told, over the four quarters of 2007, the price index for personal consumption expenditures, or PCE, increased by 3.4 percent, up from 1.9 percent during 2006. Excluding the prices of food and energy, PCE price inflation ran at a 2.1-percent rate in 2007, down a bit from 2006.

To date, inflation expectations appear to have remained reasonably well anchored, but any tendency of inflation expectations to become unmoored or for the Fed's inflation-fighting credibility to be eroded could greatly complicate the task of sustaining price stability and reduce the central bank's policy flexibility to counter shortfalls in growth in the future. Accordingly, in the months ahead we will be closely monitoring inflation expectations and the inflation situation more generally.

To address these developments, the Federal Reserve has moved in two main areas:

To help relieve the pressures in the inter-bank markets, the Federal Reserve, among other actions, recently introduced a term auction facility through which pre-specified amounts of discount window credit can be auctioned to eligible borrowers. And we have been working closely and cooperatively with other central banks to address market strains that could hamper the achievement of our broader economic objectives.

In the area of monetary policy, the Federal Open Market Committee, or FOMC, has moved aggressively, cutting its target for the Federal funds rate by a total of 225 basis points in September, including 125 basis points during January alone. As the FOMC noted in its most recent post-meeting statement, "The intent of these actions is to help promote moderate growth over time and to mitigate the risks to economic activity."

A critical task for the Federal Reserve over the course of this year will be to assess whether the stance on monetary policy is properly calibrated to foster our mandated objectives of maximum employment and price stability, and in particular, whether the policy actions taken thus far are having their intended effects.

Monetary policy works with a lag. Therefore, our policy stance must be determined in light of the medium-term forecast for real activity and inflation, as well as the risks to that forecast.

At present, my baseline outlook involves a period of sluggish growth, followed by a somewhat stronger pace of growth starting later this year as the effects of monetary and fiscal stimulus begin to be felt. At the same time, overall consumer price inflation should moderate from its recent rates, and the public's longer-term inflation expectations should remain reasonably well anchored.

Although the baseline outlook envisions an improving picture, it is important to recognize that downside risks to growth remain, including the possibilities that the housing market or the labor market may deteriorate to an extent beyond that currently anticipated or that credit conditions may tighten substantially further.

The FOMC will be carefully evaluating incoming information bearing on the economic outlook and will act in a timely manner, as needed, to support growth and to provide adequate insurance against downside risks.

Thank you, Mr. Chairman.

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

Chris Cox, we welcome you to the Committee.

STATEMENT OF CHRISTOPHER COX, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. COX. Thank you, Mr. Chairman, Senator Shelby, and Members of the Committee. I appreciate the opportunity to be here today to update you on the work that the Securities and Exchange Commission is doing in this area.

The deterioration of credit and liquidity conditions stemming from problems in the U.S. residential mortgage market has posed a number of challenges for our agency. We have been working closely with the other members of the President's Working Group on Financial Markets, including, of course, Secretary Paulson and Chairman Bernanke, with whom it is my privilege to appear today. We have also been working closely with our international regulatory counterparts, which is a reflection of the global impact that these U.S. market events have had.

To coordinate the Commission's subprime efforts across each of our divisions and offices, Erik Sirri, who is the Director of the Division of Trading and Markets, is leading an agency-wide task force. As you know, the Commission is not a front-line regulator of the mortgage lending business, the derivatives industry, or the monoline insurance industry. But the securities markets and the market participants that the Commission does regulate—not to mention the investors whom it is our mission to protect—have been deeply affected by the problems with residential mortgage-backed securities and collateralized debt obligations.

Among the questions that have been raised within our jurisdiction are the accounting treatment of the special purpose trusts and their assets; the adequacy of capital and liquidity at the Nation's major investment banks, and the strength of their risk management practices; the impact on money market funds from the devaluation of what had previously been presumptively safe assets; the quality of issuer disclosure by public companies involved in structured finance; the role of the credit rating agencies, over which the SEC gained regulatory jurisdiction 8 months ago; and the possibility of violations of the securities laws by subprime lenders, investment banks, broker-dealers, and other market participants.

The accounting issues have centered around the questions of balance sheet consolidation and valuation. Twice in recent months—first in July of 2007 and again in January of this year—the SEC has provided guidance on the application of current accounting rules in the case of limited modifications for loans where default is reasonably foreseeable. In that circumstance, we have said, the limited modification would not invalidate off-balance-sheet treatment. This guidance has allowed refinancings and other work-out arrangements to proceed, with the advantage of keeping people in their homes and maximizing the value of the securitized assets. This is, however, a short-term response. For the longer term, the Commission's Chief Accountant has asked the Financial Accounting Standards Board to revisit the underlying accounting issues to determine whether or not the experience of the last several months points to the need not only for further clarifying guidance, but also for changes in the applicable rules.

Another important aspect of our oversight responsibility is our Consolidated Supervised Entities program. Through this program the Commission supervises five of the systemically important U.S. securities firms on a consolidated, or group-wide, basis. Those firms are Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley. This prudential supervision of the Nation's largest investment banks is designed to be broadly consistent with Federal Reserve oversight of commercial bank holding companies, and its overarching purpose is to monitor for any weakness in any part of the firm that might place the regulated bank or broker-dealer at risk. In particular, the Commission focuses on capital adequacy, liquidity, and liquidity risk management at the CSE firms.

Subprime issues have also had an impact on the mutual fund industry, and, in particular, we have been active in working with the managers of money market funds as they cope with the downgrading of ratings and the declines in value of securities in which their funds have invested. We are also working in the area of public company disclosure to improve the quality of disclosure by banks and other financial institutions about subprime-related issues.

In December 2007, the Commission wrote to 25 leading financial institutions, highlighting several disclosure areas that they should consider in relation to their exposure to off-balance-sheet entities and structured finance products.

Last summer, using the new statutory authority that the Congress gave the SEC effective in June of 2007, the Commission began examinations of the role of the credit rating agencies in the subprime market turmoil. These examinations are focused on whether the rating agencies diverged from their stated methodologies for determining credit ratings in order to publish higher ratings, and whether their role in bringing residential mortgage-backed securities and collateralized debt obligations to market impaired their ability to be impartial in their ratings.

Beyond these ongoing examinations, we are also taking a fresh look at the wisdom of the legislative and regulatory provisions that grant a central role to the rating agencies in our markets.

During the past 30 years, regulators, including the Commission, have increasingly used credit ratings as a proxy for objective standards in a variety of contexts. In addition, a number of Federal, State, and foreign laws and regulations today use credit ratings in this and analogous ways. The recent market disruptions have shown the limitations of this arrangement. As a result, I have directed the Commission staff to explore alternatives to the existing regulatory reliance on credit ratings where feasible. I have also directed the staff to develop proposals for new rules under the Credit Rating Agency Reform Act that respond directly to the shortcomings we have seen through the subprime experience.

Finally, but perhaps most importantly, policing our markets to ensure compliance with the securities laws is also a critical aspect of borrower responsibility in connection with the subprime market turmoil. Our Division of Enforcement currently has over three dozen cases that are related to subprime activity. These investigations involve several areas of potential violations of the securities laws, but because they are still ongoing, the specific details remain confidential. Each of the actions we are taking and each of those that we are contemplating is designed to safeguard the health of our capital markets, to protect investors, and to promote capital formation.

I appreciate the opportunity, Mr. Chairman, to describe the main aspects of the Commission's work in this area, and I would be happy to answer the Committee's questions.

Chairman DODD. We thank you very, very much, and we appreciate your testimony, all three of you, here this morning.

First, let me announce that there has been an objection expressed, so we will have to take this vote on the ILC issue at another time, and I will schedule a time for that at the convenience of Members. I again apologize for the glitch yesterday on a technical matter in terms of how that vote occurred.

What I would like to do now is I am going to have the clock on for about 8 minutes per Member. I counted up here. We have got a tremendous turnout here, almost the entire membership of the Committee, and that should make it possible for us to complete at least one round here before our witnesses have to leave at noon or a little after noon. So I will try and keep an eye on the clock myself as we go forward.

Let me begin, if I can, with our witnesses. When this problem first began to emerge, I think it was expressed by some of you here at the witness table and I think many people certainly hoped that this problem would be contained within the housing sector, be limited to that. Obviously, we are learning as each week and month goes by that this problem is spreading, and your testimony this morning reflects the recognition of that.

It has been deeply troubling—and I am sure my colleagues from New York and New Jersey are going to want to focus on this as well, but I could not help but note yesterday the lead story in the Wall Street Journal talking about how this credit crunch issue now could affect student loans, that some—I forget the number—colleges in the State of Michigan may be adversely affected as a result of the lack of availability of credit, forcing families to rethink how they are going to finance their children's education.

The decline in home values, certainly we have seen, as I mentioned in my opening comments, the first time since the Great Depression we have had nationally a decline in values occurring, and the predictions of where those values may go. Literally, as people are watching, their values are declining. That equity they had built up over the years with the hopes of utilizing that equity for many different ideas, certainly not the least of which is possibly to finance their children's higher education, is certainly disappearing. So that pressure is mounting here, both the availability of credit and the lack of equity in homes.

Then this morning's news about the headline, "Train Pulls Out of New Corner of Debt Market," talking about the Port Authority of New Jersey and New York, that increase from 4.2 percent to 20 percent, raise in the weekly interest rates to something around $300,000, this is one example—I presume there are many more around the country—to just once again highlight how this is expanding, this problem, beyond just a housing issue.

And so my first basic question is: What are you going to do about it? I mean, this is a—what are we going to do about it? What are we going to do about it? This is not an issue that can—we can discuss it and the details of it, but this is growing. Should parents, for instance, be thinking about alternative means of financing their children's education as a result of this credit crunch and student loan availability? Is it that serious here? And I would be very interested in hearing some response as to what you think else can be done, what actions Congress should or should not be taking, what steps further the administration could be taking, and what admonitions or warnings should be given to the American public. As we try to rebuild that confidence, it is also important, I think, at hours like this that we express to them the steps they ought to be thinking about in light of some of these facts we are seeing.

Mr. BERNANKE. Mr. Chairman, the examples that——

Chairman DODD. You have to push that button, I think, Mr. Chairman.

Mr. BERNANKE. Sorry. Mr. Chairman, the examples that you are referring to illustrate the complex chains of causality that we are seeing promulgating throughout the financial markets at this point. The sequence in this event is that the losses in housing affected the value of CDOs, which in turn has hurt the bond insurance corporations, which in turn has reduced the value of their guarantees for these particular securities that make up municipal bonds and student loans and has disrupted that market, as you point out. So there is this very complex chain.

I think with respect to municipal bonds and student loans, the good news is that the underlying quality of those credits is generally very good. No one is really doubting that the Port Authority's credit quality is any worse than it was before or thinking that it was worse than it was before. So I do not think that this is a long-term situation. I think it is going to require some adjustment, some rethinking in terms of how best to market these securities in ways that will be attractive to investors. It illustrates, though, the unexpected effects and consequences.

I think the best thing we can do—there are a whole number of measures that we can do, but from the Federal Reserve's point of view, one of the best things we can do, of course, is to try and maintain a strong economy that will help cause, you know, eventually stabilization in the housing markets, stabilization in the credit markets, and that will allow these unexpected consequences to reverse themselves.

Chairman DODD. Mr. Secretary.

Secretary PAULSON. Yes, I very much agree with that and would just make a couple of additional points here.

What we are seeing is, although it was subprime that maybe produced the spark that got this going, we had a dry forest out there, because for some time we had a lot of seemingly excess liquidity, low levels of inflation around the world, and investors reached for yield and mispriced risk in a number of markets. Now what we are seeing is a reaction, and the areas of the market that are under the most stress today are those that are the most complex products or auction products for municipals, preferreds, and so on.

The example you have given is one that will solve itself pretty easily because the Port Authority will refinance, they will not pay 20-percent interest rates. But it is indicative of a broader problem. And to me, in addition to what the Chairman said, the other thing that needs to be done is to keep encouraging our financial institutions to recognize their losses, let the market work, and raise capital. And if there is any doubt they need capital, they need to go and raise capital, recapitalize so that they get the capital base they need. We do not want to see them shrink their balance sheets and pull back from doing the things they need to do in the economy.

So, again, as risk is being re-priced, these things are not pretty while you are going through them, but these adjustments are necessary, and I believe the markets are going to work. But again, if we do anything, it is encouraging institutions to recognize the losses and raise capital.

Chairman DODD. What about the student loan issue here? The same answer? Would you have the same answer regarding the availability of student loans?

Secretary PAULSON. I would say, Mr. Chairman, I believe it is the same answer, but this is something we are looking at carefully. I think the underlying credits, I agree with the Chairman, are good. But there have been a number of changes, regulatory changes and others, that have impacted some of these companies. They have reduced profit margins. There are a number of things working here, and so this is something that we at Treasury are going to look at very carefully in the next couple of months. But I agree with the Chairman's general comment.

Chairman DODD. Is it a legitimate matter of concern, however, in light of what we——

Secretary PAULSON. Of course. Every one of these issues as we work our way through the markets impact real people. So we are talking about it in terms of the institutions and the markets, but they impact real people. And even when we are talking about things like some of these auction prefers and municipal auctions, if the auction fails and there is a 20-percent interest rate, then there will be a refinancing. There will be some auctions that may fail where there is a lower interest rate and there will not be a refinancing, and individual investors will end up losing money.

So, yes, they are all legitimate concerns, and student loans is something that we need to watch very carefully.

Chairman DODD. Let me jump quickly, if I can, in the time remaining here, to these projections regarding economic growth. And, again, I looked at yesterday—was it yesterday that the Philadelphia Federal Reserve Bank released an estimate of economists that revised their projections for economic growth to 1.8 percent in 2008. The Congressional Budget Office is projecting 1.7 percent as the growth rate for 2008 as what they call their blue chip economics report.

I would like to ask both the Chairman of the Federal Reserve and the Secretary of the Treasury: One, is it fair to conclude—and I think you suggested this, maybe, in your testimony, but let me ask it again. Is it fair to conclude then that the Fed's economic projections that were made earlier—and correct me if I am wrong, Mr. Chairman. Somewhere between 1.8 and 2.5 percent I think were the earlier projections, that range. Is it fair then to conclude today that the projections for 2008 need to be downgraded in your view? And, second—let me just ask the questions together to save time. The administration had a 2.7-percent growth rate. Again, I realize, look, predictions are exactly what they are. No one has an absolute crystal ball here. But that seems to be an excessively high projection in light of even the ones made earlier, Mr. Secretary. What was the purpose of that? It is not even close to being the reality of what you projected then.

Secretary PAULSON. That was made in November, and as you will recall, Mr. Chairman, as we watched—and we have been watching this economy very, very carefully—that consumer spending and business spending held up right into the fall. You will recall that the GDP growth was almost 5 percent in the third quarter, and then spending fell off very quickly. We would not have a similar forecast today.

Chairman DODD. What would be your forecast today? What do you——

Secretary PAULSON. I do not have a single-point forecast, but I will tell you it would be less, but I do believe we are going to keep growing here. I think that the risks are to the downside. We are watching it carefully. I think it is very important, this economic growth package. We are all focused on this, and there are no guarantees. But I continue to believe this economy is going to keep growing.

Chairman DODD. Will there be an adjusted number the Treasury will be coming out with shortly here that we can look to?

Secretary PAULSON. This was not a Treasury forecast. This was a forecast that was a joint forecast by CEA, the Treasury, OMB, and we come out with those periodically.

Chairman DODD. Mr. Chairman?

Mr. BERNANKE. Mr. Chairman, the Federal Reserve has recently changed to making quarterly projections, so you are referring to the October projection.

Chairman DODD. Right.

Mr. BERNANKE. In about a week, we will have a new set of projections, and it will show lower projections of growth, and they will be reasonably consistent with what we are seeing with private forecasters and so on. They do show, as I suggested in my testimony, that growth looks to be weak but still positive during the first half of the year, and with some expectation of strengthening later in the year. But, again, that is a baseline, and there are risks to that forecast.

Chairman DODD. Thank you very much.

Senator Shelby.

Senator SHELBY. Thank you.

Chairman Bernanke, Congress is facing a range of choices in addressing housing market conditions. Some of my colleagues seem to be suggesting that we should protect the entire home market from a decline in value, while others suggest allowing market forces to provide the solution.

What do you think as Chairman of the Fed that our goal should be as we consider how or even if we should respond to current conditions?

Mr. BERNANKE. Well, Senator Shelby, first of all, I think we should all be open-minded and creative and keep thinking about different options. For the moment, we are working trying to support the Treasury in getting the private sector to be aggressive, to scale up its activities, to try to be more effective in meeting this large number of delinquencies that they are facing. The Federal Reserve is also working in communities, working with community groups and supporting counseling efforts and so on. So I think that is the first line of defense, is to make sure that the private sector is scaling up and is being aggressive and effective in dealing with these delinquencies.

I think immediately what I would commend to the Congress in terms of making further progress would be to address the FHA and GSE bills. The FHA provides an opportunity to refinance troubled borrowers into more stable, long-term, Government-supported mortgages. And an effective reform of supervision of the GSEs would allow the GSEs faithfully to expand their activities and to support the housing market, you know, more effectively.

Senator SHELBY. Are you still concerned about the long-term systemic risks that our GSEs have out there?

Mr. BERNANKE. I do think that is the concern. I would like to see a reform bill, a supervisory bill that addresses those concerns, that creates a strong, world-class regulator, that provides for adequate capital, receivership, and a public purpose for the portfolios. But I do believe that if that were all done, then the GSEs would be much better placed to raise capital, which they need to do, and with more capital to assist the housing market in particular by securitizing more mortgages.

Senator SHELBY. Chairman Bernanke, we appear to have swung from a cycle of credit being too freely available to the possibility that credit is now priced too highly or not available at all.

You noted in your testimony, and I will quote, "considerable evidence that banks have become more restrictive in their lending to firms and households. The Fed has attempted to counter this problem in part through its term auction facility."

Do you believe that financial institutions are now in a position of overly stringent underwriting? And if so, what are your bank examiners doing to counter any overly stringent action by financial institutions in the current—due to the current situation?

Mr. BERNANKE. Senator, well, first you are correct, as Secretary Paulson mentioned, that we started out in a period probably where risks were underpriced and where credit was too freely available. We are going through a retrenchment, and it is a painful retrenchment. Some of that is certainly necessary to get back to a more normal level of underwriting and credit availability.

We do have some concerns that the combination of losses by banks which reduced their capital and the expansion of their balance sheets as they took on off-balance-sheet vehicles or they are unable to securitize some of their loans have made some of these banks less able to extend credit than they would under normal circumstances. And we think that is going to be a drag on the economy. Our surveys show that terms and conditions have tightened.

I agree very strongly with Secretary Paulson that the best remedy to that is for the banks to reveal their losses, to get them behind them, then to go out and raise more capital so that they can operate in a safe way and in a normal way.

With respect to the supervisors, we need to achieve an appropriate balance. On the one hand, we certainly in no way want to sacrifice our important responsibility to maintain the safety and soundness of the banks. And to the extent that they have less capital and they are facing a more risky situation, then it is appropriate from that perspective for them to be more careful in their lending.

On the other hand, we do not want to overreact so strongly to go far beyond what is reasonable and balanced to create an unnecessary credit crunch, and we are trying to make sure that we balance those important objectives, maintaining safety and soundness while not unnecessarily constricting credit to the American economy.

Senator SHELBY. Do you believe that there is a strong likelihood that there will be more charge-offs, you know, downgrading of a lot of our subprime securities, and even perhaps others, that will have an effect on some of our banks' capital?

Mr. BERNANKE. Well, it seems likely that there will be additional charge-offs. But an important consideration at this point is the evolution of the housing market and the economy. Many banks have already written down their mortgage holdings, for example, essentially under the assumption that the housing market will contract considerably further. Should the housing market do better than expected, some of those writedowns might be reversed, potentially. But I think it is a good guess, given recent trends, that we will see some additional writedowns in banks, in investment banks, in the coming quarters.

Senator SHELBY. As a bank regulator, do you see any possibility that some of our big banks might fail? You know, the U.K. has had the Northern Rock problem. Do you envision that here? Is that something that capital will keep from happening?

Mr. BERNANKE. Senator, our concern is primarily about the ability of the banks to make credit available. The banks came into this episode very well capitalized, with very strong earnings. They have been able to go out and raise new capital, and so all the banks—I will let Chairman Cox talk about the investment banks, but I believe it is the case there as well. But certainly all the banks that we supervise remain at strong capital positions, and at this point we do not see any imminent risk of any insolvencies.

Senator SHELBY. Secretary Paulson, given the importance of bond insurance to the national economy—the Chairman alluded to that earlier—what has been the Treasury Department's involvement with the New York Insurance Department's efforts to rescue the bond insurers that a lot of people believe we have got to bolster?

Secretary PAULSON. OK, well, we have obviously a strong interest in this because the bond insurers play an important role in the markets. And as you know, these institutions are regulated at the State level. So we, along with the Fed and others, have been actively monitoring what is going on there. We were supportive of the efforts, which are private sector efforts, to get all of the relevant people together—the parties: the rating agencies; the advisers, the financial advisers to these companies; investors are involved. And so we are watching this very closely.

Senator SHELBY. Can I ask one quick question?

Chairman DODD. Yes.

Senator SHELBY. Chairman Cox, could you update the Committee on the status of the SEC's examination of the rating agencies and whether the SEC has reached any conclusions about why the rating agencies appear to have grossly underestimated the riskiness of many securitized assets? I know you have talked to us about that before. Is that an ongoing thing?

Mr. COX. Yes, it is, and we are in the process of inferring lessons even now. As you know, our authority given to us by the Congress is months old, but we have aggressively used that authority. We have ongoing investigations—I should say "inspections"—of the credit rating agencies underway for the purpose of determining, among other things, whether or not, first, they followed their own procedures with respect to conflicts of interest, and then whether those procedures, if properly followed, were sufficiently sturdy in practice to prevent the conflicts which we know exist in the current model from interfering with the ability of the analysts to be independent.

My estimation is that we will have ideas based on this experience for making that process more sturdy in plenty of time to inform our planned rule writing this year.

Senator SHELBY. Are you looking at the possibilities of ways to avoid the conflict of interest that looked so prevalent to so many people between the rating agencies, the advice they give them, the consulting they give them, and then rate the securities themselves?

Mr. COX. We are. The issuer-pays model, and the subscription model, all have potentials for conflicts of interest, and so what is most important is designing structures, procedures to deal with those conflicts. We cannot make them all go away. They are embedded in the market.

One of the ways that the Congress, I think rightly, anticipated in the Credit Rating Agency Reform Act that we can deal with these conflicts is through competition. There are two kinds of competition—bad and good—in this area. The bad kind of competition, of course, would adhere in an issue where they are going first to one rating agency, then another, then another, until finally they get the high rating that they are willing to purchase. The good kind of competition is one in which the track records of these rating agencies are ruthlessly compared in the marketplace, and the SEC, I think, is going to be able to help facilitate that kind of head-to-head comparison. Comparability is difficult to achieve given the kinds of disclosure that currently are made.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

After speaking with Senator Shelby, I realized we are not going to be able to get to everyone if I keep to 8 minutes. So we are going to restrict that time down to 5 minutes. I will not bang down the gavel, but so that everybody gets a chance here—and, obviously, if we can get through one round, we will go back for a second round with people. So I just did the math, and I realized we are not going to get to everybody. And I want everybody to have a chance to raise questions.

Senator Reed.

Senator REED. Thank you very much, Mr. Chairman, and thank you, gentlemen, for your testimony today.

We are all engaged in dealing with a host of very complicated, interrelated issues, but when you step back, one of the most sobering factors that has been alluded to by the Chairman is that if we just let things sort of work out over the next several months, there could be as much as a 20- to 30-percent devaluation in the value of homes in the United States, which some people have estimated to be on the order for $4 to $6 trillion on household wealth. That is going to be a huge shock to the quality of life of most Americans. It is going to translate into whether children go to college or which college they go to. It is going to translate into whether they are prepared for retirement. It is going to translate into whether or not they can cope with a serious health crisis without insurance. And, frankly, that is a concern on the minds of my constituents right now, and the clock is ticking much faster, and I get the sense that the market is moving to these corrections, which puts, I think, huge pressure on not simply letting the market work out but to take much more deliberate, much more focused, much more concentrated action, because at some point the American people will demand it even more affirmatively than they are today.

That said, I think there are two major challenges: one, timely, effective action to ease this liquidity crisis; but, second, a very sober, careful review of how we got here by the regulatory agencies so that we do not repeat these mistakes. And we have seen this happen before. Enron collapsed. We had FASB produce rules about special purpose entities. FASB got beaten back to move from a more specific rule to more principles based, and now, as Chairman Cox indicated, they are rethinking that. We have been there before, and I will ask just a question to Chairman Bernanke.

First, you are not only the monetary policy leader in the country, but you also are the major regulator of financial institutions. You have on a daily basis, I would presume, hundreds of Federal Reserve examiners, agents in these institutions looking at everything they are doing. Have you looked back now and begun a searching review, an after-action report of the lapses that allowed these situations to develop?

Mr. BERNANKE. Senator, certainly we are looking at all those issues. I think I should say that this is very much an international issue, that other countries as well are very much involved in this, and there is, in fact, an elaborate process underway which is involving, first of all, each individual agency doing extensive analysis. We at the Federal Reserve have looked at our practices, have looked at a variety of other issues. Those are being combined together in a joint analysis of the President's Working Group, of which we all three are members. That in turn is feeding into international bodies, such as the Financial Stability Forum and the Basel Committee, which are trying to develop lessons learned not just for the Federal Reserve or for the United States, but for the entire world in terms of our regulatory processes and approaches.

So we have thought about it very extensively both in terms of our own agency but there is, in fact, a very substantial international effort underway. And, in fact, the Financial Stability Forum at the G–7 meetings last weekend just released a preliminary report. We expect to see an extensive report at the next meetings in Washington, I think it is in April.

Senator REED. And these reports will be publicly distributed with very specific analysis of the steps that might have been taken previously by the Fed, SEC, and the Treasury Department?

Mr. BERNANKE. They will be very principles based. They will be talking about the kinds of approaches we need to take in order to make sure these problems do not happen again, but yes.

Senator REED. I appreciate that, Mr. Chairman, but I think at some point you have got to drill down to the specifics of adequacy of your procedures, adequacy of your staffing, cooperation from financial institutions. You know, we were aware of these SIVs and these SPEs for years and years and years. Suddenly, they are roaring and, you know, unstable—destabilizing balance sheets.

Let me switch to a slightly related question. Both you and the Treasury Secretary have said that the banks have to reveal very quickly their losses. Have they revealed their losses to you? You say in your statement there is still some uncertainty about what they have on their balance sheets. I would think that would be the first point of clarification. Do you feel that you are getting the kind of——

Mr. BERNANKE. We are getting very good information. The difficulty is that for many of these assets, a clear, succinct, sharp measure of the loss is not always easy because many of them are not traded frequently in markets, they are very idiosyncratic, and their valuations can change from day to day depending on, for example, how the market is valuing subprime mortgages. So it is not an easy problem.

The FASB has set up a set of standards which divides measurements into three levels: those assets which have a market value; those which can only be addressed through modeling, which means using some market information but also some assumptions and models internally; and, third, those categories which are mostly judgment. And so inherently it is very difficult to get sharp answers, but—Chairman Cox can add to this, but we certainly are getting good cooperation, and we are urging our institutions to disclose as promptly and as effectively as possible.

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

Chairman DODD. Thank you very much.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman. I serve on the Budget Committee, and I am looking forward to getting our budget reported out around the 1st of March, the first week in March, at least. And we put out 5-year budgets, and in the next 5 years here are some of the problems that I see facing our economy and facing the Congress as a challenge. I would like to have you comment on these, if you would.

First of all, if the surge continues to work in Iraq, then that means that we will be pulling back troops to the United States homeland, and we will probably see a cranking down of the industrial-military complex. Historically, after a major conflict, you know, unemployment goes up because of them returning home. We also are looking at in the next 5 years, if Congress does nothing, a tax increase that will happen that will amount to about a $1.3 trillion increase in taxes over the next 10-year period, I am told by the Finance Committee. We are looking at growth in entitlements. We are looking at persistent deficits and high energy costs.

Do you have any suggestions or any priorities that we should be looking at when we put this budget together and those problems that need to be addressed? I thought I would start with Dr. Bernanke and then perhaps Secretary Paulson and then hopefully Chairman of the SEC, Chris Cox, would comment.

Mr. BERNANKE. Well, I will be quick. You have, obviously, a number of difficult issues in the next 4 or 5 years. The alternative minimum tax remains an issue. If you are going to eliminate that permanently, how are you going to replace that revenue or reduce the spending?

Domestic programs, the administration's budget requires a very tough lid on domestic spending. That is going to be very trying. It is very demanding for the Congress.

Management of Iraq and Afghanistan spending, as that comes down.

Those are some of the issues you will be facing in the near term, but as I said on a number of previous occasions, it is likely to see some—there is likely to be some near-term improvements in the deficit over the next 5 years or so. As we move into the next decade, the entitlement issues are really going to begin to be seen in the annual budgets, as, for example, Social Security stops producing a surplus each year and begins to be a net drain on the Federal budget.

So from a longer-term fiscal perspective, I think the entitlement issues are the dominant question. The CBO estimates that in 2030 the entitlement spending plus interest payments will essentially take up the entire Government budget. And even so, the deficit might be as high as 9 percent of GDP.

So the critical issue for the medium term and the long term is the entitlement question.

Senator ALLARD. Secretary Paulson.

Secretary PAULSON. Yes, I will be brief because I agree with that. There are some short-term issues, but they all pale with the longer-term issues. When you look at our long-term competitiveness and financial flexibility and the big structural issues, No. 1 or right up there has got to be entitlements. And I am sure we as a country will come to some solution, but the longer we wait, the bigger burden we place on the next generation. And that is a huge problem staring us in the face, and it is one that is solvable.

I would say energy security ranks right up there with that when you are looking at big structural economic issues, and then we are just going to have to continue to also look at other issues of competitiveness, and I think we know what they are. When we look at keeping our technology spending up, R&D spending, there are some issues that very much relate to immigration and making sure we have the talent here and that the people that are graduating from our top universities with degrees in engineering and other sciences, and we do not ship them out. Many of them are foreign nationals, and we are shipping them back overseas——

Senator ALLARD. I want to cut you short here because I want to give Mr. Cox an opportunity to respond, too. When you were a Member of Congress, you always concerned yourself about high tax rates, and maybe you want to elaborate on what the other two said. And then also I would like to hear what you think about the $1.3 trillion tax increase that we could be facing in the next 5 years because the temporary taxes will be expiring.

Mr. COX. Well, Senator Allard, at the Securities and Exchange Commission, we look at things from the perspective of the investor, and so, as you and the Congress formulate fiscal policy, I hope that you will continue to be attentive to effects, both intended and sometimes unintended, on incentives for savings and for investment. It is vitally important to our mission that Americans make proper choices about how they spend their money. We, at your direction and with your funding, spend a good deal of money on investor education, all designed for these purposes. If Government policy in other ways provides disincentives for what we all consider to be wise and good behavior, then the country, the whole savings mechanism, intermediation, and ultimately our Nation's and global economic growth pay.

Senator ALLARD. Mr. Chairman, I see my time has expired.

Chairman DODD. Thank you very much, Senator.

Senator Menendez. Bob.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you all for your testimony.

You know, nearly a year ago, when we had one of the first hearings on the foreclosure issue in this Committee, I said that we were looking at a tsunami of foreclosures, and the response then by members of the administration was—we had variations on the theme that the mounting waves of foreclosure, it was not a crisis; that it was contained; that it soon would be over. And instead of warning bells from those who are supposed to keep tabs on the pulse of the markets, we had timid responses. And instead of a clarion call to securitizers, lenders, brokers, and everyone who had a hand in the mortgage chain to take responsible action, we a let's-wait-and-see approach. And I think we have seen what the let's-wait-and-see approach has produced and where it has gotten us.

Now, certainly when it comes to our markets, a knee-jerk reaction isn't in the Nation's interest, and that is certainly not what I am talking about. But when there is a real crisis at bay, when there is a storm brewing on the horizon, we count on those at the top—and certainly that is all of you—to sound the alarm. And to many of us, I think what we got was a snooze button. We have been behind the curve.

And so I say that as a premise to two sets of questions that I hope to get some honest answers on. One is that I know the topic of this hearing is the economy. Mr. Secretary, are we headed toward or in danger of being in a recession?

Secretary PAULSON. Senator, I do not know how to answer it any more clearly than I did in my testimony, so I will say again I believe that we are going to continue to grow, albeit at a slower rate. The risks are to the downside. I do not have a crystal ball, but we did not sit back and wait. What we have done is move very quickly, I believe—you know, Congress and the Administration—with a stimulus package.

Senator MENENDEZ. Well, we appreciate the stimulus, but there are those of us who believe that that in and of itself is not sufficient. Let me just go through a few statistics. Last quarter, the economy grew at six-tenths of a percent, too slow to promote robust job growth. We lost 17,000 jobs last month. A number of Wall Street firms—including your former firm, Mr. Secretary, Goldman

Sachs, Morgan Stanley, Merrill Lynch—predict a recession this year. A survey of the Federal Reserve Bank of Philadelphia released just this Tuesday, on average forecasters said there was a 47-percent chance the economy would shrink in the first quarter of this year and a 43-percent chance that the economy would shrink in the following quarter, the second quarter of 2008. Every time it has risen above 40 percent, the economy has gone into a recession. In a recent survey of economists by USA Today, more economists are increasingly predicting a recession compared to last October when only a third, now nearly half.

So my point is for us to be able to move forward, we have to have some honest assessments and not be suggesting that—I do not want to talk down the economy, but at the same time we need to be able to work to build it up if we know we have challenges. And part of that challenge is the housing crisis, as the Chairman so aptly said at the beginning of his statement.

You know, Mr. Secretary, you characterize the administration's efforts as "aggressive action." I have to be honest with you. I remain unconvinced. I do not know that Hope Now is aggressive action when we are seeing foreclosures outpacing loan modifications 7 to 1. For subprime ARMs, which are at the root of the crisis, it is even worse—13 to 1. That does not even deal with the payment option ARMs that are looming on the horizon.

And so are you telling the Committee that what the administration has proposed to date, particularly on the foreclosure crisis, which is at the root of our economic challenge where many of us feel that either we are in or headed toward a recession, that the voluntary actions are sufficient to stem the hemorrhaging and to ultimately—not only the hemorrhaging and the losses of homes for Americans, but at the same time the consequential effect it has on the economy?

Secretary PAULSON. I would say to begin with, if you are trying to talk the economy up, I would hate to see you try to talk it down.

Senator MENENDEZ. I am just not trying to hide my head in the sand either.

Secretary PAULSON. I am not either. But I would say that the Hope Now Alliance in my judgment has been an aggressive approach to stem avoidable foreclosures. To have 90 percent of the subprime market covered for adjustable rate mortgages—and, again, as I have said, I believe that what we are going to see as we go forward here. We are going to see that those mortgage holders that have their interest rates reset and, if they have been able to make the initial rates, they are going to be able to stay in their home if they want to stay in their home.

Now, it took us until early January to get this group together. There were all sorts of technical hurdles. As Chairman Cox said, we obtained guidance from the SEC in early January. We are going to be very transparent. We are going to look at how it is working and if the industry is not performing, we will be all over them.

Now, that deals with one part of this, and one part only. And the housing market is going through a correction. As you know, we have a number of other things. We would like to get the FHA modernization legislation signed. We have some proposals for tax-exempt financing. I am very open to looking at other ideas. I look at many ideas, look at them all the time, and it is a lot easier for people to say, "Do something," than to say what it is we should do.

So, again, we are going to keep looking at it and watching this quickly and watching it carefully.

Senator MENENDEZ. Well, Mr. Chairman, my time is up. I just want to say that there are several other initiatives. We look forward to having you consider them because we believe that just the voluntary aspect alone is not going to make us whole, either in stopping the American dream from being an American nightmare and too much debt that will result from that, too much loss in property values across the landscape of the country, and at the same time too much of a negative ripple effect in the economy.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Menendez. And I raise this, as the Chairman knows and the Secretary knows, we started this process last March with the industry, the stakeholders, Senator Shelby and I did when we had those meetings. And I think other members may have shown up in those days, and we worked on a set of principles. And I am hoping it works as well. We all would like to see this work. You can understand Senator Menendez's skepticism and the skepticism we feel about it, just worried this is not going to be enough or is too timid and not catching up, Mr. Secretary.

Secretary PAULSON. Yes. I would just simply say it will certainly not be enough if the test we are using is going to somehow or other prevent all foreclosures.

Chairman DODD. No, no.

Secretary PAULSON. Or to prevent a necessary market correction. Our principle here has been: How do we prevent a market failure? How do we prevent those foreclosures that are avoidable? And so we are open—and I am open, I know the Chairman is—for other ideas. But, again, we are watching it carefully. I think we have been pretty active and pretty proactive on this. And, again, we are open to suggestions.

Chairman DODD. I hear that.

Senator Hagel.

Senator HAGEL. Thank you, Mr. Chairman.

Gentlemen, welcome. Just a note regarding the line of questioning that Senator Allard reviewed with the three of you. We are all aware that recently S&P and Moody's warned that if we do not deal with this entitlement issue, then our U.S. AAA bond ratings are in jeopardy, and we could see that as recently over the next few years. And I add that to the comments that you have made just to reconnect with not only the urgency of this issue but the reality of the consequences if we do not deal with these entitlement challenges that are ahead of us.

I would like to talk for a moment about infrastructure. Senator Dodd and I have an infrastructure bill that we have introduced, and it would essentially leverage public and private capital—a little different approach than what we have seen in the past, and the reason for that is it is very clear to me that with the kind of deficits that we are running, will continue to run, with the obligations that you have noted here over the last few minutes, and most Americans are aware of, that the necessary capital for infrastructure is not going to be there. I do not know where we are going to get it.

I noted, Secretary Paulson, that you did not think it should be included in the stimulus package—which I agree with, by the way. I think it is far larger than dropping rebate checks from an airplane. And I would be very interested in first understanding if the Treasury Department has looked at this infrastructure issue, will be making recommendations on what we should be doing. We clearly have an inadequate structure, and as we look down the road, again I do not know where we are going to find that capital, when the rest of the world is devoting an astounding amount of their resources to their infrastructure. And in a time when we are living at the most competitive time in the history of man, without an adequate infrastructure it will certainly have consequences on our ability to compete in the world. Secretary Paulson.

Secretary PAULSON. Yes, Senator, I agree that infrastructure is a significant issue in this country and others over the intermediate and longer term. This is not an issue that falls right within the Treasury's wheelhouse in the United States. We have other agencies that have responsibility for that.

I would say to you, though, that, for instance, I was out late last year in California at an event, a trade event, where there was a good bit of discussion about infrastructure, because I think the infrastructure has a very important role to play. And, again, the focus there was on the private sector/public sector partnerships and how to structure infrastructure projects so there could be more private capital involved. In this country and almost anywhere else around the world, I have looked at it and the needs are so large that it is going to be very difficult for the public sector to do it alone.

So a big part of this is going to be structuring infrastructure projects so that they attract private capital.

Senator HAGEL. Thank you.

I would also like to return to a line of questioning that, in particular, Senator Shelby has had regarding the GSEs. And we are all familiar with the fact that Fannie and Freddie are currently holding—either they own or are guaranteeing over $5 trillion in mortgage-backed securities, which are not registered with the Securities and Exchange Commission.

I asked a question at a hearing last week on this, and I quoted your response back to me, Chairman Cox, on whether it would be important to have the GSEs registering their debt as well with the SEC, and one of the Assistant Secretaries of Treasury noted it would be helpful.

I would like to address that issue specifically with you, Chairman Cox, as well as you, Secretary Paulson, on the importance of registering that debt and understanding what the securities are that Fannie and Freddie own or guarantee, $5 trillion worth. Do we really understand what they have? And would that registration with the SEC help us understand it? Chairman Cox.

Mr. COX. Well, I think you are absolutely right, Senator, that because GSEs sell securities to the public, they have public investors, they do not have the full faith and credit of the Government backing them, their disclosures should comply with the Federal securities laws. This has been done essentially on a voluntary basis heretofore. As you know, we had accounting problems at both Fannie and Freddie that have resulted in delays in getting them into compliance with respect to their 1934 Act compliance. Fannie is now there. Their periodic reports are being filed on time. Their 10K is expected on time this year. Freddie is not there yet.

I think there is no question about the benefit to the markets and to investors from the maximum amount of transparency.

Senator HAGEL. Secretary Paulson, do you care to respond?

Secretary PAULSON. Yes. I do not have much to add to that. It makes sense. I think Fannie has registered under the 1934 Act. Freddie is working to do that. That is, I think, very important, and I am also very focused on getting, as you all know, a GSE reform bill, which is, I think, at least as important.

Senator HAGEL. Thank you.

Mr. Chairman, thank you.

Chairman DODD. Thank you very much, Senator Hagel, and I appreciate your raising the issue of the infrastructure bill that you and I are working on.

In fact, we might ask the Treasury and others to take a look at this proposal, Mr. Secretary. We have not asked, I do not think, for comments on it. But this is one we worked on over the last 2½ years, putting together this idea of exactly what you are talking about as a way to attract private/public capital, because you are not going to do it on the Appropriations Committee.

Secretary PAULSON. Right.

Chairman DODD. The needs are in the trillions of dollars.

Secretary PAULSON. Yes.

Chairman DODD. And it is going to take much more creative financing than what we have been accustomed to if we are going to do something about it. So I would be interested in your comments.

Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

I remain a bit surprised and troubled, Secretary Paulson, that your comments tend to gloss over some structural problems in our economy. Every day 200 families in Ohio, for instance, lose their homes to foreclosure, and none of that surprises you. And the troubles—I mean, to be sure, the troubles are worse in my State than perhaps the, quote-unquote, national average. But they are also not much different—if different in magnitude, not much different from the rest of the country's. Wages have been stagnant. Chairman Bernanke as long ago as 14 months talked about income equality and how the industry has repeated that message and some ideas about what to do about it. Job growth has been anemic in the last 7 years. You know about gas prices, home heating costs. The food bank pantries around my State tell me it is worse than at any time in the last quarter century. And for the first time, as we know, in our lifetimes, families' housing wealth across the country is evaporating, as Senator Reed had pointed out.

The stimulus package that the President signed into law should help somewhat, but even there we need to do much more. And I want to ask you a specific question.

If I understand correctly, rebates will be issued only to people who file tax returns, but millions of eligible Americans who receive railroad retirement or Social Security retirement or disability benefits are not required to file tax returns. If they do somehow get word and do go to the IRS free-file program, they will be kicked out because the software is programmed to prevent them from filing.

I am sure you aware of this. I would just like to know, Mr. Secretary, what steps you plan to take to ensure that everyone receives what Congress believes they are due.

Secretary PAULSON. That is the question we are really focused on right now. There is going to be a huge effort getting those people who normally do not file to file, and file as soon as possible. So in addition to the IRS website, there is going to be a big outreach effort, and we are going to go to a number of agencies, and to Members of Congress, because we have some experience in the past with the telephone excise tax and doing things on a smaller scale. But you have pointed your finger at an issue, because we have got to get to 130 million people and a good number of those are not normal filers.

Senator BROWN. And your job is both to find them and to make sure the software does not kick them out when you do find them. You can assure us of that?

Secretary PAULSON. Our idea is to find them, get to them, and encourage them to file and make it easy for them to file, because there should be a very easy basis for doing this.

Senator BROWN. OK. Thank you.

Chairman Cox, nice to see you again. I appreciate the attention you are giving to sovereign wealth funds. I am curious why there is not much concern attached to this issue as many think there should be. As you will recall, President Clinton in, I believe, 1999 proposed to invest a quarter of the Social Security surplus, about $50 billion a year, in equity index funds. The reaction to that proposal in some quarters was pretty energetic. The esteemed Chairman of the House Republican Policy Committee called it "the largest nationalization in history, threatening the very soundness of the economy." A Presidential candidate at the time called it a blatant Big Government power grab.

I do not want to relitigate the Social Security question, but when we are looking at much greater amounts of money being invested selectively by foreign governments, and often governments very hostile, if not hostile to us certainly very different in their makeup in terms of being democratic and sharing the values that we have, we are looking at much greater amounts of money being invested selectively by foreign governments. Shouldn't there be a little more concern about their investment in U.S. private concerns—banks, other financial institutions, manufacturing companies, service companies—in this country?

Mr. COX. Well, these are important questions for the Congress, for the markets, certainly for all of us in the President's Working Group, and in some special ways for the Securities and Exchange Commission, because sovereign wealth funds, as any other large investors, come directly into contact with our regulatory system.

As you know, sovereign wealth funds have recently made investments in Citigroup, in Merrill Lynch, Morgan Stanley, UBS. These investments from the standpoint of the Securities and Exchange

Commission have been treated in the same fashion as would any investments by any large investor. And I think the reason for that cannot be said often enough in this context. It is because the United States welcomes and will continue to welcome with open arms both foreign investment in U.S. capital markets and the opportunity for Americans to invest beyond our borders. But in this context it is certainly worth paying attention to the unique features of sovereign wealth funds. They are not, first of all, all the same, as you know. But, because they are fundamentally arms of governments, they raise all the familiar questions about government ownership of industry, to which you alluded in your statement. They are growing in size, but they have been around for a long time.

And so, in one sense, there is certainly no cause for alarm. Kuwait started its first sovereign wealth fund, which was not called that, over a half-century ago. Today one estimate from the Federal Reserve of New York puts the size of all of these funds combined at about $2.5 trillion. That is a lot of money. To be sure, it is more, for example, than all the world's hedge funds combined. On the other hand, as a percentage of assets that are managed by SEC-registered investment advisers, it is about 6.5 percent of that $38 trillion. And as a percentage of all of the world's investable assets—equities, bonds, and bank holdings—it is about 1.2 percent, although the Federal Reserve of New York estimates it is going to grow to about 4 percent.

So I think that we have the opportunity to watch this phenomenon and to understand it. It is not something that we have to deal with definitively this week. On the other hand, if the trends that are being identified are correct, if they really do grow, as is expected, to some 4 percent of global financial markets in 7 years, that could at some point have a qualitative impact on our markets. And I think you are right to focus on it, but I would also caution that if what we do first is regulate and restrict, then we may have the kinds of impacts on our own capital markets that we are concerned about governments of other countries imposing upon us. So the remedy can also be a problem. We have to be very thoughtful about what we do in response. And, as you know, this question is being looked at by a lot of people in a lot of ways, including a focus on transparency I know that Secretary Paulson is leading as Chairman of the President's Working Group, because we have all agreed that both the sovereign wealth funds and the countries in which they invest will all be better off if they behave like any other commercial actors and if they are completely transparent.

Thank you.

Senator BROWN. I appreciate the work——

Chairman DODD. Your microphone, please.

Senator BROWN. I appreciate the work of Senator Biden. I am just still a little bit confused that there was such anger and outrage that the U.S. Government would consider investing, but there is sort of tepid acceptance or indifference to investment by a Chinese or Dubai fund. I just remain a bit confused by that. But thank you.

Chairman DODD. All right. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

I have got 5 minutes and lots of questions, so if you would keep your answers short, I would appreciate it.

Chairman Bernanke and Secretary Paulson, how much of the stimulus in the bill signed by the President yesterday needs to get into the economy and how quickly does it need to get there to have an impact in the second half of the year?

Mr. BERNANKE. Senator, I think that the provisions made for the very quick action by Congress, the fact that the Treasury is working hard to get the IRS to send the money out very quickly, I think it will have an impact as early as the third quarter, maybe even a little bit in the second quarter. So it is a very timely bill in that respect, and I think it will be helpful.

Senator BUNNING. But how much of the stimulus package—we have got $160 billion. How much of that has to get in?

Mr. BERNANKE. Secretary Paulson could help me, but I believe that the money is going to be disbursed—over about 10 weeks or so?

Secretary PAULSON. Yes, it will get out quickly, Senator. We are going to get the first payments out in the very beginning of May, and I think the vast majority of the payments going out to individuals will be out by mid-summer.

Senator BUNNING. So it can have a significant impact.

Secretary PAULSON. Yes, it will—we are going to get this out quickly.

Senator BUNNING. There are a lot of us who worried that it was not going to. OK.

Chairman Bernanke and Secretary Paulson, with Fed fund rates at 3 percent and the President having just signed the economic stimulus package, do you have the proper tools today to react to an external energy shock or a disruption or a terrorist attack?

Mr. BERNANKE. Well, certainly, as I said, the monetary and fiscal stimulus we have should give us a better second half than otherwise would have been the case, and that should make the economy more resilient in the face of some kind of external shock. It would depend on the size of the shock, the nature of the shock, but it certainly makes us more resilient.

Secretary PAULSON. I would agree with that. We could all envision shocks that would be more severe than others. We are a bit more fragile than we were before we went into this period because the economy is slowing down and our institutions are not as well capitalized. They are adequately capitalized, but they are a bit more fragile. But I believe we are doing what we need to do, and if there is a shock, we will figure out how to react to it.

Senator BUNNING. All right. Well, thank you.

Chairman Bernanke, our unemployment rate last month was 4.9 percent. The average rate has been from 4.5 percent to 5.5 percent. How close do you consider that to full employment? What is the natural rate of unemployment for our economy today?

Mr. BERNANKE. Senator, that is very contentious, and we are not very sure. People differ considerably. But recently the U.S. economy has shown an ability to maintain an unemployment rate somewhat a little bit below 5 percent. So we are not far from what many economists would call "the natural rate." But I would really emphasize that there is an enormous amount of uncertainty about exactly where that is.

Senator BUNNING. Well, 10 years ago, 6 percent was considered full employment.

Mr. BERNANKE. Well, the economy has changed. I mean, the——

Senator BUNNING. That is why I am asking.

Mr. BERNANKE. Yes, and I think it is not a question of changing estimates. I think it is the fact that the economy, the demographics have changed, the ability to find jobs has improved, for example, using the Internet. A number of other factors have gone in to bring down that rate, and I think that is consistent with evolution of the economy.

Senator BUNNING. You have, I believe, answered this before, Secretary Paulson, but do you believe the banks and other financial institutions are adequately stating their exposure relating to the mortgage mess, including risks to prime in all types of other loans?

Secretary PAULSON. I believe that there is a big effort being made to do that, and as Chairman Bernanke said, some of the securities they are holding, there is not a——

Senator BUNNING. A free market or open market.

Secretary PAULSON. A market, and so what they are doing is they are marking these securities based upon ratings and based upon changes in the economy. And so this is difficult, but I think a lot of progress has been made, and I think that I am doing everything I can—and I know the Chairman is and Chairman Cox is—to encourage banks to take the losses and raise capital.

Senator BUNNING. Chairman Bernanke, I just want to give you a heads up. When you see something coming, don't put it off as the Chairman of the Fed. Take action immediately, because this housing market has been coming to us for a year, a year and a half, and we did not react properly to it.

Thank you.

Chairman DODD. Let me inquire—I appreciate it, Senator Casey. Thanks very much.

Senator Schumer.

Senator SCHUMER. Well, thank you, Mr. Chairman, and I want to thank my colleagues and my colleague from Pennsylvania as well. I have a few questions.

First, you know, being from New York, I talk to a lot of people who are involved in the credit markets, and more and more it seems there is a disconnect. They are in a state of severe worry, even some I talk to panic about the brittleness, the frozenness of the credit markets, which affects everything. And the statements that both Secretary Paulson and Chairman Bernanke have made have said, well, this is a problem, but it will not even take us into recession.

My question is: When we are now seeing credit really damaged in corporate lending, lower-grade corporate lending, this 20 percent that the Port Authority paid shows a brittleness and an inflexibility. That is a good, safe investment, the Port Authority. I do not know how many people think the Port Authority is going broke, and you have got to pay 20 percent when the previous rate was 4.2 percent?

Aren't we reaching a point where the lack of confidence overall in credit in this country—not just in housing, not just in student loans, but throughout, with the combination of the complex credit tools that have been used and the fact that people seem to have a sort of rather happy attitude about all of this until the housing crisis hit, aren't you underestimating not paying enough attention to the severity of the problem in the credit markets, which could become a much greater problem to the economy than the lack of—you know, the slowdown in consumer spending?

Secretary PAULSON. Yes, I would just say one thing, Senator. Yesterday and today, I talked with six or seven CEOs of the major firms in New York and continually get updates. I understand what happened in the auction and looking at other auctions that are coming up. It is one thing to identify a problem; it is another to know exactly what to do about it.

I do believe, though, that what you are seeing here is the market pulling back from complexity, from any kind of instrument that is going to finance longer-term assets on a shorter-term basis.

Senator SCHUMER. Aren't they more worried than your testimony or Chairman Bernanke's——

Secretary PAULSON. Well, I——

Senator SCHUMER. I talked to them, too, and they seem much more worried than you guys are.

Secretary PAULSON. Well, let me say some seem more worried than others. I will tell you this: I have watched these things before, and it will take a while to get through this, and it is something we are watching carefully. But, again, the situations you talked about, like, for instance, the 20-percent rate. That is an overreaction. It is more of a reaction against the structure than the credit. It will be very quickly refinanced. And, again, I do not mean to be overly complacent, but I do say that one of the things we are going to have to do is re-price risk, mark securities to market, and raise capital.

Senator SCHUMER. Right, OK. I am going to—since you and I talked on the phone about this yesterday, Mr. Chairman, I will go to my next question because I want to stay—the problem that we have had with the mortgage insurance is a problem, of course, not with mortgage insurance itself where the State regulators have done a good job, but when these companies then went over and did CDOs in—I am sorry, with bond insurance, with the Government bond insurance. When these companies like MBIA stepped into some new territory, CDOs, mortgage bonds, et cetera, led to their problems, not necessarily the insuring of State and local risk. And this brings in a problem of systemic risk. So I am considering introducing legislation that would regulate them when they do get involved in other types of activities, at least have some kind of Federal oversight greater than we have now. I am not sure if it should be by the Fed or by some other agency.

I would like, Chairman Bernanke, your opinion of that and, Secretary Paulson, your opinion of whether there should be some greater oversight, Federal, on the systemic risk side, not necessarily on the insuring government side, of these bond agencies—these bond insurers.

Mr. BERNANKE. Senator, I am not quite sure what you have in mind. From a microeconomic point of view, the State insurance department regulates them, and we have no complaints about their regulation. But from a macroeconomic or from a market stability point of view, we are obviously watching that situation very carefully.

I am not quite sure what additional powers you would have in mind, but, you know, I think that it is important to note the monoline problem is in some sense a reflection of the deeper underlying problem, which is the problems in the CDOs, the problems in the underlying assets.

Senator SCHUMER. Yes.

Mr. BERNANKE. The best way to address this issue is to strengthen the underlying economy, the housing market and so on.

Senator SCHUMER. Maybe they should not be able to buy such a high percentage of these types of things in terms of systemic risk without any regulation.

Secretary Paulson.

Secretary PAULSON. Yes, I would say something, Senator Schumer, that addresses this, at least in part. One of the things we are working on very diligently right now at Treasury is developing a blueprint, a regulatory blueprint, for today's world and today's markets, because if someone came down from Mars and you were trying to explain the regulatory structure and how this works the way, it does. The regulatory structure has not evolved with the markets, and it is a patchwork quilt in many ways.

And so hopefully when we are ready to unveil this, we can have some good discussion.

Senator SCHUMER. I think it is a good idea for you to look at that, and I am, too.

Thank you, Mr. Chairman, and I thank my colleague from Pennsylvania.

Chairman DODD. Thank you very much, Senator. I appreciate it. Senator Dole.

Senator DOLE. Yes, thank you, Mr. Chairman.

First, I certainly want to echo the favorable comments that we have heard this morning regarding GSE reform. I have been a sponsor of that legislation, a cosponsor with Senator Hagel, and am very pleased to hear the strong support,and I hope we can move on that expeditiously.

Chairman Cox, since the passage of Sarbanes-Oxley, there have been a number of complaints from smaller companies, from financial institutions, with regard to Section 404 and the burdensome nature of compliance, especially from the financial institutions because they are heavily regulated.

Has there been any thought of easing the Section 404 requirements for these institutions?

Mr. COX. Most definitely, Senator. In fact, both at the Securities and Exchange Commission and at the Public Company Accounting Oversight Board, which implements the audit rules for SOX 404, we have taken it upon ourselves to slay the 404 beast. It has been, more than any part of Sarbanes-Oxley, the subject of criticism both here in the United States and abroad, not so much because of what

Congress intended this provision to do, but because of the way that it was implemented.

And so, to begin with, the SEC issued guidance for companies that had not existed before. The companies were having to use the guidance that was intended for auditors so that they could do their own internal assessment without the auditors under 404(a). And, second, we repealed entirely the long and cumbersome and very expensive auditing standard that had been adopted under very urgent conditions right after the passage of Sarbanes-Oxley, Audit Standard No. 2, and replaced it with something that is shorter, simpler, more principles based, top down, risk focused, guided by materiality and scaled to companies of all sizes. That is now going to kick in for this year, and we have a cost-benefit study underway at the SEC to make sure that it is working as we intended.

Finally, with respect to the smaller public companies, we have on multiple occasions extended their time for compliance, and we have just done so one more time into 2009.

Senator DOLE. Thank you.

Secretary Paulson, on January 24th, Business Week reported that sovereign wealth funds were the main topic of the Davos World Economic Forum talks. This has been mentioned already this morning, but I wanted to get you to reflect on this a moment because I know that some countries, like Norway, have a more transparent investment process while other countries, like China and Russia, have less so.

What is the current status of the Treasury's work in this area with appropriate international entities to come up with a way that these funds can be at least more transparent or better understood?

Secretary PAULSON. Senator Dole, thank you very much. We are quite focused on this topic, and as Chairman Cox says, although they are a growing part of the capital markets in terms of their size, on a relative basis they are still fairly modest. But we are quite focused, and what we are focused on is to make sure that what they are driven by is commercial and economic purposes. We have had a history for many years with sovereign wealth funds, and for the most part, they are driven by getting a higher risk-adjusted return. They are driven by economic purposes.

We at Treasury have spent a lot of time meeting with the sovereign wealth funds. We had a breakfast at Treasury where we had 25 or 30 of them there, and they all assure us that they are driven by economic intent. But our purpose there is to come up, and we are encouraging the IMF to work with them and others, with a set of business practices, best practices, principles that have to do with governance and transparency, and that will help them convince so many of the countries that are going to be the recipients of their investment that their intent is for economic purposes.

Again, I want to reiterate what Chairman Cox says. In this country, we welcome foreign investment. That is the highest vote of confidence anyone can pay, is to make a direct investment in our economy. We want to be welcoming to that investment, but we also want to be vigilant.

Senator DOLE. Thank you very much.

Chairman DODD. Thank you very much, Senator.

Senator CASEY. And thank you, Senator Casey, for yielding to Senator Schumer. I appreciate it.

Thank you, Mr. Chairman. Thanks for calling this hearing, and it is great to have these three individuals here—Secretary Paulson, Chairman Bernanke, and Chairman Cox. We appreciate your testimony and your service to the country.

I want to speak first with regard to the subprime prices. Secretary Paulson, I wanted to just lay some Pennsylvania facts on the table. Two overall facts for the State—three, really. When you look at the third quarters of 2005 versus 2007, the number of delinquencies in our State has increased by some 40,000. Then if you go forward and talk about foreclosures, full-blown foreclosures, the projection is third quarter 2007 versus third quarter 2009, that is supposed to go up by some 45,000. They are statewide numbers.

One number which I do not think many of us talk about is a number that I just came across recently that was in a report by the Keystone Research Center. I would ask, Mr. Chairman, consent that this report be made part of the record.

Chairman DODD. It will be made a part of the record.

Senator CASEY. It is entitled, "A Building Storm: The Housing Market and the Pennsylvania Economy." It is by the Keystone Research Center, Mark Price and Stephen Herzenberg.

An interesting fact in here, which I put on the table as a foundation for my first question, is that we all know that subprime mortgages affect principally, in many cases, in many communities almost exclusively, low-income families. However, we sometimes think about that as an urban issue.

This report found that the highest subprime mortgage rates are at least in Pennsylvania, in addition to the city of Philadelphia, the other eight in the top nine were rural counties. Overwhelming numbers, almost half the mortgages subprime. I say that in the context of my question in terms of the people we are worried about here and that I know you are worried about, and to ask you how you respond to some of the recent criticism that we have seen in the press.

I know that, for example, the Wall Street Journal—not what I would call a left-leaning newspaper—from yesterday, "Earlier subprime rescue falters." I know you have seen that story. That is a national story that says in part in the first paragraph, "Earlier efforts have done little to help the most troubled borrowers." It goes on to talk about criticisms of what has been happening so far.

And then just yesterday, as well, the Pittsburgh Tribune Review newspaper—again, not a left-leaning newspaper—the headline is "Mortgage lifeline falls short," and it talks about the Allegheny County Sheriff's Department, a big county in Pennsylvania, second largest county, saying that they are doing what the new initiative sets forth to do. And I would ask you to respond to that because I think people are worried that there is not the sense of urgency and we are not getting the results that we should have in the last couple of months.

Secretary PAULSON. Well, Senator, I understand that, and I spent time myself going around visiting communities where there are the most foreclosures. So I spent time on the ground. I have spent I would say a third of my time on this issue. And it is a difficult issue. It is not an easy issue.

Take the case of the initiative that was announced earlier this week, Project Lifeline. There was a lot of criticism that it is not enough, et cetera, et cetera. That effort is aimed at anyone in the U.S. that has a mortgage and that is delinquent 90 days. So they are right on the verge of losing their home. And one very sad fact is that over 50 percent of the foreclosures take place where the homeowner never talks to anyone.

Now, it is very difficult to help someone if they will not try to help themselves or talk to anyone. So we have a hotline, 888–995–HOPE, and we are urging people to call. This effort, again, is a last-ditch effort to get to people and get to them with a mailing and say here are some simple, pre-set procedures you can go through, and if you go through them, there may be an opportunity to have a modification in your loan agreement.

Now, some people criticize that, and I frankly do not understand where their criticism comes from, because it is something we all should be doing. Now, is that going to help all those people stay in their homes? No. But it will help some people stay in their homes.

The other effort that we have been working very, very hard on is the number of adjustable rate mortgages. And you are right, the next 2 years are going to be the toughest 2 years. The poorest quality mortgages in terms of underwriting procedures were made in 2006, so there are almost 2 million adjustable rate mortgages where the rates are going to be reset and move up. So we have 90 percent of the industry working very hard overcoming many technical issues and accounting issues. We have the industry telling us—and I believe they are very sincere in doing this—that they are going to move very quickly to deal with those homeowners that are able to make their initial payments and aren't able to afford the others, and help them avoid foreclosure. There are going to be fast-track modifications which are interest rate freezes. There are going to be refinancings. They are going to give us the information.

So I did not create this problem. I am working to try to do something about it. If this effort does not work, then we will make adjustments to it. I do not mean to sound heartless because, I will tell you, when you are there and you look at the predatory lending abuses it is heart-rending. But what we are doing is trying to deal with it.

All I can say to you is if you have other ideas for me for Pennsylvania, send them on in, because I think the tax-exempt financing can be helpful if that gets passed. We are going to try to make all of these programs work to the extent they can. And I agree with you, it is not just an urban problem. It is a serious problem, and we are doing everything we can to deal with it.

Senator CASEY. Well, and we are working on it here, too, as you know, but I am out of time.

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

Let me turn to Senator Corker.

Senator CORKER. Mr. Chairman, thank you. And to our panel, I want to say that I followed your careers and have tremendous respect for you being in the positions that you are in, and I am glad that you are.

I will also say that I think the most discouraging moment of my 13-month career here has been this so-called economic stimulus package. We spent most of our morning talking about credit, and sprinkling $160 billion around the country and asking people to spend it as quickly as possible to solve this problem to me was not a solution worth debating or passing. But we have done that, and I just—obviously, these entities that are losing billions of dollars in the mortgage business, that is not a good thing for them either. And we have seen that when you can make a little money doing some conduit and securitized lending, you make a whole lot doing more, and so excesses occur.

What do we see happening, Secretary Paulson, in the private sector to—obviously, the borrower and the lender are now separated. In some cases, the files may be in a warehouse in Kansas or Europe someplace, and so it is very difficult to solve these individual problems. What do we see the private sector—not today but over time—doing adjustment-wise to keep this kind of thing from occurring in the future?

Secretary PAULSON. Well, clearly there will be an aversion for some period of time to complexity, because one of the real problems we have here is complexity and an over reliance on credit ratings. So that will be one reaction.

You pointed to the conduits and SIVs, which are very interesting. There was a great deal of focus on private pools of capital, hedge funds, and a lot of other issues. I think the regulators overall had to be surprised to see that some of the biggest issues were in the big regulated entities and the lack of transparency. And there is a lot of work being done to address this.

I do not come from the school that says that the private sector itself will deal with it. I believe there needs to be a regulatory response, a policy response. The first thing we need to do is get through this period with minimizing the impact on the real economy. But as both Chairman Bernanke and Chairman Cox have mentioned, we are working and thinking about what the right response is.

The last thing I would just say very quickly, which, without being overly defensive on the stimulus, when you look at housing overall, and you see estimates of the degree to which housing prices in some areas of the country are overvalued, there are two ways you can have a correction: housing prices going down or the economy continuing to grow and growing into that.

So one way of minimizing the extent of the correction is to keep our economy healthy and growing. The focus of this Administration has been let us get in and do things aggressively to avoid those foreclosures that are preventable, to prevent a market failure with the kinds of things we have been doing, and let us do what we can to keep the overall economy growing, recognizing that this correction is necessary.

So that is the response there.

Senator CORKER. Well, I did notice you said the focus of this Administration. I still have to believe that at night you are receiving cell phone calls from some of your former colleagues wondering what in the world we were doing. And I am sure that explanation——

Secretary PAULSON. Well, I will tell you: they have not.

Senator CORKER [continuing]. Has been developed.

Secretary PAULSON. The interesting thing is every colleague that I have talked to or CEO of the financial services industry wanted a response like the stimulus plan and believe it will be helpful, but believe it is not sufficient.

When they say not sufficient, they all recognize that as helpful as monetary policy is and as helpful as the stimulus is that those programs alone will not be sufficient; that the industry is going to need to re-price risk, recognize losses, raise capital, and that given the degree of integration of our capital markets into the global capital markets and the degree of complexity means, it is going to take time and some pain before we work through this.

Senator CORKER. Just—I know my time is up, just a quick one word response from you and Chairman Bernanke, if we could.

But there have been a lot of descriptions about where we are in the housing sector, whether it is a crisis or whether this is a correction. And I am wondering if each of you might chose a word to describe where we are today.

Secretary PAULSON. I do not use loaded words. And so I have been using a correction, because it is a correction. And I would say this: that 93 percent of the mortgage holders in this country are making their mortgage payment on time. But what we have and why we have different voices is again this is a nationwide issue.

There is a different degree of a problem in different areas of the country. And at the end of December, I went around and I visited a number of communities that had the highest rates of foreclosure. And they fit into two categories.

They fit into—either those communities that may have a strong underlying economy, but where there had been very, very rapid appreciation of home prices, to the point that when you look back on it, it is hard to even imagine home prices going up 15 percent, 18 percent a year and not sustainable.

When you look at parts of—I was in Orlando, Florida; I was in Stockton, California, where you had home prices going up very quickly. And then, you would go to a place like Kansas City, Missouri, or you look at parts of Pennsylvania or Ohio or Michigan, where you maybe did not have the same appreciation, lower appreciation, but where we have a tough economy.

Where the economy is weaker and that, coupled with some of the very bad lending practices, have put us where we are.

Mr. BERNANKE. I think the mortgage payment rate is probably closer to 98 percent, but in any case it is—most people—obviously, the great majority of Americans are paying their mortgages on time.

I agree with what the Secretary said, in particular there is two phenomena—on the one hand, in parts of the country where there was enormous price appreciation, that has been vulnerable to correction. So that is really in some sense an offsetting of what happened over the last 5 to 10 years in those markets.

There are, however, other places in the upper Midwest, for example, where they never got that much appreciation. Now, prices are falling because of general weakness in the economy, and that is one of the reasons why there is a direct connection between broad economic health and job creation and prices of housing, and there is a link there.

Senator CORKER. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator, very much. I was—I could not help resist when you are asking whether it is a correction or crisis. Where you stand on that issue depends on where you sit.

Senator CORKER. That is right.

Chairman DODD. And if you are sitting there watching your house get foreclosed, believe me, it is a crisis. And we can move around with these numbers all we want. The fact is this is a big problem. And I agree I do not want to see the—it would be inappropriate for the Secretary or the Chairman to start putting a label of a word on there. That could have its own self-fulfilling prophecy here, so we ought to be careful about language. Language has significance and implications.

But needless to say, I think we all agree here. We would not be sitting here if this were not a major issue we need to grapple with here, and I do not want to—I am not trying to engage in hyperbole, but I do not think we ought to underplay it either. I think you have got to be honest with people about this is serious and requires a lot of work. And I think that is the point worth making.

Secretary PAULSON. We have both said for some time by far the biggest risk to the economy is the housing downturn.

Chairman DODD. Thanks very much.

Senator Carper.

Senator CARPER. Thanks, Mr. Chairman. Gentlemen, welcome. Thanks very much for joining us and for your testimony today.

I want to especially thank you, Mr. Secretary, for the good work, for the leadership that you demonstrated in working with the House and Senate to craft a stimulus package, which I think does no harm and hopefully will do some good as we get into the summer and the latter part of this year.

I want to commend Chairman Bernanke. I want to commend you and those with whom you work on the work that you have done—lowering the Fed Funds rate I thought in an unprecedented way, not once but twice last month.

But thank you for being there. And I think what you have done is actually more important than what we have done in terms of the stimulus side. And we—I am anxious to know when do you think these—when will we know whether or not these steps are working? And how will we know. Let us just start with that.

When will we know whether these steps are working and how will we know?

Mr. BERNANKE. Well, Senator, we will be looking over the next few quarters obviously at the general performance of the economy, but as I mentioned in my testimony, I think there are a few areas of particular sensitivity we need to watch. First is the housing market. We need to begin to see some stabilization in starts and sales. That would be very productive in terms of both of the economy and the credit markets.

Second is the labor market. We would like—we do not expect a rip-roaring labor market by any means, but it would be nice if the labor market would begin to stabilize close to current levels.

And third, the credit markets. Senator Schumer was correct that there is a lot of concern among participants in the financial markets about the state of the credit markets. Much of that is connected with uncertainty about the broad economy. A significant worsening in financial conditions or in credit availability would certainly be a warning bell that we need to take further action.

Senator CARPER. OK. Good.

Treasurer Paulson, any—Secretary Paulson, anything you want to add or take away to what the Chairman has said?

Secretary PAULSON. I would just simply say looking at the Housing Initiative, the HOPE Now Alliance, we are going to be getting numbers every month. And so in terms of that initiative, we are going to look at it and we are all going to see that they are doing what they say they are going to do and how it is working.

Senator CARPER. All right. Thank you.

Mr. BERNANKE. Senator, if I could just add a word on that?

Senator CARPER. Please.

Mr. BERNANKE. I mean, one of the big problems with the foreclosure issue is we have not had good numbers. We have had numerous studies that are not comparable. We do not know exactly what they refer to. It is hard to know how much progress is being made.

So I think getting consistent numbers over time will be extremely helpful.

Senator CARPER. Good. There is an interest on both sides here, Democrat and Republican, in doing more on the housing side and trying to address one, the properties for which—which have been foreclosed, the properties that are sitting vacant, then trying to make sure that there—we somehow encourage homeowners to come in, new owners to come in, purchase those properties, and bring—and live in them.

And there is an interest in doing some other things to restore liquidity in this area of our economy. Among the steps that have been suggested that would be helpful—one, reauthorize FHA. Do so in a way that we bring the FHA into the 21st century and make it relevant. There are a number of aspects of that that would be helpful.

So our proposal to work with our State housing authorities to give them greater flexibility to refinance troubled mortgages, because Senator Isakson has an idea that we provide a $5,000 tax credit to anybody that would move into a home that has been foreclosed and to live in that home.

Or there has been a suggestion that we enlarge, appropriate a little more money to CDBG, Community Development Block Grant funds, with a stipulation that those monies be used to help in this regard.

There has been talk about us passing a strong GSC bill, strong regulator, and somehow include in there the—make permanent or more permanent the increase in the mortgage that can be financed through GSEs. And also we have this idea about government-era—or actually Depression-era government corporation, sort of a quasigovernment corporation, to kind of revisit that and try to bring that into the 21st century and see if it could be made relevant.

That is sort of a menu that has been suggested to us, and there are other ideas, good and bad.

Of that list, which one or two seems to make the most sense to you for us to take as a next step?

Secretary PAULSON. Well, first of all, I am familiar with all of the ideas, and we review every idea and continually review them.

And clearly, among the things that we believe should be done now is GSE reform. So put that at the top of the list right there with the FHA modernization, and, of course, you have all said that. So we just now need to get them into the law. We have a Senate bill. We have a House bill. We need to get legislation passed that can be signed.

So I put those at the top of the list, along with the tax exempt financing authority for the State and municipal governments to let them come up with their own programs to assist with mortgage financing and help as the situation may warrant at the State and local level.

I have been very interested and talked with Senator Isakson about his bill. We continue to study it, think about it, think about other alternatives, but the issues—the initiatives that we are for right now are the ones that I mentioned.

Senator CARPER. Thank you. Last question for Chairman Bernanke. Just give us a quick update on Regulation Z. Where we are going? Where you are going? And when we can likely see that so we will have better disclosure with respect to credit cards and other items.

Mr. BERNANKE. Thank you. Senator, as you know, we did a very extensive review of disclosures for credit cards. We have a new Schumer box. Senator Schumer is not here.

Senator CARPER. Cannot we come up with a better name for it than the Schumer box?

Mr. BERNANKE. Do you have a suggestion, Senator?

Senator CARPER. Carper box.

Mr. BERNANKE. Among the benefits are a much clearer disclosure of penalties and other issues.

We have—the comment period has closed. We received lots of comments. We are working through them now. So we expect to have a final rule soon. And we are hopeful that it will be a major help to making people better understand their credit cards and what their responsibilities are.

Senator CARPER. When you say soon, today is the day that the pitchers and catchers report for spring training. You think soon might be opening day of baseball season?

Mr. BERNANKE. I am sorry?

Senator CARPER. I am trying to understand what soon might be. I am in a baseball mode today.

Mr. BERNANKE. Yes. I—we will shoot for opening day.

Senator CARPER. Good. Thank you very much. That would be a good way to start the season. Thank you.

Chairman DODD. Thank you. Senator Bennett.

Senator BENNETT. Thank you much, Mr. Chairman.

Chairman Cox, you and I have had a number of discussions about naked short selling. I have a lot of opinions about the mortgage thing. We have beaten that horse to death. And I will move on to another subject without sending the signal that I am not interested in the other issues, the economy and so on. It is just that it has all been plowed before.

Let me give—I have done some investigating on my own, and let me give you some of the benefit of that and then ask you to comment, and I have a suggestion for you.

Three months prior to the SHO Regulation, which you issued to try to deal with naked short selling, the volume in Fails to Deliver on NASDAQ was 150 million shares a day, and 3 months after, it was 20 million shares, which would show great progress.

Unfortunately, there is an indication that all it shows is that the people who are involved in naked short selling have hidden their activities a little more carefully than they did before.

Let me give you some examples. First, for those listening in that do not understand exactly what we are talking about, when a broker dealer purchases the sale of a short share, he has 3 days to deliver a borrowed share to the purchaser and the purchaser has 3 days to deliver his money.

And in the old days, when I was short selling and losing money doing it, the buyer did not—if the buyer did not receive his shares by settlement day, 3 days after the trade, he took his money back and undid he transaction.

So he got a crinkly piece of paper that said I really do have these shares. Well, we have done away with that now with the DTCC. Everything is electronic, and what he gets in his account is an electronic blip that says you own that share, and he does not know whether it is a real share or a counterfeit share.

And increasingly, it is easier in this electronic world to give you a counterfeit share.

Now, many of the people who engage in short selling have multiple entities, many of them offshore, and they sell large naked short positions from entity to entity. Position rolls is what they call it, and they are frequently done broker to broker or hedge fund to hedge fund in block trades that do not appear on any exchange. And each movement resets the time clock for the naked position so that the Fail to Deliver, which you monitor, never shows up.

And it is a way of keeping the company off the SHO threshold list. And the stock lend of these kinds of counterfeit shares is enormously profitable for the broker dealers who do it, because they charge short sellers fees for the "borrowed" shares. They are really manufactured shares, whether they are real or counterfeit.

And when the shares are loaned to a short, they are supposed to remain with the short until he covers his position by purchasing real shares.

Well, the broker dealers do 1 day lends, which enables the short to identify to the SEC the account that the shares were borrowed from and as soon as the report is sent in, the shares are returned to the broker dealer to be loaned to the next short.

This allows eight to 10 shorts to borrow the same shares, resetting the SHO Failed to Deliver clock each time, which makes the counterfeit shares look like legitimate shares and the broker dealer charges each short for it.

We have the situation, which we have talked about before, that illustrates this. Robert Simpson, an investor, in 2005 bought every single issued and outstanding share of a company called Global Links Corporation, every single one, and then filed with the SEC his report that he now owned 100 percent of the shares and then he watched that share—that stock trade 37 million shares the next day and 22 million shares the day after that. They were obviously trading counterfeit shares.

All right. My concern is with the DTCC, which is the clearinghouse that handles all of these electronic shares and through whom the creation of counterfeit shares becomes possible. They are totally opaque. It becomes impossible to find out what is going on.

I have had a number of conversations with you personally and with your staff and I salute publicly the work that the SEC is doing to try to curb this.

But I have seen companies in my own State see their share prices driven down virtually to nothing when there are more shares trading than there are shares outstanding. They have tried to solve it by getting the DTCC to give them physical control of their shares. The DTCC will not. One of the investment bankers involved in this helping a new company that said we want to go public said all right, I will help you go public on the condition that you never allow physical control of your shares to disappear. You cannot allow a single share to go to the DTCC because as soon as you do, you expose yourself to the creation of counterfeit shares.

So my question to you is what can we do to get more transparency over the DTCC? And do you have any authority to deal with them to try to create transparency so that the creation of counterfeit shares begins to stop?

Mr. COX. Well, Senator, thank you for describing some of the pathologies that surround this phenomenon of naked short selling and also for your compliments to the Agency for the work that we have been doing on this.

We take, as you know, illegal naked short selling very, very seriously, and we are pursuing wrongdoing very seriously.

What you have described, in part, with the daisy chaining of share lending and with resetting the Reg SHO clock and so on could amount to market manipulation in violation of Rule 10(b)(5) so that what we might have on our hands is not just insufficient regulation, but outright fraud. And certainly, in those cases, the Commission——

Senator BENNETT. I am convinced you do.

Mr. COX [continuing]. Is equipped with tools to deal with this.

The net settlement aspect of the way that DTCC operates has other consequences that we are trying to deal with in related contexts as well, as you know, such as over voting in elections and the related question of broker voting. All of this relates, in turn, to the way our proxy system works.

And so we have an abiding interest not only in the clearing and settlement system, which is a fundamental piece of the infrastructure of the financial markets of the United States, but also we want to make sure that our proxy voting system works and that people have confidence that the markets work as they are intended.

So we will continue to work with you on this.

I just want to update you on further amendments that we are making to Reg SHO to make it work better, because each time we have taken an aggressive step, we have solved part of the problem, but we have seen it manifest in other ways.

We had a grandfather provision, as you know. It was thought, once that went into effect, that the grandfathering was itself contributing to the problem, so we have now repealed the grandfather provision. The phase-in period for putting this new rule into effect, which gets everything down to 13 consecutive days, was just 6 weeks ago.

And so, we are going to monitor very closely whether that has been useful.

The other thing that we were doing is disclosing aggregate fail to deliver data on our own Web site for the first time. And we hope that that contributes to people getting at this problem.

So we look forward, Senator, to working with you and your staff and being as public and open as we can about our fight to stop abusive naked short selling.

Senator BENNETT. Thank you.

Chairman DODD. Thank you very much, Senator, and I—just to take before I turn to Senator Bayh, I just want to reiterate the concern Senator Shelby has, I have as well, Chairman Cox, on the rating agency issues. We have had one hearing on it already. We may want to do it again, but we are very interested in hearing—I know you responded to Senator Shelby's questions regarding this, but we are very interested in following up with you; obviously, Secretary Paulson as well, having almost a lifelong experience in this area; and the publicly traded company issue, looking at these companies to determine whether or not any wrongdoing occurred is something I want to make a request of you to maybe report back informally, at least initially to Senator Shelby and I in this area, and then possibly make it the subject for another hearing to focus on that specifically, the publicly traded companies and the rating agency ideas, if any.

As you said in your testimony here, there are a number of ideas out there. We want to make sure we do the right thing, understanding what is going on, what percentage; obviously a relatively small percentage of the market, but nonetheless, a very important and critical area.

So we will invite that comment from the SEC.

Mr. COX. We will look forward to reporting back to you, Mr. Chairman.

Chairman DODD. Thanks very much. Senator Bayh.

Senator BAYH. Thank you, Mr. Chairman. In fact, my first comment was going to be about the rating agencies. But before I get to that, I would like to thank all three of you for your public service.

I have a high regard for each of you and you take your fair share of criticism, but I think you also deserve a fair amount of praise for what you do on behalf of all of us.

Chairman Cox, I listened with interest to—and I am going to look with interest for the recommendations that you have actually come up with about how do we prevent these conflicts of interest that were apparent.

And I think it is good that you are thinking about requiring greater disclosure so that the discipline of the marketplace can function.

But the losses here have been so staggering and the adverse consequences to our economy have been so great, this may have—and the damage to our global brand as a safe and secure place from which investments originate that this may be one area where some minimum standards for conduct mandated by regulation or law may be in order.

So I encourage you to take a very rigorous look at this. Human nature being what it is, abuses can tend to reoccur, and so more information is great. The discipline of the market is great, but some minimum standards for conduct may be in order here, and I would just encourage you along those lines and along with the Chairman and Senator Shelby await with interest your report because so many people bought what they thought was AAA rated stuff, and it was infected with anything but. And we have got to make sure that that kind of thing does not reoccur.

That said, I would like to turn to Chairman Bernanke and Secretary Paulson.

I am—in follow up on something that both Senator Dole and Senator Brown raised, and that is the whole issue of the sovereign wealth fund, and both of you encourage—you said one of the most important things our financial institutions can do is to raise capital. They have been busy doing that. A good chunk of it has come from the sovereign wealth fund area.

And, Secretary Paulson, I want to follow up on something that you said and the President said, I think it is very important that our country remain a safe and secure place for capital investment from abroad, including from sovereign wealth funds.

As you had pointed out to date, and I think maybe the Chairman mentioned this—oh, no the—Commissioner Cox mentioned this, to date the experience has been a very positive one. The investments have been passive. But a recent behavior by the Russian government, China's relentless pursuit of economic advantage, using any number of levers to obtain that, does give some pause.

And I want to follow up on something that Senator Brown was asking, and I am being somewhat of a devil's advocate here, but let me just put it to you this way: I am fascinated by the prospect that this Administration could be standing for the proposition that U.S. Government ownership of U.S. businesses is an acceptable thing.

Chairman Bernanke, your predecessor came before the Congress and stated very clearly that in his view, it was not an acceptable thing because of unavoidable risk of political interference with economic decisionmaking.

And, Mr. Secretary, one of your predecessors, Secretary O'Neill, said the same thing. I think his direct quote was the U.S. Government has no business owning U.S. businesses.

And so my question to both of you is would you agree with those statements? And, if not, the left wing of my party will be delighted.

And so I am kind of curious. If our own government, the Federal Government, of our country let us say to solve the Social Security problem, or any number of other things were proposing taking major equity stakes in U.S. companies, would that be OK? If not, what should we do to safeguard against the risk of political interference?

Secretary PAULSON. Well, Senator Bayh, clearly, I do not believe that the U.S. Government should be owning our companies or parts of the private sector. We are an economy that has been open for a long time. We have privatized. But we are in a situation where in various parts of the world, their economies are still privatizing or they have huge pools of money.

And even in our economy, you know, we have State pension funds. We have CALPERS. Alaska has its fund. There are different forms of funds, and the overriding question is do we want our capital markets to be open and competitive. We do not want them after having privatized, to be not open to market forces.

So I think the real question we are getting at is, are the investments coming into our country driven by market forces or are they being driven by political forces? And that is where the focus is, and being vigilant there. That is why the focus on best practices, transparency, and so on.

Senator BAYH. If I could be indulged to just follow up, Mr. Chairman. Mr. Secretary, thank you for your response. I would observe a couple of things.

First, our State pension funds, which are sometimes raised as an analogy, as you know, are subjected to all sorts of transparency requirements, governance restrictions, which I think the sovereign wealth funds would probably bridle at.

So that is No. 1. It is sort of an imperfect analogy.

Second, some of the shareholder activism that our State pension funds engage in proves the point that they are susceptible to sometimes having political agendas, which—and I think you would agree that just as our own government would be susceptible to that, foreign governments would be no less susceptible. So how do we attract the capital and yet protect against the potential, not yet the reality, but the potential as these become bigger and bigger players for something other than economic motivations to be driving decisionmaking?

Secretary PAULSON. I think we are saying the same thing. And what we are doing because we are approaching this at Treasury from two angles, two ends.

First, we have been very actively engaging with sovereign wealth funds, the newer ones and some of the established ones that have some very good procedures, processes, transparencies, and we have been talking with them about their motives, about their governance, about their processes and procedures, and we have been encouraging them and saying you want to make investments around the world. There are these very natural and understandable concerns. You can assuage these concerns by developing best practices and by living by those best practices.

And so there has been a lot of work done at Treasury and at the G–7 and to do this right now. The IMF is helping lead an effort to get more transparency.

Then, on the other side, we are working with the countries that are going to be the recipients of a lot of this investment—the OECD countries coming up with also best practices so countries will not dress up protectionist sentiments as being, you know, using the sovereign wealth funds as an excuse—to close their markets from investment.

There has been in this country for some time and in many countries in the world a concern about foreign investment.

I can remember back in the 1970s and 1980s, when Japanese companies were buying the Rockefeller Center or golf courses or investing, and there was just this huge concern.

So there is a concern in our country that I think has been for a long time somewhat unfounded, and there is a concern in many other countries that would try to hold back foreign investment.

I think it is a two-pronged approach. We need to be vigilant, as Chairman Cox says, although the amount of money has increased, as a percentage of global wealth, it has not really increased that much.

The trend lines say it is going to increase. Sovereign wealth funds are going to increase. I never am quite sure I believe all the trends, because the past is very seldom a great predictor of the future, but we are watching it carefully, and we are very vigilant here.

Senator BAYH. My time has expired, Mr. Chairman. Chairman Bernanke, you get off the hook here today, because we have exhausted our time.

I would only observe, Secretary, that we are talking about government investment, not private. We would not even be having this discussion if it was about private foreign investment.

And with regard to best practices and the IMF and all that sort of thing, perhaps with some of the more traditional investors with a long-term track record that might work well. Some of the newer actors—let us take China, for example. I know you have worked very diligently to try and convince them about the best practices of allowing the marketplace to set exchange rates.

Their progress has been, let us say, halting to date. As a matter of fact, it is that practice that has led to some of the reserves they have accumulated which now lead us to the sovereign wealth fund issue.

So some of us are a bit skeptical that moral suasion and best practices alone will be enough to convince some of the new actors on the stage to behave in a way that the American people would view as good for our economy and yet insulating us from the potential for political abuse.

Secretary PAULSON. Can I make one other point that is related to all of this? And, as Chairman of the CFIUS process, I work very hard to look at national security and other issues and enforce the law.

I would say the other thing that we have got going for us is once any investment comes into this country, we have the full force of the SEC, the Justice Department, all of the laws, all of the regulations we have to protect us, protect us against abuses and so on. So, again, I think we need to be vigilant. I do not think we need to be fearful, and I know you are not suggesting that. You are I think in a very careful way raising the issues, and these are issues we are all focused on.

Senator BAYH. Thank you.

Chairman DODD. Thank you very much. Let me just—you know, since you have raised CFIUS and I thought this was important. I want to thank Senator Bayh and others who raised this. We had a very good hearing Senator Bayh chaired earlier in the year. This is a very important subject matter for the very reason. The last thing we want to be is xenophobic about this subject matter. It has been a—there has been a great source of wealth creation in the country to attract capital to come here.

On the CFIUS, I am having—we did a good job I think here working with the Administration and writing that legislation. And there is some, I think, maybe a little confusion about the question of these bright lines, and you sort of alluded to it right there, which provokes this point.

And that is we set a line on a certain amount of investment in the country that would trigger CFIUS and the kind of examination—national security issues.

As I recall having written this, along with other members here, that line is not that bright. I mean there are ways in which actually, as you point out, I think we need to be clear on this that we are—the CFIUS process can actually be engaged far short of a minimum amount of investment in the country, where there are some controlling interests, board members, other matters here that would allow the Treasury and others to take a good hard look at this.

And it might be helpful, Mr. Secretary, to clarify that a bit. In light of Senator Bayh's question, I think we might reduce some of the concerns about the ability of us to actually make the very examination you just suggested in your last point.

Secretary PAULSON. Well, right. Well, first of all, CFIUS is——

Chairman DODD. National security motivated.

Secretary PAULSON. National security——

Chairman DODD. I agree. And it is——

Secretary PAULSON [continuing]. It is focused on national security, so that is paramount.

Chairman DODD. But Senator Bayh's point here when you are talking about some of these issues, that line gets blurred a bit between national security and economic investment.

Secretary PAULSON. It is so. It is focused on national security, and then, as you said, when you look at control, what is control and there we do not have bright lines. It can be different in different situations. So I think it is very important that we have the flexibility when we look at this, because, as someone who has worked in the capital markets for a long time, I can just tell you depending on the size of the company, the composition of the shareholder base, the composition of the board, control can take place at different shareholding levels.

So, again, we have flexibility, and we are vigilant there.

Chairman DODD. I do not want to dwell on the point, but I think, in fact, Senator Bayh talking the other day, we made the point that it was recent major investment in a major bank in New York, and then the—and then there was an investor that had less than 10 percent, but before they decided on the new CEO, they went out and checked with that latest investor, which raises the issue.

Anyway, we are going to run out of time here. The last questioner is Senator Akaka, and then we are going to be through. Thanks.

Senator AKAKA. Thank you very much, Mr. Chairman. I want to add my welcome to Secretary Paulson, Chairman Bernanke, and Chairman Cox to this Committee's hearing on our economy and financial markets.

I want you to know that the years I have been here, I have been very interested in financial literacy and raising the level of information to our people in this country so they may work with the financial industry.

Mr. Secretary, the Fair and Accurate Credit Transactions Act created the Financial Literacy and Education Commission, of which you are the designated chairman. And because of my feelings, I feel this is very, very important to our country.

Without a sufficient understanding of economics and personal finances, individuals would not be able manage their finances appropriately or evaluate credit opportunities successfully, invest in long-term financial goals in an increasingly complex marketplace; or to be able to cope with difficult financial situations.

It is essential that we work toward improving education, consumer protections as well, and empowering individuals and families through economic and financial literacy in order to build stronger families and businesses and communities.

So I want to see the Commission improve the financial literacy of all Americans.

The GAO has recommended that the Financial Literacy and Education Commission incorporate additional elements into the national strategy to help, and these are the two: to help measure results and ensure accountability.

So my question to you is what has the Financial Literacy and Education Commission done to address the issue of measuring results and ensuring accountability?

Secretary PAULSON. Senator, first of all, thank you very much for the question, and thank you for your leadership in this area, which is absolutely critical.

As you have said, I chair the Commission, and the President had asked me to put together a plan, which we have put together, which we have rolled out, and it is one that is aimed not just at educational institutions, but it is aimed at the workplace. It is aimed at communities, and it is really quite a comprehensive plan.

And I would very much welcome the opportunity to come up and spend some time with you on this and really to talk to you about this in some detail.

Senator AKAKA. Thank you.

Secretary PAULSON. Thank you.

Senator AKAKA. Thank you for that. I appreciate it.

Chairman Bernanke, in my home State of Hawaii, remittances are extremely important to many of my constituents, and a portion of their hard-earned wages are sent to relatives abroad.

I am concerned that the fees that are often paid are too high. And our banks and our credit unions often provide lower-cost remittances.

So my question to you is what do you think must be done to encourage more people to utilize mainstream financial institutions for remittances services?

Mr. BERNANKE. Senator, you are correct. That is a very important question, one the Federal Reserve has been very much involved in. I think there is, in some cases, a tendency for new arrivals to be distrustful of the banks or less willing to be involved in the banking system. And it is incumbent on the banks and the credit unions to reach out to a new group of customers who not only will be remittance customers, but once they become acquainted with the bank could become depositors or savers or borrowers as well.

So we have encouraged banks and other financial institutions to reach out, to get people, staff, who speak the relevant language, to have community outreach, to try to bring people into their organizations. As you point out, frequently they can offer remittance services at reasonable prices.

The Federal Reserve has also been trying to support these efforts by establishing relationships with, for example, banks in Mexico that will help transmit remittances at the lowest possible cost.

So I think by, you know, through all these efforts, we will accomplish several goals. One is to increase competition and improve service and reduce costs for remittances in particularly immigrant neighborhoods; at the same time, bring more people into the mainstream of our financial system and it relates, of course, to financial literacy so they can be full participants in our economy.

Senator AKAKA. Thank you very much, Mr. Chairman. My time has expired. I will submit a question for the record.

Chairman DODD. Thank you very much, Senator. I appreciate it very much.

And I am going to—this has been very patient. We have kept you a long time today, but very, very important and very valuable.

Chairman Cox, Senator Shelby has a question for you, but I am going to excuse our two other witnesses. I know they have other appointments to make. I want to thank both of you. This is an ongoing obviously conversation. I think this is a very serious problem. Obviously, language is important, but I think we need to emphasize how important it is we work together to do everything we can to get this moving in the right direction.

Let me just also suggest to you here—I am going to leave the record open for written questions. I would ask that because we have had some problem in getting answers back within 2 weeks, and I would ask the respective offices of the Treasury and the Fed if you could have the answers back within 2 weeks, it would be very, very helpful. Thank you very much.

Senator Shelby.

Senator SHELBY. Chairman Cox, I will be brief. One of the factors that has not helped the current crisis in our credit markets is our lack of transparency. There is no price reporting mechanism for collateralized debt obligations in credit default swaps, for example.

One of the biggest shocks to our financial system was the rapid loss of confidence in complex instruments like these that were sold by banks to a handful of investors.

Do you believe it would be beneficial to our markets to allow the investors to see the actual prices for these complex instruments? And what steps could you take as a regulator, as the Chairman of the SEC, to make that happen?

Mr. COX. Senator, transparency is helpful in any market, and certainly that is the case here.

Senator SHELBY. It helps set the market, does it not?

Mr. COX. In particular, when one combines the lack of transparency with complexity of the instruments——

Senator SHELBY. Yes.

Mr. COX [continuing]. Part of the reason that the ubiquity of these products has resulted in consequences that one might not have predicted on the face of it all is that there was a whole lot of reliance on other parties, on other guarantors of quality, and what the market now insists on doing is finding out for itself whether or not investments are of sufficient investment grade that funds and firms will make these investments themselves.

So all that we can do to help to provide transparency in this market, the SEC will do.

Senator SHELBY. That is good. Thank you.

Chairman DODD. Very good. Chairman Cox, we thank you very much as well. Thanks for staying around a few extra minutes for Senator Shelby's question.

Mr. COX. Thank you.

Chairman DODD. It was a very good hearing. We had—I think virtually every—almost member attend, indicating obviously the interest in the broad subject matter here.

I want to thank my colleague, Senator Shelby, and other members of the Committee, and the Committee will stand adjourned.

[Whereupon, at 1:02 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

Statement of Senator Tim Johnson
Senate Committee on Banking, Housing and Urban Affairs
"The State of the United States Economy and Financial Markets"
February 14, 2008

Chairman Dodd, thank you for holding today's hearing on the current state of the U.S. economy and financial markets. I also want to thank today's witnesses; I look forward to your testimony. This is an important and timely hearing.

Each day we find mostly unwelcome messages about the state of the economy. On Monday, the White House optimistically predicted that the economy will continue to expand, but at a slower rate; yet some analysts contend that we are already in a recession; others believe the worse is yet to come in the housing market and home prices could fall an additional 25% this year.

Credit for non-prime borrowers is nearly shut down, home-equity loans and lines of credit are limited, jumbo mortgage rates are high, and nearly a third of planned home sales were canceled or delayed in the last quarter of the year because of loan problems.

The only mortgages being securitized successfully are the ones bought by Fannie Mae and Freddie Mac which accounted for about 87% of mortgage securitizations in December, and Fannie and Freddie continue to tighten standards and raise fees. Banks and commercial firms continue to report record losses and write-offs, and foreign countries continue to buy up that debt.

We are seeing further concerns regarding the role of credit rating agencies in the subprime mortgage crisis. And now, there are significant troubles in the bond insurance market. As the number of mortgage defaults increase, rating agencies have become worried that bonds backed by troubled loans could also default, triggering payments from bond insurers and threatening the bond insurers' credit ratings. If bond insurers are downgraded, the rating of the bond it insures drops, causing the value of the bond to fall. This could create even further problems for the economy. Additionally, I have serious concerns about how well-equipped the state regulatory system for bond insurance is to deal with the national and international implications of the weaknesses in this market.

It is my hope that the $168 billion economic stimulus package that the President signed into law yesterday will provide some relief to these looming economic concerns. While obviously not a permanent fix for economic trouble, I hope the stimulus will go a long way toward reversing recent downturns.

The Federal Reserve rate cuts, tax rebates, small business tax incentives and recent HOPE Now changes to freeze certain foreclosures and broaden outreach effort to delinquent subprime borrowers are necessary emergency measures, but it is also important that we work to protect the economic security of Americans by looking for long-term solutions. Creating an environment that fosters good paying jobs, investing in the public good, emphasizing entrepreneurship, addressing the costs of healthcare and energy prices, and protecting Americans pocketbooks by promoting financial literacy all come to my mind. I hope that the panelists today can offer some ideas on how we can stabilize the economy and financial markets in the short-term and long-term.

Statement of U.S. Senator Elizabeth Dole
Banking Committee Hearing on "The State of the United States Economy and Financial Markets"
10:00 a.m. Thursday, February 14, 2008 - 538 Dirksen
Opening Statement

Chairman Dodd and Ranking Member Shelby, thank you for holding this important hearing on the state of our economy and financial markets. I appreciate this committee's careful consideration of this issue today, particularly in light of current housing and financial unrest.

Since last August, our financial markets have experienced tremendous uncertainty. Credit and capital markets around the world have struggled to comprehend the ramifications of the U.S. subprime lending and housing crisis. Fortunately, the Federal Reserve has been quick to act, lowering the federal funds rate from 5.25 percent to 3 percent.

Congress is also working to help boost our economy. I am pleased that just last week we passed an economic stimulus package that provides tax incentives to help businesses invest and create jobs and that targets Americans, such as seniors and disabled veterans, who need it most.

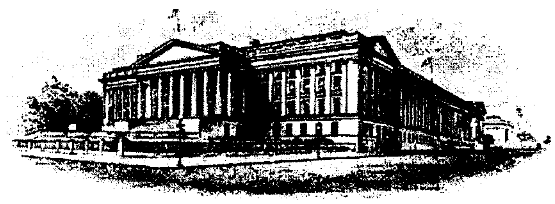
Over the past quarter, preliminary indications show that the growth in Gross Domestic Product (GDP) was six-tenths of one percent. This is down from the third quarter GDP growth of 4.9 percent. Another troubling statistic is the Labor Department's latest finding that while the U.S. unemployment rate for January 2008 actually declined, the number of payroll jobs *also* declined. As a former Secretary of Labor, I find this latest economic indicator troubling, and I will be watchful of a developing trend in the coming months.

In my home state of North Carolina, the unemployment rate in 2007 hovered around 5 percent. This rate was a bit higher in the first part of last year; however, in recent months North Carolina's rate has remained close to the national average.

In recent years, North Carolina has undergone a difficult economic transition, and our state continues to evolve from a manufacturing and agriculture-based economy to a more services-oriented economy. This transition in my home state highlights the need across our country to address the growing gap between skilled and unskilled workers, so that there are opportunities for all as our economy moves forward.

To this end, Senator Cantwell and I introduced the Trade Adjustment Assistance Reform Act of 2007, which would allow more workers to receive TAA benefits, even when their jobs relocate to countries without preferential trade agreements with the United States. Eligible workers can obtain training, job search and relocation allowances, income support and other reemployment services. TAA is critical to ensuring that displaced workers don't slip through the cracks and that they have the ability to train for new careers. Since my time as Secretary of Labor, I have championed the TAA program, and I strongly support its reauthorization.

Again, Chairman Dodd and Ranking Member Shelby, thank you for holding this hearing. I look forward to hearing from our witnesses today and hearing their assessment of the state of the U.S. economy.



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10:00 a.m. (EST), February 14, 2008
CONTACT Brookly McLaughlin, (202) 622-2920

TREASURY SECRETARY HENRY M. PAULSON, JR.
OPENING STATEMENT BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

WASHINGTON- Chairman Dodd, Senator Shelby, Members of the Committee:

Thank you for the opportunity to be here today. I am pleased to appear with my colleagues Chairman Bernanke and Chairman Cox. I appreciate their leadership on the challenges confronting our economy and capital markets, and look forward to continued close, productive working relationships.

The U.S. economy is fundamentally strong, diverse and resilient, yet after years of unsustainable home price appreciation, our economy is undergoing a significant and necessary housing correction. The housing correction, high energy prices and capital market turmoil are weighing on current economic growth. I believe that our economy will continue to grow, although its pace in coming quarters will be slower than what we have seen in recent years.

Four weeks ago, recognizing the downside risks to our economy and that the short-term cost of doing nothing was too high, President Bush called for an economic growth package to provide a temporary boost to our economy as we weather the housing correction.

The Congress responded with bipartisanship, cooperation and speed to pass an economic growth package that is temporary, broad-based and will assist our economy quickly. We have demonstrated to the nation and the world that we can come together to address the needs of the American people as we weather the housing downturn.

Yesterday, the President signed the economic package into law and Treasury is already working to send payments out to more than 130 million American households.

The IRS will manage the current tax filing season and simultaneously prepare to issue these additional payments starting in early May. Payments will be largely completed this summer, putting cash in the hands of millions of Americans at a time when our economy is experiencing slower growth. Together, the payments to individuals and the investment incentives for businesses will help create more than half a million jobs by the end of this year.

In addition to this growth plan, the Administration will continue to focus on aggressive action to try to provide alternative options to foreclosures. This includes encouraging the HOPE NOW alliance, a coalition representing over 90 percent of the subprime servicing market, and non-profit mortgage counseling organizations, trade associations and investors.

This industry-wide effort employs multiple tools to reach and help struggling homeowners, including streamlining able subprime borrowers into re-financings and loan modifications.

The HOPE NOW effort is making progress. According to updated statistics, in the second half of 2007 the industry assisted 869,000 homeowners, including 545,000 subprime borrowers who received loan modifications and repayment plans. The progress rate is accelerating; the number of subprime modifications in the fourth quarter doubled over the rate in the third quarter. In Q4 alone, of the estimated 1.5 million homeowners of all types delinquent 60 or more days, over 470,000 received help from their servicer and almost 30 percent of those received a loan modification.

I expect that this progress will accelerate in 2008. In January, the industry began implementing a new framework to streamline mortgage modifications for able but struggling subprime borrowers. As announced by the American Securitization Forum, this framework will greatly speed the financial evaluation process --- borrowers who have made their initial payments but cannot afford the interest rate reset may be fast-tracked for modification or re-finance, allowing mortgage counselors and servicers to devote time and resources to the more difficult cases.

Currently, I am focusing on two aspects of this effort: first, on ensuring that the ASF framework is adopted throughout the industry, so that the industry is better prepared to deal with the rising volume of subprime mortgage resets; and second, on ensuring that the HOPE NOW alliance produces timely metrics so that policy makers and industry participants can evaluate progress and make adjustments as needed.

I appreciate this Committee's leadership and specific efforts to address issues that have arisen during the housing downturn. Finalizing the FHA modernization bill will provide additional tools to help homeowners and I encourage you and the House to reach consensus as soon as possible. Enactment of GSE regulatory reform is also a very high priority for Treasury and the Administration, and I commend the chairman and committee members for your willingness to move forward promptly. While not under this committee's jurisdiction, the Administration has also proposed legislation that will allow states to issue tax-exempt bonds for innovative refinancing programs. This tax proposal is in addition to that signed into law in December, which provides temporary tax relief for homeowners facing increased taxes due to forgiven mortgage debt. All of these initiatives may help mitigate the housing headwinds, and we remain open to other good ideas as we move forward.

Treasury continues to monitor capital markets closely and to advocate strong market discipline and robust risk management. While we are in a difficult transition period as markets reassess and re-price risk, I have confidence in our markets. They have recovered from stressful periods in the past, and they will do so again.

Working through the current stress is our first concern. Through the President's Working Group on Financial Markets, we are also reviewing underlying issues ranging from enhancing risk management to market infrastructure, to reporting and disclosure, to ratings and investor practices. We know a short-term boost to our economy is needed. We also know that it is just as important to get the long-term policy response right.

Thank you and I am pleased to take your questions.

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For release on delivery
10:00 a.m. EST
February 14, 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

February 14, 2008

Chairman Dodd, Senator Shelby, and other members of the Committee, I am pleased to be here to offer my views on financial conditions, the near-term economic outlook, and related issues.

As you know, financial markets in the United States and in a number of other industrialized countries have been under considerable strain since late last summer. Heightened investor concerns about the credit quality of mortgages, especially subprime mortgages with adjustable interest rates, triggered the financial turmoil. However, other factors, including a broader retrenchment in the willingness of investors to bear risk, difficulties in valuing complex or illiquid financial products, uncertainties about the exposures of major financial institutions to credit losses, and concerns about the weaker outlook for the economy, have also roiled the financial markets in recent months.

As the concerns of investors increased, money center banks and other large financial institutions have come under significant pressure to take onto their own balance sheets the assets of some of the off-balance-sheet investment vehicles that they had sponsored. Bank balance sheets have swollen further as a consequence of the sharp reduction in investor willingness to buy securitized credits, which has forced banks to retain a substantially higher share of previously committed and new loans in their own portfolios. Banks have also reported large losses, reflecting marked declines in the market prices of mortgages and other assets that they hold. Recently, deterioration in the financial condition of some bond insurers has led some commercial and investment banks to take further markdowns and has added to strains in the financial markets.

The banking system has been highly profitable in recent years and entered this episode with strong capital positions. Some institutions have responded to their recent losses by raising additional capital. Notwithstanding these positive factors, the unexpected losses and the increased pressure on their balance sheets have prompted banks to become protective of their liquidity and balance sheet capacity and, thus, to become less willing to provide funding to other market participants, including other banks. Banks have also become more restrictive in their lending to firms and households. For example, in the latest Senior Loan Officer Opinion Survey conducted by the Federal Reserve, banks reported having further tightened their lending standards and terms for a broad range of loan types over the past three months. More-expensive and less-available credit seems likely to continue to be a source of restraint on economic growth.

In part as the result of the developments in financial markets, the outlook for the economy has worsened in recent months, and the downside risks to growth have increased. To date, the largest economic effects of the financial turmoil appear to have been on the housing market, which, as you know, has deteriorated significantly over the past two years or so. The virtual shutdown of the subprime mortgage market and a widening of spreads on jumbo mortgage loans have further reduced the demand for housing, while foreclosures are adding to the already-elevated inventory of unsold homes. Further cuts in homebuilding and in related activities are likely.

Conditions in the labor market have also softened. Payroll employment, after increasing about 95,000 per month on average in the fourth quarter, declined by an estimated 17,000 jobs in January. Employment in the construction and manufacturing sectors has continued to fall, while the pace of job gains in the services industries has slowed. The softer labor market, together with factors including higher energy prices, lower equity prices, and declining home values, seem likely to weigh on consumer spending in the near term. On the other hand, growth in U.S. exports should continue to provide some offset to the softening in domestic demand, and the recently approved fiscal package should help to support household and business spending during the second half of this year and into the first part of next year.

On the inflation front, a key development over the past year has been the steep run-up in the price of oil. Last year, food prices also increased exceptionally rapidly by recent standards, and the foreign exchange value of the dollar weakened. All told, over the four quarters of 2007, the price index for personal consumption expenditures (PCE) increased 3.4 percent, up from 1.9 percent during 2006. Excluding the prices of food and energy, PCE price inflation ran at a 2.1 percent rate in 2007, down a bit from 2006. To date, inflation expectations appear to have remained reasonably well anchored, but any tendency of inflation expectations to become unmoored or for the Fed's inflation-fighting credibility to be eroded could greatly complicate the task of sustaining price stability and reduce the central bank's policy flexibility to counter shortfalls in growth in the future. Accordingly, in the months ahead we will be closely monitoring inflation expectations and the inflation situation more generally.

To address these developments, the Federal Reserve has moved in two main areas. To help relieve the pressures in the interbank markets, the Federal Reserve--among other actions--recently introduced a term auction facility (TAF), through which prespecified amounts of discount window credit can be auctioned to eligible borrowers, and we have been working closely and cooperatively with other central banks to address market strains that could hamper the achievement of our broader economic objectives.

In the area of monetary policy, the Federal Open Market Committee (FOMC) has moved aggressively, cutting its target for the federal funds rate by a total of 225 basis points since September, including 125 basis points during January alone. As the FOMC noted in its most recent post-meeting statement, the intent of these actions is to help promote moderate growth over time and to mitigate the risks to economic activity.

A critical task for the Federal Reserve over the course of this year will be to assess whether the stance of monetary policy is properly calibrated to foster our mandated objectives of maximum employment and price stability and, in particular, whether the policy actions taken thus far are having their intended effects. Monetary policy works with a lag. Therefore, our policy stance must be determined in light of the medium-term forecast for real activity and inflation, as well as the risks to that forecast. At present, my baseline outlook involves a period of sluggish growth, followed by a somewhat stronger pace of growth starting later this year as the effects of monetary and fiscal stimulus begin to be felt. At the same time, overall consumer price inflation should moderate from its recent rates, and the public's longer-term inflation expectations should remain reasonably well anchored.

Although the baseline outlook envisions an improving picture, it is important to recognize that downside risks to growth remain, including the possibilities that the housing market or the labor market may deteriorate to an extent beyond that currently anticipated, or that credit conditions may tighten substantially further. The FOMC will be carefully evaluating incoming information bearing on the economic outlook and will act in a timely manner as needed to support growth and to provide adequate insurance against downside risks.

Testimony
of
Christopher Cox
Chairman, U.S. Securities and Exchange Commission

Before the
U.S. Senate Committee on Banking, Housing and Urban Affairs

On

The State of the United States Economy and Financial Markets

February 14, 2008

Chairman Dodd, Senator Shelby, and Members of the Committee:

Thank you for the opportunity to update you on the work of the Securities and Exchange Commission in light of recent market events. Beginning last summer, U.S. and overseas markets have been roiled by the deterioration of credit and liquidity conditions in the U.S. residential mortgage market, especially the subprime portion of that market. As mortgage delinquencies rose, other financial instruments tied to the value of those mortgages declined in value, placing pressure on large financial institutions – both those that had packaged and marketed these securities and those that had purchased them based, at least in part, on the high credit ratings. The resulting large losses for some market participants, the concern in the markets about the future performance of a range of complex structured finance instruments, and the more generalized concern about the effects on credit markets overall have led to a more risk-averse environment, and have contributed to a slowdown in the rate of the nation's economic growth.

For the SEC, these recent market difficulties have posed a number of challenges. In addressing them, the Commission has worked closely with the other members of the President's Working Group on Financial Markets – including Secretary Paulson and Chairman Bernanke, who are testifying with me here today. We have also worked closely with our international regulatory counterparts, a reflection of the global impact that the U.S. market events have had, and the increasingly interconnected nature of today's worldwide capital markets.

The Commission's priorities in using the powers within our jurisdiction is to protect investors, keep our markets healthy and vibrant, and promote capital formation. Given the scope and complexity of the issues connected to the problems in the subprime securities market, the Commission's efforts in this area have involved nearly every major SEC division and office, and every area of emphasis – including monitoring systemic risk, guarding against market abuses, and clarifying the application of accounting rules concerning the restructuring of mortgages. To coordinate the efforts of all of the Commission's Divisions and Offices, Erik Sirri, the Director of the Division of Trading and Markets, is leading an agency-wide Task Force composed of senior leadership from each of the relevant disciplines within the SEC.

While the Commission is not a front-line regulator of the mortgage lending business, the derivatives industry, or the monoline insurance industry, as has been widely reported the securities markets and the market participants that the Commission does regulate – not to mention the investors whom it is our mission to protect – have been deeply affected by the problems stemming from the widespread packaging and selling of residential mortgages as securities issued by special purpose trusts that qualify for off-balance sheet treatment under current accounting rules. Among the questions that have been raised within our jurisdiction are the accounting treatment of these trusts and their assets; the adequacy of capital and liquidity at the nation's major investment banks, and the strength of their risk management practices; the impact on money market funds from the devaluation of presumptively safe assets; the quality of issuer disclosure by public companies involved in structured finance; the role of the credit rating agencies, over which the SEC gained regulatory authority eight months ago; and the possibility of violations of the securities laws by subprime lenders, investment banks, broker-dealers, and other market participants.

The accounting issues have centered around the questions of balance sheet consolidation and valuation. Current accounting rules limit the discretion of firms to actively manage special purpose trusts (and the underlying loans they hold) once a loan has been sold, if they wish to continue to maintain off-balance sheet treatment. Twice in recent months, first in July 2007 and again in January 2008, the SEC has provided guidance on the application of these rules in the case of limited modifications for loans where default is reasonably foreseeable. In that circumstance, we have said, the limited modification would not invalidate off-balance sheet treatment. This guidance has allowed refinancings and other work-out arrangements to proceed that otherwise would have been forestalled due to highly unfavorable accounting consequences, with the advantage of keeping people in their homes and maximizing the value of the securitized assets. This is, however, a short-term response. The Commission's Chief Accountant has also asked the Financial Accounting Standards Board to revisit the underlying accounting pronouncements to determine whether the experience of the last several months points to the need not only for further clarifying guidance, but also for changes in the applicable rules.

The members of the President's Working Group on Financial Markets, which includes the Commission, play an active role in overseeing the stability of the financial system. One important aspect of that oversight is our Consolidated Supervised Entities (CSE) program, through which the Commission currently supervises five of the systemically important U.S. securities firms on a consolidated, or group-wide, basis. The CSE program currently includes Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley. This prudential supervision of the nation's largest investment banks is designed to be broadly consistent with Federal Reserve oversight of commercial bank holding companies. The purpose of the CSE program is to monitor for, and act quickly in response to, financial or operational weakness in a CSE holding company or its unregulated affiliates that might place regulated entities (including U.S. and foreign-registered banks and broker-dealers), or the broader financial system, at risk.

The Commission subjects the CSE firms to a number of requirements, including monthly computation of a capital adequacy measure consistent with the Basel II Standard; maintenance of substantial amounts of liquidity at the holding company level; and documentation of a comprehensive system of internal controls. Further, the holding company must provide the

Commission on a regular basis with extensive information regarding its capital and risk exposures, including market and credit risk exposures. Under the CSE program, liquidity and liquidity risk management are also a critical focus. This is because the ability of a firm to withstand market, credit, and other types of stress events is linked not just to the amount of capital the firm possesses, but also to the sufficiency of liquid assets to meet obligations as they arise. The Commission seeks to determine whether each CSE firm has adopted and follows procedures 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 one year.

In addition to monitoring capital adequacy, liquidity, and liquidity risk management at the CSE firms, Commission staff meet regularly with senior managers of critical control functions at the firms who are focused on market and credit risk exposures. These include senior financial controllers, treasury personnel, internal audit personnel, and risk managers. Commission staff also meet periodically with the top management of the CSE firms. As a result of this regular interaction, the Commission has been able to identify emerging trends – for example, the CSE program provided an early window for our accounting professionals into the challenge facing all financial firms in valuing assets for which the secondary market was no longer liquid.

Another aspect of our oversight is the mutual fund industry. Here, too, the Commission staff has been active in working with the managers of money market funds as they cope with the downgrading of ratings and the declines in value of securities in which their funds have invested. Commission rules limit money market funds to investing in high-quality, short-term investments in an effort to ensure that these bedrocks of the financial system are reliable in all market conditions. Losses by a money market fund would be reflected by the fund re-pricing its securities below $1.00 (known as "breaking the buck"). Only one fund, and that of very modest size, has ever broken the buck since the development of money market funds in the 1970s. The Commission is closely monitoring the fund industry and while we have seen some instances of funds requiring infusions of capital from the corporate parents of fund advisers, we are not aware of any money market fund that is threatened with having to reprice below $1.00.

We are also working to increase the transparency of the key publicly-traded financial institutions in their disclosures to markets and investors. In December 2007, Commission staff wrote to 25 leading financial institutions that are publicly owned companies, highlighting specific disclosure issues that the firms should consider in relation to their exposure to off-balance-sheet entities and certain structured finance products. Better illuminating the facts concerning these exposures should give counterparties increased confidence in the fundamental soundness of the financial system.

Last summer, using the new statutory authority that gave the SEC regulatory jurisdiction over the credit rating agencies effective in June 2007, the Commission began examinations of the role of the rating agencies in the subprime market turmoil. The rating agencies have been publicly criticized regarding the accuracy of their ratings of certain structured finance products, especially subprime residential mortgage-backed securities and collateralized debt obligations. Critics have faulted the rating agencies for initially assigning ratings to those securities that were too high; for failing to adjust those ratings as the performance of the underlying assets deteriorated; and for not maintaining appropriate independence from the issuers and underwriters of those securities.

Our examinations are focused on whether the rating agencies diverged from their stated methodologies and procedures for determining credit ratings in order to publish higher ratings. They are also focusing on whether the rating agencies followed their stated procedures for managing conflicts of interest inherent in the business of determining credit ratings for residential mortgage-backed securities. In this regard, the examinations will seek to determine whether the credit rating agencies' role in the process of bringing residential mortgage-backed securities and collateralized debt obligations to market impaired their ability to be impartial in their ratings. I expect to receive preliminary reports from these examinations in the coming months, with a final report in the early summer. In the meantime, we will keep you apprised of our progress and ongoing lessons from these examinations.

In addition to the Commission's examinations of credit rating agencies, President Bush has directed the President's Working Group on Financial Markets to examine more generally the role of credit rating agencies in lending practices, how their ratings are used, and how securitization – the repackaging and selling of assets – has changed the mortgage industry and related business practices. As a member of the President's Working Group, the SEC is taking a leading role in this study.

Beyond these ongoing reviews, we are also re-examining the wisdom of the legislative and regulatory provisions that have granted a central role to the rating agencies in our markets. More than just providing the markets one view of the likelihood of default, the past several months have demonstrated the power of credit ratings to move markets, and their potential to create cascading effects in those markets. For example, the precipitous downgrade of the ratings of residential mortgage-backed securities and CDOs affected not only the rated securities but the funds and institutions that held and sponsored them; and now, the actual and anticipated ratings downgrades of the monoline insurers has impacted the ability and willingness of money market funds to hold certain assets, and contributed to a retrenchment from risk as some market participants have lost faith in the ratings.

This sensitivity to changes in credit ratings (which extends to the monoline insurers, whose own ratings determine the degree to which investors and issuers are willing to rely on them) is perhaps nowhere more pronounced than in the municipal securities market. In the municipal market, the lack of uniform, timely, and robust disclosure can leave investors with little more than a credit rating to rely on when making an investment decision. In a letter to the Chairman and Ranking Member of this Committee in July 2007, I proposed a more comprehensive disclosure regime to ensure that investors have access to the same high-quality disclosure from municipal issuers that is already required of corporate issuers. The recent problems reinforce the need for such disclosures. I hope the Committee will seriously consider those proposals to provide investors with better information in this important sector of the market.

Government's contribution to the widespread market reliance on credit ratings, by incorporating them into the regulatory and legal framework, has a long history. But the need to revisit the issue was recognized several years ago. In the Sarbanes-Oxley Act of 2002, the

Congress rightly focused on whether the government imprimatur for the ratings agencies was wise. The Sarbanes-Oxley Act required the Commission to study and report on the role of the rating agencies – and that report, in turn, contributed in part to the Credit Rating Agency Reform Act, which has now given the SEC the opportunity to write new rules that can create greater competition and transparency in this area.

During the past 30 years, regulators, including the Commission, have increasingly used credit ratings as a proxy for objective standards for monitoring the risk of investments held by regulated entities. We have also used them as a shorthand in describing an appropriate disclosure framework for securities of differing risks. For example, since 1975 the Commission has relied on credit ratings to distinguish among grades of investment safety in various regulations under the federal securities laws. In addition, a number of federal, state, and foreign laws and regulations today use credit ratings in this and analogous ways. The recent market disruptions highlight the limitations of this arrangement. As a result, I have directed the Commission staff to explore alternatives to Commission regulatory reliance on credit ratings where feasible.

I have also directed the staff to develop proposals for new, more detailed rules under the new Credit Rating Agency Reform Act that respond directly to the shortcomings we have seen through the subprime experience. Among the proposals that the Commission may consider as early as this spring are rules that would require credit rating agencies to make disclosures regarding past ratings, in a format that would improve the comparability of track records and promote competitive assessments of the accuracy of the agencies' past ratings. In addition, new rules could be aimed at enhancing investor understanding of important differences between ratings for municipal and corporate debt and for structured debt instruments.

Policing our markets to ensure compliance with the securities laws is also a critical aspect of our jurisdictional responsibility in connection with the subprime market turmoil. Our Division of Enforcement currently has more than three dozen subprime-related investigations underway. The Division formed a subprime working group in the spring of 2007 to coordinate the investigations in this area. They are coordinating with banking regulators as appropriate. The investigations involve several areas of potential violations of the securities laws, including securitization issues by underwriters and other firms involved in the process of bringing subprime securities to market, as well as disclosures, valuations, and sales to investors. Because these law enforcement investigations are underway, specific details remain confidential. It has not yet been determined in any particular case whether or not securities laws were broken.

Finally, the Commission has been actively working with our international counterparts to deal with the global market aspects of the recent market disruptions. In just the past two weeks, I have met to discuss these issues with my European Union counterpart, with securities regulators from over two dozen countries at the International Organization of Securities Commissions meetings in Amsterdam, and with the chairmen of securities regulatory agencies in China, Brazil, South Africa, and South Korea this week in Washington. The SEC is also working with the Financial Stability Forum, an international grouping of financial regulators, international financial institutions, and government officials, to develop a common understanding of the root causes of the market turbulence, and to develop responsible solutions.

There are two IOSCO projects of particular relevance to today's discussion. First, I am co-chairing IOSCO's Subprime Task Force, which was created to systematically study the recent financial market turmoil and make appropriate recommendations to better protect public markets from the spillover effects of mortgage underwriting practices and securitization activities. Specifically, this Task Force is looking at four areas:

- enhanced transparency by issuers of structured products and appropriate due diligence from investors;
- the risk management process for intermediaries;
- valuation and accounting issues; and
- the roles and duties of credit rating agencies.

The Task Force is due to publish its final conclusions in May 2008.

Second, reporting to the Subprime Task Force is an IOSCO Task Force focusing exclusively on the role of credit rating agencies in the structured finance market. This Credit Rating Agencies Task Force, which the SEC also chairs, is examining various advancements in the IOSCO Code of Conduct Fundamentals for credit rating agencies. IOSCO plans to produce a consultation paper on proposed changes to the model Code of Conduct.

Each of the regulatory actions we are taking and each of those that we are contemplating, both here and abroad, is designed to promote the health of our capital markets, to protect investors, and to promote capital formation. I appreciate the opportunity to describe the main aspects of the Commission's work in this area, and I would be happy to take your questions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR AKAKA FROM HENRY M. PAULSON

A. RESOURCES FOR FLEC ACTIVITIES

In its review of the Financial Literacy and Education Commission (FLEC), the GAO indicated that effective national strategies should include discussions of cost, the sources and types of resources needed, and where those resources should be targeted.

Q.1. What resources will be needed to ensure that FLEC can adequately fulfill its mandates?

A.1. The Commission is presently fulfilling its mandates through the existing resources of the 20 agencies that comprise the Commission.

Q.2. What additional resources will be required to support the President's Financial Literacy Council?

A.2. Additional resources to support the President's Advisory Council on Financial Literacy are not required. It is expected that the Council will work closely with the private sector to accomplish its objectives.

Q.3. Will you commit that this new council will not take resources away from the Commission?

A.3. The President's Advisory Council on Financial Literacy will not divert resources away from the Financial Literacy and Education Commission.

B. THE UNBANKED

Secretary Paulson, approximately 10 million households in the United States do not have accounts at mainstream financial institutions. Unfortunately, too many of these households depend on high-cost fringe financial services. The unbanked lose too many resources to check cashers and refund anticipation loan providers. They also miss out on opportunities to save and borrow at credit unions and banks.

Q.4. In addition to efforts to increase financial literacy, what is the Department of the Treasury doing to help bring the unbanked into mainstream financial institutions?

A.4. On behalf of the Financial Literacy and Education Commission, Treasury held four regional conferences entitled "How to Bank the Unbanked" in 2006 and 2007. The conferences were held in Chicago, New York, Seattle, and Edinburg, Texas. Treasury is using findings from these conferences to implement its Community Financial Access Pilot. This new initiative will provide assistance to eight demonstration sites throughout 2008 and 2009. In each pilot location, Community Consultants (Treasury staff) will provide technical assistance to implement community initiatives. At the conclusion of the pilot Treasury will release to the public information on effective practices. As of February 2008, the Community Consultants have begun the process of assessing community needs, facilitating partnerships, working with local organizations to develop financial products to bring the unbanked into mainstream financial institutions, and implementing financial education services.

C. CFA RECOMMENDATIONS FOR THE COMMISSION

During a financial literacy oversight hearing held in April, Mr. Steve Brobeck from the Consumer Federation of America outlined several strategies to achieve significant and measurable improvements in specific financial decisions made by most Americans. Examples of these include encouraging self-measurement of net personal wealth, use of automatic savings opportunities, periodic checking of credit records, and on-time repayment of loans. He also recommended that the Commission develop an online tool that could be widely promoted as an annual financial checkup instrument. This was a very interesting recommendation that could lead to the development of concrete proposals that would result in positive behavioral change.

Q.5. Will the Commission be developing similar strategies to achieve significant and measurable improvement in the decision making of consumers?

A.5. The Commission tracks its progress in two ways: Completion of tasks listed in Taking Ownership of the Future: The National Strategy for Financial Literacy ("National Strategy"), and the level of distribution of financial education information.

The Commission's National Strategy includes enumerated "Calls to Action" to improve the nation's financial literacy. The primary method used by the Commission to measure its progress is the completion of the Calls to Action. Of the 32 Calls to Action, 22 of them require implementation by the Federal government. Of the 22 Calls to Action for the Federal government, 12 have been completed.

The Commission also records the volume of its material distribution. Since April 2006, more than 2,140,000 English-language publications and 41,700 Spanish-language publications have been ordered through the My Money Web site and 1–888–My Money hotline. In addition, approximately 106,500 combined English- and Spanish-language versions of the Commission's National Strategy have been distributed.

The Commission has also measured approximately 35,000 monthly visits to the My Money Web site (or 1,150 per day), with a total of nearly 1.5 million visits since the site launched in October 2004.

Additionally, during the first meeting of the newly created President's Advisory Council on Financial Literacy (Council), the Council advised the Treasury Department to consult with the Financial Industry Regulatory Authority Investor Education Foundation (Foundation) on an upcoming baseline survey the Foundation will be conducting on the financial knowledge, attitudes and behaviors of the adult population in the United States. Treasury and the Council will use the results of the survey to assess the nation's current level of financial literacy and to measure future changes in financial literacy. The survey will be helpful in targeting and monitoring the effectiveness of both the Council's and the Commission's financial literacy initiatives.

D. STIMULUS ANTICIPATION LOANS

I am concerned that working families will have their stimulus checks unnecessarily diminished by payday lenders. With a completed 2007 tax form, payday lenders will be able to provide a stimulus anticipation loan to taxpayers. The interest rates on payday loans are outrageously high.

Q.6. What will the Department of the Treasury do to prevent predatory lenders from exploiting working families?

A.6.

Weblink: On behalf of the Financial Literacy and Education Commission, the Department of the Treasury has provided a link on the front page of MyMoney.gov leading to a fact sheet on the economic stimulus package on the IRS website. This information contains stimulus payment scenarios, answers to frequently asked questions, and a rebate scam alert.

Mailing: Also, for 20.5 million recipients of Social Security or Veterans Affairs benefits the Internal Revenue Service has mailed informational packages on the stimulus payment to help them get their payment. Many of these recipients receiving the informational package are unlikely to have filed a tax return for 2006 but must file for 2007 to receive the stimulus payment. The tax package contains everything the recipients will need to file a 2007 tax form immediately. The package is specially designed for people who may qualify for a stimulus payment but who normally aren't required to file a tax return. The mailing is separate from the more than 130 million other economic stimulus letters that were sent to taxpayers who filed tax returns in 2006. Both of these mailings list the IRS website as a resource to visit with any questions or concerns regarding the stimulus payment.

Pilot Outreach Campaign: In the second half of 2008, the Department of the Treasury will develop messages to educate adults on how to determine actual lending needs, consider total lending costs, and comparison shop for the best alternatives. These materials will be delivered in selected markets through a number of channels such as targeted radio announcements, printed materials, and Internet advertisements. Adults will be directed to educational materials available at MyMoney.gov. These materials will focus on how to avoid predatory loans and obtain low-cost financial services.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR TESTER FROM HENRY M. PAULSON

Q.1. As many have noted, the strength of a country's economy dictates the strength of its currency. As the dollar has rapidly declined in currency markets—down almost 30% over the last five years—what will continued stagnation in growth mean for the dollar? And will the recent interest rate cuts strengthen or lessen the dollar's position? What will it mean for American consumers?

A.1. As I have stated before, a strong dollar is in our nation's interest. Economies have their ups and downs, but I am confident that the long-term strength and vitality of the U.S. economy will eventually be reflected in currency markets.

Q.2. In the course of previous critical economic situations—recessions—we have witnessed a wave of bank failures due to a variety of factors. Do you have any concern that banks will be in similar situations in the coming months? Or will the failure of non-bank mortgage lenders (finance companies) that operate outside the banking reserve system be the only casualties from the housing and credit crunch that we are currently facing?

A.2. Our financial institutions entered this period of turmoil well-capitalized. A number of financial institutions have experienced problems associated with the current dislocation in mortgage and other credit markets. To date, most of the failures have been concentrated in non-bank mortgage lenders, although there have been a few failures of federally-insured depository institutions. I have encouraged financial institutions broadly to continue raising capital should they think it necessary, so they can continue to lend and support our economy.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM HENRY M. PAULSON

Q.1. Considerable work has already been done establishing that our capital markets are at risk of falling behind and providing specific regulatory, tax, and liability reforms to revive the leadership position of the U.S. capital markets. Do you agree that it is past time for all of us to resolve these outstanding issues and action is required now?

A.1. A strong financial system is vitally important—not for Wall Street, not for bankers, but for working Americans. When our markets work, people throughout our economy benefit—Americans seeking to buy a car or buy a home, families borrowing to pay for college, innovators borrowing on the strength of a good idea for a new product or technology, and businesses financing investments that create new jobs.

The current regulatory framework for financial institutions is based on a structure that has been largely knit together over the past 75 years. It has evolved in an accretive way in response to problems without any real focus on overall mission: Congress established the national bank charter in 1863 during the Civil War, the Federal Reserve System in 1913 in response to various episodes of financial instability, and the federal deposit insurance system during the Great Depression. Changes were made to the regulatory structure in the intervening years in response to other financial crises (e.g., the thrift crises of the 1980s) or as enhancements (e.g., the Gramm-Leach-Bliley Act of 1999 ("GLB Act")), but for the most part the underlying structure resembles what existed in the 1930s.

Q.2. What are the top initiatives that your agency is pursuing to meet this need, when will you propose them, and have you set deadlines for implementation?

A.2. Last March, Treasury convened a blue-ribbon panel to discuss U.S. capital markets competitiveness. Industry leaders and policymakers alike agreed that the competitiveness of our financial services sector and its ability to support U.S. economic growth—is constrained by an outdated financial regulatory framework. As the conclusion to a process that began in June 2007, on March 31, 2008, Treasury released its “Blueprint for a Modernized Financial Regulatory Structure.”

In this report, Treasury presents a series of short, intermediate and long-term recommendations for reform of the U.S. regulatory structure. The short-term recommendations present actionable changes to improve regulatory coordination and oversight immediately. The intermediate recommendations focus on eliminating some of the duplication of a functional regulatory system, but more importantly try to modernize the regulatory structure for certain financial services sectors within the current framework. Finally, we also include a long term model for discussion. This model holistically addresses the inadequacies of the current functional regulatory system.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOLE FROM HENRY M. PAULSON

Q.1. Secretary Paulson, I want to commend you for this Administration’s efforts to assist distressed borrowers—Treasury’s collaboration with the HOPE NOW coalition, Project Lifeline, the cooperation with the private sector on the 30-day foreclosure freeze—these are all important initiatives. But I would like to ask you if there is even more we could be doing to provide distressed borrowers with refinancing options, too, so we can get them back into mortgages that are appropriate for them?

A.1. Treasury recognizes the critical importance of refinancing as an option to help distressed borrowers avoid foreclosure; several key actions have been taken in this area.

In September, HUD announced FHA Secure, a program targeted at helping borrowers with adjustable-rate mortgages refinance into a lower-rate loan. Since the announcement of the program, FHA has closed more than 140,000 refinancing loans, and expects to close 300,000 loans by the end of 2008. FHA Modernization is essential to allow FHA to achieve even further progress, and Treasury urges Congress to enact this legislation.

In December, the American Securitization Forum announced the ASF fast-track framework for streamlining the refinancing and modifying of subprime loans facing rate resets. The ability to identify loans that qualify for refinancing is a key element of the framework, and Treasury has encouraged Hope Now Alliance members to make refinancing an even more central part of their toolkit in addressing the needs of distressed borrowers.

We have also called on Congress to complete GSE reform and pass legislation to encourage states to encourage refinancing by issuing tax exempt bonds.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM BEN S. BERNANKE

Q.1. Considerable work has already been done establishing that our capital markets are at risk of falling behind and providing specific regulatory, tax, and liability reforms to revive the leadership position of the U.S. capital markets. Do you agree that it is past time for all of us to resolve these outstanding issues and action is required now?

Q.2. What are the top initiatives that your agency is pursuing to meet this need, when will you propose them, and have you set deadlines for implementation?

A.1. and A.2. The Federal Reserve currently is engaged in diagnosing the causes of financial market turmoil and developing regulatory responses to address the problems that have been identified. Efforts to put markets and market participants on a sound footing are our top priorities, and they will remain so for some time. That said, however, these efforts also are consistent with the long-term goal of ensuring that U.S. markets deliver financial services in a competitive and efficient manner. Regulatory policies are being evaluated carefully to ensure that they do not exacerbate strains on markets or market participants. In addition, responses are being coordinated with authorities in other jurisdictions to maintain a level playing field for global market participants going forward.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR TESTER FROM BEN S. BERNANKE

Q.1. As many have noted, the strength of a country's economy dictates the strength of its currency. As the dollar has rapidly declined in currency markets—down almost 30% over the last five years—what will continued stagnation in growth mean for the dollar? And will the recent interest rate cuts strengthen or lessen the dollar's position? What will it mean for American consumers?

A.1. In the long run, exchange rates tend to be set by markets on the basis of an economy's fundamental strengths. Over shorter horizons, however, a wide array of factors may influence the exchange rate, including movements in interest rates here and abroad, expectations of future economic policies, and the evolution of the nation's trade and current account balances. For much of the period since 2002, the U.S. economy has expanded solidly, even as the value of the dollar has declined in foreign exchange markets. Most recently, the dollar has weakened alongside indicators of U.S. economic growth.

Recent cuts in U.S. interest rates have reduced the rate of return on liquid, dollar-denominated debt instruments, and thus, all else equal, may have had some effect on the near-term trajectory of the dollar. However, we believe that responding to slowing economic activity through monetary policy actions helps to safeguard the economy's essential dynamism and thus, in the medium and long run, should be reflected in the exchange value of the dollar. Such a development, in turn, would restrain increases in the cost of living that owe, in part, to rising import prices.

Q.2. In the course of previous critical economic situations—recessions—we have witnessed a wave of bank failures due to a variety of factors. Do you have any concern that banks will be in similar situations in the coming months? Or will. the failure of non-bank mortgage lenders (finance companies) that operate outside the banking reserve system be the only casualties from the housing and credit crunch that we are currently facing?

A.2. While most banking institutions continue to perform well amidst the ongoing financial turmoil, a few institutions—some larger, some smaller—are facing difficulties. These difficulties could be exacerbated by weakening economic fundamentals. As in past periods of financial distress, some banks will fail should challenges presented by the current environment continue.

One must put any discussion of possible bank failures in perspective and recognize that even in good times, banks can fail. For more than a decade we have experienced few bank failures—no more than ten in any given year since 1995 and none in 2005 and 2006.

In general, U.S. banks entered the current period of financial distress with strong capital ratios, which should reduce any potential threats to their solvency. Through our examination, monitoring and surveillance programs we will work diligently to identify problem institutions and take the appropriate supervisory response. When bank failures do occur we will strive to minimize the risk to the deposit insurance fund.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM CHRISTOPHER COX

Q.1. Concerns have arisen that some NRSROs use the same letters for credit ratings for municipal debt, corporate debt and structured debt instruments which have different default rates. For example, one NRSRO's cumulative five-year default rate for CDOs rated at its minimum investment grade was between eight and ten times higher than its default rate for corporate bonds that it similarly rated.

Do you feel that this is a subject of concern? Do you think that investors would benefit from requiring clearer or different credit ratings scales or designations for municipal debt, corporate debt and structured debt instruments?

A.1. Yes. Because a number of commenters have indicated that there should be greater differentiation of ratings of securitized products from corporate ratings, the Commission recently proposed new rules that would require credit rating agencies either to use distinct ratings symbols for structured products, or to make special disclosure of the differences between ratings for structured products and other securities, such as corporate bonds.

Q.2. The full Committee held a hearing on "The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets" on September 26, 2007, only a few days after the SEC's new authority took effect under Public Law 109–291, the Credit Rating Agency Reform Act of 2006. At the Committee's September hearing, Columbia University Professor Jack Coffee recommended that "the SEC . . . calculate the five year cumulative default rates on different classes of financial products and disclose this data on one centralized web site."

What is your view of this recommendation?

A.2. I believe that credit ratings performance measurement statistics are vital to users' ability to understand how well a credit rating agency has assessed the creditworthiness of issuers and obligors. The rules that we proposed on June 11, 2008, include new disclosure requirements to facilitate reliable comparisons of performance between NRSROs. The disclosure of performance statistics for NRSROs would provide better comparability of ratings performance across the NRSROs. This could include specifying the time periods to be covered by the statistics (e.g., 1, 3, and 10 years) and requiring statistics for different ratings classes. As with Professor Coffee's recommendation, the goal is to make the NRSROs' performance statistics more useful and transparent. I have also asked the Commission staff to carefully review the recommendations suggested by Professor Coffee in considering possible future rulemaking. The staff is also reviewing what additional performance measurement statistics, including historical downgrade and default rates within each rating grade, would be useful to users of ratings.

Q.3. Since the time of the hearing, what has the SEC learned about the NRSROs, including their ability to manage conflicts of interest and their role in the subprime crisis? Do you feel NRSROs should be subject to additional regulatory requirements, such as due diligence requirements or an obligation to update past ratings when rating model assumptions are changed? Does the SEC need more statutory authority to perform its mission in this area?

A.3. Beginning last fall, using the new statutory authority that took effect in September 2007, the Commission began examinations of the role of the rating agencies in the subprime market turmoil. We have just released the findings from these exams and the Commission staff has provided a detailed briefing on our findings to your staff. A copy of the report has been separately provided to you. Given the recent enactment of the Rating Agency Reform Act, I believe the Commission has sufficient authority to address any problems that are identified through our examinations, including those relating to conflicts of interest and whether firms followed their stated procedures with respect to keeping ratings up to date. As I have indicated, the Commission staff is also preparing additional rulemakings using that new authority. If we should find that we lack needed authority, we would, of course, work with you to address any deficiency.

Q.4. A key factor in restoring and maintaining investor confidence is having a Federal securities regulator that is fully funded and has sufficient authority to protect large and small investors while facilitating fair and efficient capital markets.

The President's proposed Budget would fund the SEC for FY 2009 at $913 million, an increase of less than 1% over FY 2008 ($906 million). The Enforcement Division's proposed budget for FY 2009 ($318 million) is about 1% more than the budget for FY 2008 ($315 million). This year, the SEC will ramp up the examination and regulation of the NRSROs, investigate conduct related to the subprime crisis, review late filings for options backdating, review corporate disclosures, oversee rules for new markets and engage in other important activities. Will this budget be sufficient to effectively perform your duties?

A.4. As you know, the SEC has an enormous task, overseeing the nearly $44 trillion traded on U.S. equity markets; the disclosures of almost 13,000 public companies; and the activities of about 11,000 investment advisers, nearly 1,000 fund complexes, and 5,700 broker-dealers, among others. Given the size and complexity of the markets we regulate, even if the SEC's budget were to double or triple, the agency still would need to carefully set priorities. The SEC must continue to think strategically about which areas of the market pose the greatest risk, and which areas of potential improvement hold the greatest benefit for investors. And given the fast pace of today's capital markets, we must remain agile and flexible enough to redirect our resources with little notice.

- The FY 2009 request would result in 4% overall increase over two years, which is sufficient for the SEC to fulfill its mission, continue its major initiatives, and deploy resources as needed to emerging issues. Nonetheless, any additional money that the Congress saw fit to provide would be put to good use.

Q.5. Would you recommend that Congress make any statutory changes to allow the Commission to resolve the current subprime crisis or face the next crisis more effectively?

A.5. Yes. As I testified to the Committee, the Consolidated Supervised Entities program should be authorized in statute and made mandatory for investment banks, as opposed to today's voluntary program. In addition, last year, the Commission proposed numerous authorization proposals that would improve the functioning of the SEC, including by enhancing our enforcement authority. Finally, in July 2007 I wrote to the Committee's leadership calling for improvements in the statutory regime governing municipal securities in order to improve the functioning of that important market, where we can expect further subprime and derivatives-related problems.

Q.6. Public companies, including banks and securities firms, are required to make full and fair disclosures in their securities filings about collateralized debt obligation holdings and their valuation. As the subprime crisis has progressed, some investors have complained that corporations filed inadequate disclosures and inaccurate valuations about their holdings in certain mortgage-backed securities. In December 2007, the SEC staff asked public companies with investments in structured investment vehicles and other collateralized debt obligations to make specific types of disclosures in their filings.

Will the SEC staff increase the frequency and thoroughness of its reviews of corporate filings, or take other appropriate steps, to make certain that investors are given appropriate information about such investments?

A.6. Yes. Through its regular and systematic review of public company disclosure, the Division of Corporation Finance reviews, at a minimum, the financial statements of each public company at least once every three years. Also, consistent with the requirements of Sections 408 of the Sarbanes-Oxley Act of 2002, the Division of

Corporation Finance reviews the disclosure of the largest companies more frequently. Over the past eight months, Division of Corporation Finance staff noted that a number of large financial institutions could improve their disclosure regarding off-balance sheet arrangements by providing additional information to their investors. As a result, and in recognition of changing economic circumstances, the staff sent letters to certain large financial institutions in early December highlighting disclosure points that the staff recommended the institutions consider when responding to the Commission's disclosure requirements relating to exposure to off-balance sheet arrangements. The staff posted a sample of the December 2007 letter on the Commission's website so that all companies with material off-balance sheet arrangements could consider the disclosure suggestions. A similar effort is contemplated with respect to firms' disclosure of how they are valuing complex and illiquid securities.

The staff will continue to monitor the disclosure these financial institutions provide and will, as appropriate, make suggestions on how they can continue to improve their disclosure. The Division of Corporation Finance will also continue its regular and systematic review of public company disclosure and consider whether additional action is warranted.

Q.7. Some large U.S. financial firms that took major write-downs resulting from their subprime holdings have raised capital by selling securities to sovereign wealth funds, which are owned by foreign governments. The partial ownership of U.S. companies by foreign governments offers additional sources of capital but also has raised questions involving conflicts of interest, transparency, market efficiency and the enforcement of securities laws abroad. These funds could invest for purely economic reasons or could attempt to influence a corporation's policies and practices—such as location of business operations, allocation of credit or capital, hiring decisions or lobbying agenda.

Chairman Cox, in a recent speech you raised two good questions: "What are the logical and likely outcomes of growth in this kind of activity? Could the rise of sovereign business ultimately change the character of U.S. markets? How should we go about answering these questions? What are your views on these matters?

A.7. Our market economy is not premised on government ownership of commercial enterprises. Governments have other important roles to play in the economy, including as regulators, and an arms-length relationship to commercial and competitive concerns is healthy to the functioning of a genuine market. Nonetheless, in other nations government ownership of business, including increasingly through equity investments, is the norm. When such governments make portfolio investments in the U.S. capital market, there are—as with cross-border investment generally—potential benefits. Through their competition for investments in the United States, sovereign wealth funds can help offer U.S. companies a lower cost of capital and a more liquid market for their securities than might otherwise be available. But those same benefits would likely accrue to U.S. companies and markets if the foreign investment were privately directed, rather than government directed. A sovereign investor in a number of potential concerns for regulators and other market participants:

- Because investor is a government, the incentives that normally drive private sector marketplace participants to make decisions may be absent, or at least very different. Sovereign wealth funds, and sovereign businesses, may therefore have a distorting effect on markets, the pricing of assets, and the allocation of resources.
- In addition, neither sovereign wealth funds nor sovereign businesses are typically transparent in their motives or operations. Generally, the level of transparency is related to the degree to which the government itself is transparent to its citizens and to the public. Overall, disclosure by sovereign wealth funds leaves much to be desired, while public disclosure surrounding sovereign business tends to stop at the level of the company's interaction with the government itself.
- Another concern about sovereign wealth funds and sovereign businesses is not that they are foreign, but that their managers are sovereign. Conflicts of interest necessarily arise when government is both the regulator and the regulated. Rules that might be rigorously applied to private sector competitors will not necessarily be applied in the same way to the sovereign who makes the rules.
- Governments that control sovereign wealth funds and sovereign businesses, because they are governments, can in some cases control certain economic events, and they may have information advantages over private market participants. Governments routinely are privy to certain types of information that most private investors are not.
- In addition, there is the increased opportunity for political corruption. Graft, bribery, and other forms of financial corruption by governments and political figures is an unfortunate fact of life throughout the world—as the Commission's enforcement responsibilities under the Foreign Corrupt Practices Act remind us on a daily basis. When individuals with government power also possess enormous commercial power and exercise control over large amounts of investable assets, the risk of misuse of those assets, and of their conversion for personal gain, rises markedly.

Q.8. Congress approved our CFIUS reform law last year to address national security threats that might arise from a foreign agents' access to sensitive U.S. technology, critical infrastructure, or important defense supplies. It is not necessarily meant to address some critics' concerns over foreign companies' potential use of passive investment as economic leverage on U.S. capital markets.

In a speech at Harvard University's Kennedy School of Government on October 24, 2007, you stated "the rise of sovereign wealth funds challenge our regulatory model in a number of ways...if government-owned investments lack transparency, they could contribute to market volatility stemming from uncertainty about the allocation of their assets." What tools and enforcement authority are currently available to the SEC to protect investors from such market volatility and to ensure fair and orderly markets?

A.8. The SEC currently has rules that impose disclosure obligations on all large investment funds, including sovereign wealth funds. The primary disclosure requirements applicable to unregistered funds arise under Sections 13 and 16 of the Exchange Act. These provisions require the reporting of beneficial ownership of securities if the owner acquires more than a certain threshold percentages of the stock of an issuer. These provisions apply to fund advisers as the beneficial owners of the securities in the funds they manage. For example, if a fund adviser has acquired more than 5% of the stock of an issuer, Section 13 applies and the adviser must file a Form 13D or 13G. If a fund adviser has acquired more than 10% of the stock of an issuer, Section 16 applies and the adviser must file a Form 3 or 4. The forms require the fund adviser to state whether the fund has any intent to change control of the company, or whether the acquisition is instead a passive investment.

Investment advisers having investment discretion over $100 million or more in Section 130 securities (generally any equities registered pursuant to Section 12 of the Exchange Act) also must also file a Form 13F, which is a quarterly report of all the Section 13(f) securities positions held by the adviser. In filing Form 13F, an adviser to multiple clients may aggregate all of his clients' positions in a particular security. The required filings provide the SEC and the public with a quarterly "snapshot" of the fund's Section 13(f) securities holdings.

The SEC has brought enforcement actions for violation of these disclosure requirements. See, e.g., In re Quattro Global Capital, LLC, Adv. Act Rel. No. 2634 (Aug. 15, 2007) (action against registered investment adviser having investment discretion over at least $100 million in relevant assets for failure to file quarterly Form 13F disclosing its Section 13(f) securities for a period of over three years); SEC v. Scott R. Sacane, et al., Lit. Rel. No. 20258 (Aug. 29, 2007) (SEC settled action for disclosure violations under Sections 13 and 16 of the Exchange Act as part of a market manipulation scheme). If a fund were not complying with its reporting obligations, the Division of Investment Management would likely bring the filing requirements to the funds' attention. If further steps are necessary to obtain the necessary disclosures, the Enforcement Division may file an injunctive action in federal court, or an administrative proceeding within the SEC, to compel compliance with the disclosure requirements. The difficulty with opaque investors such as sovereign wealth funds, of course, is that the SEC has no way of knowing whether they have failed to comply in the first place.

Q.9. The press reports that there is growing uncertainty regarding the ability of bond insurers to meet their financial obligations in the event of downgrades to collateralized debt obligations, asset-backed securities, and other structured finance products containing subprime loans. In recent weeks, several bond insurers have seen their credit ratings lowered and analysts have speculated that bond insurers may face future ratings downgrades. These events could have serious implications for banks and other financial institutions which hold insured bonds or credit default swaps.

What is your assessment of this situation and the efforts of State regulators and the private sector to address this?

A.9. As a threshold matter, the Commission does not regulate these financial guarantors, known colloquially as monoline insurers; rather this is the domain of state insurance regulators. There are, however, various ways that the securities markets and their participants, which the Commission does regulate, may be impacted by ratings downgrades of monoline insurers.

These bond insurers began by insuring against defaults on bonds issued by municipalities—a market that has not historically experienced many or sizable defaults. During the 1990s, some bond insurers migrated to insuring complex securities backed by home mortgages, including subprime instruments. In insuring such structured products, many of these bond insurers assumed that losses on mortgage-backed securities would stay within historical ranges. As the housing boom continued for many years, defaults were indeed low and housing-related assets were considered relatively safe. During 2006, however, there was increasing evidence of the deterioration in home prices and a related rise in mortgage default rates. As the deterioration has continued, market participants are questioning whether such bond insurers will in fact be able to pay on their bond guarantees and credit protection that they underwrote.

Fortunately, the underlying credit of many insured municipal bonds is quite strong. Indeed, the municipal issuers are beginning to question the desirability of obtaining municipal bond insurance at all. Demand for municipal bond insurance is reportedly shrinking at the fastest pace in the industry's 36-year history. State and local governments bought protection on only 26 percent of the $40.8 billion in bonds they sold in January and February 2008, down from 53 percent a year earlier, according to data compiled by Bloomberg.[1]

The Commission staff recognizes that a significant downgrade in a monoline insurer's rating could result in the securities becoming ineligible under rule 2a–7 for investment by money market funds. Also, in the long term, the inability of bond insurers to maintain high credit ratings may restrict the supply of high-quality paper for tax-exempt money market funds.

There are other possible effects that a significant downgrade in a monoline insurer's rating could have on money market funds. The municipal securities they hold include variable rate demand notes ("VRDNs") and tender option bonds ("TOBs") that typically have liquidity backstops, or "puts," that are provided by a financial institution. These liquidity features serve to provide a source of cash to satisfy redemptions by fund shareholders, and also to shorten the municipal bonds' maturities and make them eligible investments for a money market fund. A significant downgrade could terminate the put, and thus result in money market funds holding long-term securities that would be inappropriate for funds main-

[1] Michael McDonald and Christine Richard, "Insurance Drops for Municipal Debt, Undermines MBIA," Bloomberg News, March 13, 2008.

taining a stable net asset value. The Commission staff has been in regular contact with fund management companies, which are aware of these risks and have taken steps intended to protect funds and thus fund investors from the loss of these puts.

Monoline insurer downgrades also potentially affect systemically important securities firms. SEC staff have discussed frequently the various exposures to monolines with risk managers, treasurers, and business unit personnel at these firms. While the monolines are important market participants, the systemically important securities firms are highly aware of and actively manage their exposures to the monoline sector. The Commission staff is also in regular communication with other financial services supervisors, particularly the Federal Reserve Board, which directly oversees the holding companies of the most of the systemically important commercial banks, the OCC, which oversees nationally charted commercial banks, and the UK's Financial Services Authority. Through a variety of formal and informal channels, the staff has worked with these other supervisors to understand the possible impact of downgrade or financial distress on individual institutions and on the broader financial system.

Q.10. Does it appear to you that there will result potentially significant problems involving the securitization of credit card debt?

A.10. The SEC does not regulate credit card debt markets and these securities are generally offered in private placements outside the Commission's purview. Through the SEC's supervision of systemically important securities firms the Commission does monitor the investment firms' risk exposure to and risk management of securitized products supported by a range of assets, including credit card receivables. In our ongoing and frequent discussions with senior risk officers and market participants, the firms have represented that they are aware of their risk exposures to such products and have risk controls for managing such exposures.

Q.11. What lessons has the Commission learned from the current subprime crisis?

A.11. While the Commission is not a front-line regulator of the mortgage lending business, the derivatives industry, or the monoline insurance industry, the securities markets and the market participants that the Commission does regulate—not to mention the investors whom it is our mission to protect—have been deeply affected by the problems stemming from the widespread packaging and selling of residential mortgages as securities. Among the problems that have surfaced are the deterioration in lending standards that led to the creation of so much low-quality mortgage debt; the abuses stemming from the prevalence of the originate-to-distribute model that diminished incentives to control risk, the accounting treatment of the trusts created to hold this risky debt in securitized form; the adequacy of commercial banking measures of capital and liquidity for determining the proper levels of assets at the nation's major investment banks; the impact on money market funds from the devaluation of presumptively safe assets; the quality of issuer disclosure by public companies involved in structured finance; and the adequacy of the standards for evaluating structured products employed by the credit rating agencies, over which the SEC gained regulatory authority last summer.

The deterioration of lending standards that led to the creation of so much risky paper, as well as the role of commercial banks in originating and securitizing mortgage credit, falls outside the SEC's jurisdiction. The accounting issues have centered around the questions of balance sheet consolidation. Current accounting rules limit the discretion of firms to manage special purpose trusts (and the underlying loans they hold) once a loan has been sold, if they wish to continue to maintain off-balance sheet treatment. Twice in recent months, first in July 2007 and again in January 2008, the SEC has provided interpretive guidance on the application of these rules in the case of limited modifications for loans where default is reasonably foreseeable. In that circumstance, we have said, the limited modification would not invalidate off-balance sheet treatment. As a result, these financial institutions were not required to consolidate these trusts—which would have had negative ramifications on the bank's regulatory capital requirements. As a result, refinancings and other work-out arrangements have proceeded, with the advantage of keeping people in their homes and maximizing the value of the securitized assets. This is, however, a short-term response. The Commission's Chief Accountant has also asked the Financial Accounting Standards Board to revisit the underlying accounting guidance to determine whether recent experience points to the need not only for further clarifying guidance, but also for changes in the applicable rules.

The members of the President's Working Group on Financial Markets play an active role in overseeing the stability of the financial system. One important aspect of that oversight is our Consolidated Supervised Entities (CSE) program, through which the Commission supervises the systemically important U.S. securities firms on a consolidated, or group-wide, basis. In my testimony to the Senate Banking Committee on April 3, 2008, I described in significant detail the CSE program as it related to the events leading up to the merger between Bear Stearns and JP Morgan Chase. We have learned from the Bear Stearns experience that investment banks can be subject to a "run" similar to the way deposit-taking institutions have been, and we have learned that the 2004 decision to apply commercial bank metrics for capital and liquidity to investment banks was inadequate to prevent such a run.

Another aspect of our oversight is the mutual fund industry. Here, the Commission staff has been active in working with the managers of money market funds as they cope with the downgrading of ratings and the declines in value of securities in which their funds have invested. Commission rules limit money market funds to investing in high-quality, short-term investments in an effort to ensure that these bedrocks of the financial system are reliable in all market conditions. Losses by a money market fund would be reflected by the fund re-pricing its securities below $1.00 (known as "breaking the buck"). The Commission is closely monitoring the fund industry and while we have seen some instances of funds requiring infusions of capital from the corporate parents of fund advisers, no money market fund has repriced its shares below $1.00.

In light of recent events, we are also working to increase the transparency of the key publicly-traded financial institutions in their disclosures to markets and investors. In December 2007, Commission staff wrote to 25 leading financial institutions that are publicly owned companies, highlighting specific disclosure issues that the firms should consider in relation to their exposure to off-balance-sheet entities and certain structured finance products. Better illuminating the facts concerning these exposures should give counterparties increased confidence in the fundamental soundness of the financial system. We are planning a similar initiative to increase the transparency with respect to how firms are valuing their assets.

Using the new statutory authority that took effect in September 2007, the Commission recently concluded examination of the role of the rating agencies in the subprime market turmoil. A copy of our examination report has been separately provided to you. This examination is important, because more than just providing the markets one view of the likelihood of default, the past several months have demonstrated the power of credit ratings to move markets, and their potential to create cascading effects in those markets. Beyond these ongoing examinations, we have recently proposed rules aimed at reducing the extent to which our regulatory system grants a central role to the rating agencies.

We have also proposed detailed rules under the new Credit Rating Agency Reform Act that respond directly to the shortcomings we have seen through the subprime experience. Our proposals would require credit rating agencies to make disclosures regarding past ratings, in a format that would improve the comparability of track records and promote competitive assessments of the accuracy of the agencies' past ratings. In addition, the rules would enhance investor understanding of important differences between ratings for municipal and corporate debt and for structured debt instruments.

Each of the regulatory actions we are taking and each of those that we are contemplating, both here and abroad, is designed to promote the health of our capital markets, to protect investors, and to promote capital formation.

Q.12. The public expresses concern when they perceive that corporate executives receive excessive compensation, particularly when the corporation is losing money or its stock is falling value. For example, there was public concern last October, when the CEO of a large securities firm left with reportedly over $160 million in stock, options and retirement benefits a week after the firm reported its largest-ever quarterly loss, which included write-downs of $7.9 billion across CDOs and U.S. subprime mortgages, and the firm's stock price fell significantly.

In 2006, the SEC required public companies to disclose more information about executives' compensation in annual filings, but that does not seem to have controlled the problem. Shareholders have offered proposals regarding executive compensation at the annual meetings of public companies. Recently, the SEC developed an Internet tool for investors to compare executives' compensation online.

What are the Commission's views and plans on how to address the executive compensation issue in the future?

A.12. Shareholder proposals asking boards to implement advisory shareholder votes on executive compensation—commonly called "say on pay" proposals—are one way that investors can use the enhanced information provided under the SEC's new executive compensation rules. The Commission's rules concerning such shareholder proposals allow ordinary shareholders meeting modest eligibility requirements to submit proposals that may be considered at the company's annual meeting through the company's proxy materials. The staff received 28 no-action requests to exclude "say on pay" proposals during the 2006–2007 proxy season and received 19 during the 2007–2008 proxy season. Generally, the "say on pay" proposals request that shareholders be allowed to cast non-binding votes on executive compensation at the companies' annual meetings. In most cases, the staff has found that companies must include these proposals in their proxy materials.

The Commission staff is also working to ensure that the executive compensation rules are being applied in company proxy statements as intended. In an effort to both evaluate compliance with the new rules and provide guidance on how companies could improve their first-time disclosures in this area, the Division of Corporation Finance reviewed the 2007 proxy statements of 350 companies and published its "Staff Observations in the Review of Executive Compensation Disclosure." This report provides an overview of the significant areas of comment on the first-year disclosures. Subsequently, the Division of Corporation Finance issued second comment letters to approximately 70% of the companies. Following its normal procedures, the Division of Corporation Finance is posting the correspondence relating to its completed reviews on the SEC website. This should provide greater information on the actual comments and how companies responded to them, and assist companies in enhancing future executive compensation disclosure.

The Executive Compensation Reader on the SEC website was designed to alleviate the power of XBRL data tagging for making the compensation paid to top executives understandable to investors. It was a demonstration based on one year's data for 500 of the largest American companies. We are currently working to develop XBRL data tags for general use by all public companies so that investors can do industry comparisons or perform analyses of particular forms of compensation, such as stock options, on a permanent basis.

This will provide quicker and more efficient analysis of executive compensation and will enable all shareholders to be better-informed.

Q.13. The SEC recently reported a significant decrease in the total dollar amount of penalties and disgorgements it ordered against violators in fiscal year 2007 when compared to fiscal year 2006, declining to $1.6 billion from $3.3 billion—a decline of about 50 percent. In 2007, the Division of Enforcement initiated only slightly fewer total investigations, civil proceedings, and administrative proceedings in fiscal year 2007 than in fiscal year 2006.

What are the reasons for this decrease?

A.13. Last year the Commission filed the second highest number of enforcement cases in the agency's history (655), resolving 92% of these cases successfully. The majority of the cited decline in monetary remedies is due to differences in the levels of disgorgement, a remedy requiring the securities law violator to forfeit all ill-gotten gains. Thus, the amount of disgorgement obtained depends on the circumstances of the specific case, not the discretion of the Commission. While legal, factual, and mathematical analyses are required to determine the appropriate amount of disgorgement in some cases, the amount of disgorgement is generally not subject to change by the Commission. When further sanctions are appropriate, the Enforcement Division and the Commission normally consider the amount of the disgorgement in determining the correlative size of a civil money penalty. It should be noted that in Fiscal 2007, the Commission imposed more corporate penalties (15) than in any prior year in the agency's history. The ratio of penalty to disgorgement was essentially the same in fiscal years 2006 and 2007.

In the years after the Enron scandal, the country witnessed a series of massive accounting frauds involving enormous amounts of disgorgement and penalties. These cases, including WorldCom, Qwest, AOL, Healthsouth, AIG, Fannie Mae, and Tyco, were brought in SEC fiscal years 2003 through 2006. Since these cases have made their way through the enforcement process, the level of penalties is still much higher than it had been previously, including throughout the 1990s, and as noted, corporate penalties are now much more frequent.

Q.14. Proxy Access was the subject of a November 1, 2007 letter from several colleagues on this Committee and me and of a hearing held by this Committee on November 14, 2007.

On November 28, 2007, the SEC in a split vote deprived shareholders of the right to offer proposals on proxy access. At the time, you stated "I believe we can move forward and re-open this discussion in 2008 to consider how to strengthen the proxy rules to better vindicate the fundamental state law rights of shareholders to elect directors."

Please describe your plans and timetable for reconsidering the shareholder proxy access issue at the Commission this year.

A.14. The Commission's careful and extensive review of the proxy process, which has included three Roundtables in 2007 that focused on the relationship between the federal proxy rules and state corporation law, proxy voting mechanics, and shareholder proposals, is ongoing. The November 2007 Commission action codified the staff's longstanding interpretation of the "election exclusion" in Rule 14a–8(i)(8), but as I have stated then and subsequently, I will ask the full Commission to further consider these questions this year. It is my firm belief that we can better align the federally-regulated proxy system with the state-authorized rights of shareholders to determine the directors of the companies they own.

Q.15. The SEC is budgeted nearly one billion dollars per year with which to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. The Commission is considering the concept of "mutual recognition" in which U.S. citizens could purchase or trade securities directly with foreign broker-dealers or on foreign exchanges and be regulated not by the SEC but by the foreign regulator. When considering a mutual recognition framework that would allow U.S. citizens to directly invest in foreign markets and be solicited by foreign brokers, will the SEC consider not only the comparability of a foreign regulator's regulations, but also the foreign regime's enforcement and inspection resources, independence from the government, respect for the rule of law, culture of fair dealing, tradition of investor protection, impartial regulation over market participants, and related factors?

A.15. Yes. Any mutual recognition arrangement must begin with comprehensive assessment of the foreign regulatory regime, including its enforcement and inspection resources, independence from the government, respect for the rule of law, culture of fair dealing, tradition of investor protection, and impartiality. Given the Commission's investor protection mandate, the assessment would, of course, focus on the key regulatory principles underlying the U.S.'s own regulatory regime, and would entail a consideration of the results achieved by the foreign securities regulatory system in addressing these core securities regulatory principles. In addition, the assessment of the foreign regulatory regime would consider the principles and the regulatory system of a foreign regime overall. Comprehensive arrangements for both enhanced enforcement and supervisory cooperation would also be an important component of an approach to mutual recognition. Such arrangements would facilitate robust enforcement in the event of a cross-border violation of securities laws.

Q.16. In response to a question about Section 404 of the Sarbanes-Oxley Act, you stated that "we do have a cost study underway at the SEC to make sure that it's working as we intended."

A careful assessment of the benefits can provide a useful perspective from which to view the costs. Will this study also include an assessment of the benefits to public companies that have resulted from Congressional passage of the Sarbanes-Oxley Act, such as consideration of: improved access to capital, lower cost of capital, increased stock market valuation of public companies listed in the U.S., improved internal controls, improved accounting, reduction or prevention of certain types of frauds, increased investor confidence in the information published by public companies, increased investor trust of the securities markets, more effective boards of directors, enhanced corporate governance and improved executive responsibility?

A.16. Yes. The study will consider both the benefits and costs associated with Section 404 of the Sarbanes-Oxley Act. In reviewing the sources of benefit, the study will take into account such considerations as you have listed.

Q.17. The Commission has pursued a number of investigations and enforcement actions to address the improper backdating of stock options issued to corporate executives.

On September 6, 2006, you testified to the Committee: "Not only must option grants be reported now within two business days, but this information was among the first that's now required to be reported to the SEC using interactive data. Thanks to this new data-tagging approach, economists, researchers, law enforcement and the investing public now have almost instant access to information about stock option grants in a form that they can immediately download into spreadsheets, analyze and compare."

During Fiscal Year 2007, over 2,900 Forms 4 reporting executive stock options grants were filed late with the Commission, including over 1,500 Forms 4 that were filed more than 21 business days late. Of these, over 1,100 Forms 4 were filed more than 100 business days late, and over four hundred Forms 4 were filed more than 300 business days late.

Please confirm that the Commission staff on an ongoing basis reviews late filings reporting options grants to assess whether there has been improper options backdating. Please describe the Commission's actions to deter improper options backdating.

A.17. The Division of Enforcement currently has approximately 80 open investigations regarding possible fraudulent reporting of stock option grants, including options backdating. The companies involved in the investigations are located throughout the country, are of various sizes, and span multiple industry sectors. The investigations arose from several sources, including staff investigations (with the assistance of the Office of Economic Analysis) in conjunction with late-filed Forms 4. Other sources of enforcement investigations are companies that self-report following internal investigations; companies that announce potential restatements; staff reviews and assessments of suspicious grants identified in analyses that were performed by independent research organizations, institutional investors, or analysts; and tips from the public. Although the staff cannot review all late-filed Forms 4 due to volume, the staff does review these forms in the context of specific investigations and does routinely review egregious and non-trivial cases. Also, the staff continues to review and evaluate other sources of information for indications of improper backdating.

The SEC has taken many steps to stamp out backdating of employee stock options. The revised executive compensation disclosure rules the Commission adopted in 2006 include a number of provisions that address backdating of options. For example:

- A company must now disclose how it determines when it will make equity awards. This requires a company to disclose how, and why, it backdates for its executives.
- A company must disclose the grant date of equity awards. If the grant date is different than the date on which the board took action, the company must disclose the date of the board's action.
- A company must disclose the exercise or base price of an option if it is less than the market price of the underlying security on the grant date. If it is less than the market price on the grant date, the company must disclose the market price on the grant date. This disclosure is intended to provide an investor with a complete picture of the true terms of each option award by allowing the investor to compare the grant date market price to the in-the-money exercise price.
- Further, if the exercise or base price of an option grant is not the closing market price per share on the grant date, a company

must describe its methodology for determining the exercise or base price.

Q.18. At the Banking Committee hearing on September 6, 2006, Professor Erik Lie testified ased on his then-unpublished research, conducted with Professor Randy Heron, in which they examined a sample of 39,888 stock option grants to top executives across 7,774 companies between 1996 and 2005. They estimated that "14% of all grants to top executives dated between 1996 and 2005 were backdated or otherwise manipulated."

How many cases involving improper backdating of stock options granted to executives has the Commission staff reviewed or investigated?

A.18. The Commission's Division of Enforcement currently has approximately 80 open investigations involving possible fraudulent reporting of stock option grants, including options backdating. The companies are located throughout the country, and include Fortune 500 companies as well as small cap issuers. The companies span multiple industry sectors.

Q.19. How many such cases have been the subject of enforcement proceedings or criminal referrals?

A.19. As of March 19, 2008, the Commission has filed enforcement actions against eight public companies and 31 former executives (associated with 17 different companies) alleging securities law violations in connection with backdating stock options. Parallel criminal charges have been brought against 15 former executives, three of whom have been sentenced to serve, or have agreed to a plea involving, time in prison. The executives charged include former CEOs, general counsels, chief financial officers and other accounting personnel, human resources personnel, and a former compensation committee member.

Q.20. What is your evaluation of this research of Professor Lie?

A.20. The research of Professors Lie and Heron draws information from publicly available data concerning stock option awards to top executives from 1996 through 2005 and suggests that a large number of companies had an uncanny ability to choose grant dates that coincided with low stock prices. The research suggests that patterns of potential backdating significantly decreased after 2002, when the Sarbanes-Oxley Act shortened the time period for reporting option grants to two business days.

Before the Sarbanes-Oxley Act, officers and directors were not required to contemporaneously disclose their receipt of stock option grants or exercise of their stock options. In many cases, the disclosure of this information—via a Form 5 filed by the company—was not required until after the end of the fiscal year in which the transaction took place, which, in some cases, meant an individual had more than a year to disclose a grant.

This delay in reporting provided the opportunity for companies to misrepresent the date of an option award to make it appear that the option was granted at an earlier date, and at a lower price, than when the award was actually made. The intent of backdating option grants is to allow the option recipient potentially to realize larger eventual gains, but still characterize the options as having been granted "at-the-money"—disguising the fact that the company actually granted the options "in-the-money." In this way, companies were able to give the option recipient a larger "upside" benefit while at the same time minimizing the compensation expense of the award to the company.

Sarbanes-Oxley made these kinds of abusive practices much harder to conceal. Section 403 of the Sarbanes-Oxley Act, and the Commission's rules governing ownership reports by company insiders, now require that officers and directors disclose any transactions in their companies' equity securities within two business days. Not only must option grants now be reported within two business days, but this information is required to be filed electronically through the Commission's EDGAR filing system. This allows the public almost instant access to information about stock option grants. The need to report option grants no later than two business days after the event, combined with the enhanced transparency of electronic filing, now make it exceptionally harder for companies to manipulate the grant date of option awards.

The empirical evidence we have seen indicates that in combination, these steps have dramatically reduced if not eliminated backdating abuse, and they have effectively eliminated any easy opportunities for companies to secretively grant options.

Q.21. If there is a significant difference between the number of cases estimated by Professor Lie's research and the number of cases investigated by the Commission, please explain your understanding of the reasons for the difference.

A.21. The estimates in the Lie/Heron research are based on statistical analysis. However, the determination of whether a particular company engaged in illegal backdating or other stock grant manipulations depends on the facts and circumstances of each case. For the government to make a successful case in a court of law, far more is required. The Commission has made an extraordinary commitment of resources to address the problem of stock option grant manipulation and to determine whether illegal backdating has actually occurred in specific cases. The Commission has focused its efforts on identifying intentional misconduct and alleged misconduct that postdates the executive compensation and option grant reforms enacted by Sarbanes-Oxley and the Commission's executive compensation rules.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR AKAKA FROM CHRISTOPHER COX

A. MUTUAL FUNDS

A. Mutual Funds are so important because they are the investment vehicle utilized by millions of middle-income Americans to prepare for retirement investment or other long-term financial goals and dreams.

Q.1. When do you expect the Commission to move forward on its proposals to improve mutual fund disclosures?

A.1. The Commission will consider final rulemaking on these proposals this summer. The Commission voted unanimously in November 2007 to propose rule amendments that would require every mutual fund to provide investors with a concise, plain English summary of key facts about the fund. The proposals would permit funds to harness the power of the Internet in order to provide investors with information that is easier to use and more readily accessible, while retaining the comprehensive quality of the information that is available today.

B. FINANCIAL LITERACY

Chairman Cox, I have been impressed by your commitment to protecting senior investors from fraud. I also appreciate the Commission's willingness to work with the North American Securities Administrators Association and the Financial Industry Regulatory Authority on this important issue.

Q.2. In addition to senior fraud related initiatives, what else is the SEC doing to ensure that average investors can make informed financial decisions?

A.2. On June 25, 2008, the Commission voted to propose a new rule that would define most equity-indexed annuities as securities. This would permit ordinary investors to have the protections of the securities laws governing the sales practices and suitability requirements for these products that are so often the subject of investor complaints.

The Commission's Office of Investor Education and Advocacy (OIEA) provides investors with the foundational information they need to make informed investment decisions. In addition to specialized information geared towards seniors, the military, and online investors, OIEA's webpages provide answers to Frequently Asked Questions on popular investor inquiries, including how to change the name on a stock certificate, how to check on the credentials of investment professionals, and how to file a complaint with the SEC. There's also a mutual fund cost calculator, links to viewers that makes it easier for investors to analyze public companies' and mutual funds' financial results, and links to other financial education websites.

OIEA's advocacy function has contact with nearly 100,000 investors and other constituents annually. Our investor advocates research, resolve, or redirect common complaints, including complaints involving allegations of fraud or unsuitable sales practices and complaints about specific types of securities products. To expand the communication into more preventative and educational messages, OIEA is implementing technology to enable more direct communication with investors, including "mass customized" messages of interest to investors, interactive webpages, and opt-in email/phone alerts. OIEA is also developing an audio library targeted to those without internet access that will give investors telephone access to a range of recorded messages on investing topics.

OIEA also plays a role in the Commission's regulatory policy and disclosure agenda. OIEA is conducting focus groups on the proposed mutual fund summary prospectus that highlights key information in a concise, user-friendly format. This spring, OIEA is conducting a survey of 1,000 investors to gain insights into how understandable and how useful they find other SEC-mandated disclosures, such as proxy materials and annual reports. These are first steps in OIEA's increasingly robust effort to test "usability"—encompassing disclosures and interactive media—to ensure that what is delivered to investors is as effective as possible.

As noted above, the Commission voted unanimously in November 2007 to propose rules to authorize a "summary prospectus" for mutual funds—a short, investor friendly document that discloses a mutual fund's investment objectives, as well as all of the information about fees, risks, performance, and other vital subjects that customers need to understand to make a sound investment decision. Using the Internet, investors could drill down from the summary prospectus to more detailed information, depending on their interests and needs.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM CHRISTOPHER COX

Q.1. Considerable work has already been done establishing that our capital markets are at risk of falling behind and providing specific regulatory, tax, and liability reforms to revive the leadership position of the U.S. capital markets. Do you agree that it is past time for all of us to resolve these outstanding issues and action is required now?

A.1. Yes. The Commission's statutory missions are to protect investors, keep our markets healthy and vibrant, and promote capital formation. Each of the policy areas you cite can and does impact the accomplishment of these missions, and there are opportunities for improvement in each of them. Our regulatory system needs to be consistently reexamined with a view to the rapidly changing conditions of the global marketplace. As the SEC works to improve its rules and the implementation of our rules to better achieve these goals, we welcome any assistance other policymakers can offer.

Q.2. What are the top initiatives that your agency is pursuing to meet this need, when will you propose them, and have you set deadlines for implementation?

A.2. Rationalizing the implementation of section 404 of the Sarbanes-Oxley Act remains the most important action the SEC can take to help American businesses remain competitive in the global marketplace. To make sure that the U.S. capital markets remain robust and competitive, the SEC repealed the costly Auditing Standard No. 2, which had made Sarbanes-Oxley compliance so difficult, and replaced it with a completely new standard that is top-down, risk-based, materiality-focused, and scalable for companies of all sizes. The new standard was used for the first time with annual reports filed this spring. We are now monitoring implementation of the new standard to ensure that the desired cost efficiencies are being achieved. The SEC has also delayed application of the section 404 audit requirement for smaller public companies while we conduct a benefit-cost study to ensure that the expected efficiencies from the new auditing standard and guidance for management are being realized. The study will be completed by the fourth quarter of 2008.

Additionally, in November of 2007, we adopted new rules designed to make it much simpler and easier for smaller companies to raise capital. We expanded the number of companies who can use the Commission's scaled disclosure and reporting requirements for smaller companies. Now, companies with a public float of up to $75 million can use these simpler rules, compared to the $25 million cap that was in place under the old rule. That means another 1,500 public companies will be eligible to use our simplified disclosure and reporting requirements. We also further simplified the rules themselves. We eliminated five forms, and 36 separate items that used to make up Regulation S-B. We made it more economical for smaller companies to sell restricted securities under Rule 144 of the Securities Act. We reduced the holding period from one year to six months, and eliminated many of the other restrictions on using Rule 144. And non-affiliates won't have to file forms any more—a change we expect will reduce the number of Form 144s filed with the Commission by nearly 60%. This is a way to cut the cost of capital for smaller companies without sacrificing investor protection. In taking these steps, we were responding to several key recommendations of the SEC's Advisory Committee on Smaller Public Companies, which issued its final report in April 2006.

We have also undertaken an initiative to reduce complexity in financial reporting. I appointed an Advisory Committee on Improvements to Financial Reporting which will recommend improvements that will keep America's financial reporting system as the gold standard for the world. They have already issued interim recommendations, and their final recommendations are expected this August.

Last year, the Commission voted unanimously to take the next step on the SEC's International Financial Reporting Standards "Roadmap" first announced three years ago. As a result, foreign issuers can now file their financial statements with the SEC using IFRS, without need of keeping a second set of books under U.S. GAAP. The Commission is also examining whether U.S. companies should be able to file with the SEC using International Financial Reporting Standards as published by the International Accounting Standards Board. Having a set of globally accepted accounting standards will be critical to the rapidly accelerating global integration of the world's capital markets. We will consider proposed rules on IFRS this summer.

Q.3. It is my understanding that the Commission is working on a rule proposal that would expedite the SEC's processing of rules submitted by exchanges and is engaged in efforts to update the current regulatory structure including initiatives to foster a number of new approaches to cross-border regulation. Please describe the Commission's efforts to update mutual recognition and expedite the processing of rules submitted by exchanges.

A.3. On June 25, 2008, the Commission adopted a new rule of internal procedure to speed up the handling of SRO rules. Now, rules will be published and take effect within 15 days of filing and in non-controversial cases, rules can take effect immediately. This will make the rule approval process vastly more efficient. As to mutual recognition, the SEC is currently in various stages of discussions with Australia, Canada, and the European Union concerning how cross-border activities of broker-dealers and markets are regulated in that country. On March 29, I met with Kevin Rudd, the Prime Minister of Australia, to announce that the SEC and the Australian government had begun initial discussions as a prelude to a possible formal mutual recognition arrangement for the two countries' securities markets. Those discussions are continuing. We are also engaged in similar discussions with Canada. With the European Union we are discussing the establishment of a framework that would permit the U.S. and individual EU members to engage in bilateral talks. While countries vary widely in their approaches to securities regulation, we are exploring the extent to which the protections that particular foreign jurisdictions offer investors produce similar outcomes to our own regulatory system.

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

BRIEFING PAPER

A Building Storm: The Housing Market and the Pennsylvania Economy

Mark Price
Stephen Herzenberg

The Keystone Research Center
Harrisburg, Pennsylvania
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KRC BRIEFING PAPER

A Building Storm: The Housing Market and the Pennsylvania Economy

Mark Price and Stephen Herzenberg

OVERVIEW

In the nation and in Pennsylvania, a building storm of home foreclosures, falling home prices, and tightening credit markets has put the brakes on economic growth, and led to mounting concern that the country may face a deep recession. To date, however, no one has examined in detail the housing market in Pennsylvania or the impact of housing market developments on the Pennsylvania economy.

This briefing paper fills that gap. It examines housing market trends, in Pennsylvania and in each of the commonwealth's major economic regions. It also considers recent trends in job growth and unemployment in the Pennsylvania construction industry and in the overall Pennsylvania economy. Our analysis sets the stage for a discussion of what policymakers can and should do—in Pennsylvania as well as the nation—in response to the housing crisis and a slowing economy.

We find that:

- Contrary to many perceptions, Pennsylvania, particularly in certain regions, did experience a housing bubble. To be sure, the recent run-up in housing prices began two years later in Pennsylvania than in the nation as a whole, in 2001 rather than 1999. Nonetheless:
  - Housing prices in Pennsylvania from 2001 to 2006 mirrored the national trend, rising by 54% compared to an overall inflation rate of only 13%.
  - Pennsylvania housing prices between 2001 and 2006 grew much faster than rental prices and the cost of construction, strong evidence that the uptick in housing prices stemmed from a speculative bubble.
  - Just as Pennsylvania housing prices followed the national trend on the way up, in the first three quarters of 2007 they began to follow the national trend down. If Pennsylvania housing prices continue to follow the national trend, they can be expected to fall over the rest of this year. (National housing prices are projected to fall 6% to 13% from August 2007 to August 2008.)
- Rising mortgage foreclosures are also hitting Pennsylvania as well as the nation.
  - The Center for Responsible Lending projects that the foreclosure rate on Pennsylvania subprime loans issued in 2006 will exceed by 53% the foreclosure rate on loans issued from 1998 to 2001.
  - The Joint Economic Committee of the U.S. Congress projects that, from the third quarter of 2007 to the end of 2009, there will be an estimated 45,470 subprime mortgage foreclosures in Pennsylvania, representing a loss of $2.4 billion in property values.

- Recent developments in the housing market have already contributed to a decline in employment in the Pennsylvania construction industry.
  - Seasonally adjusted employment in the Pennsylvania construction industry declined by 6,000 jobs between March and November of 2007.
  - Unemployment of construction workers in the summer months of July to September (months in which construction employment usually peaks) rose from 4% in 2006 to 7.5% in 2007.

The vulnerability of different parts of Pennsylvania to rising foreclosure rates depends on three main factors: (1) the extent to which families rely on subprime mortgages; (2) the extent to which the area experienced a housing bubble, a rough predictor of how much property values may now fall; and (3) the state of the regional economy—when unemployment rises, so do foreclosure rates.

- Families in low-income communities rely most heavily on subprime mortgages. In nine counties—eight rural ones (Cameron, Clearfield, Fayette, Forest, Jefferson, Monroe, Venango, and Warren Counties) and Philadelphia—subprime mortgages make up more than 35% of all mortgages.[1] In some neighborhoods, subprime mortgages make up 60% to 80%, or more than 80%, of the total.
- From 2001 to 2006, housing prices escalated the most within the Philadelphia metropolitan area.[2] To a lesser extent, prices also rose in the Lehigh Valley and South Central Pennsylvania.
- Currently, unemployment rates are somewhat higher in some rural parts of Pennsylvania, but no area of the state has very high unemployment rates. This is, of course, subject to change based on the national economy.

To see maps showing the share of subprime mortgages within each census tract of each county in Pennsylvania, visit http://www.keystoneresearch.org/housingmarket.

Based on the most recent economic statistics, the housing crisis so far appears to have had limited impact on overall Pennsylvania job and output growth. Relative to Michigan and Ohio to our west (where reliance on subprime mortgages interacts with the recent loss of auto industry jobs) and New Jersey and New York to our east and north (which experienced more severe housing spikes), Pennsylvania has dodged a bullet. Yet there is ample reason to think that more bullets will be coming that Pennsylvania may not be able to dodge.

- From 2001-06, Pennsylvania depended on the booming construction sector for nearly a third of total job growth. That source of economic stimulus is now evaporating.

[1] The universe of mortgages here is limited to owner-occupied, first lien home mortgages. Subprime is defined as loans with a rate spread in Federal Financial Institutions Examination Council (FFIEC) data. The FFIEC defines a first-lien home mortgage as having a rate spread if the difference between the annual percentage rate on the loan exceeds by three percentage points the interest rate on Treasury securities with comparable maturity periods.

[2] The Philadelphia metropolitan area is defined here to include the Philadelphia-Camden-Wilmington region spanning parts of PA-NJ-DE-MD.

- Nationally and in some Pennsylvania regions, falling house prices mean that families can no longer use their homes as ATM machines, thereby sharply curtailing household consumption.

- Investors have grown extremely nervous about investments in financial institutions that hold—or are feared to hold—significant numbers of subprime loans (in the form of mortgage-backed securities). Lending standards have already tightened in many markets, and a more severe credit crunch could lead to a situation in which business investors and households who are normally good credit risks suddenly find themselves unable to borrow.

Home mortgage foreclosures, the bursting of the housing bubble, and the slowdown in the economy are national problems that demand national solutions. The thrust of the last section of this report, however, is that Pennsylvania's governor and legislature need not and should not simply pass the buck to Washington. Prompt and creative action by Pennsylvania policymakers could also help Pennsylvania families and the state's economy weather the next few years—as well as inject into Washington debates a badly needed dose of outside-the-box thinking.

Turning to specifics, to limit the impact of the housing market crisis, Pennsylvania policymakers need to respond at four levels.

- *To reduce the number of future mortgages that end in foreclosure,* Pennsylvania lawmakers should (a) enact a package of six proposed reforms that protect against predatory lending in the mortgage market and (b) establish regulations that require lenders to take into account the affordability of a mortgage interest rate after the rate on an adjustable rate mortgage (ARM) rises above an initial low rate. Since these regulations would reduce the access of families to mortgages that they cannot afford, legislators should couple them with the creation of a Housing Trust Fund that helps more low-income families to buy homes that they can afford.

- *To protect families currently at risk of losing their homes,* Pennsylvania should enact policies equal to the scale of the current foreclosure problem. To do this, Pennsylvania will need additional funds from the federal government to expand two new programs that offer refinancing assistance, or loans, to homeowners who cannot afford their current payments. (These programs are the REAL (Refinance to an Affordable Loan) and HERO (Homeowner Equity Recovery Opportunity) programs.) Pennsylvania should also explore the subprime borrower protection plan proposed by Dean Baker of the Center for Economic and Policy Research. Baker suggests that giving homeowners who face foreclosure the option to rent the home indefinitely at the fair market rent would lead lenders to renegotiate some mortgages, but at lower cost to the government than subsidized refinancing.

- *To provide near-term, state-level economic stimulus,* state and local governments and school districts should accelerate the schedules for public and publicly subsidized construction projects already underway or about to launch.

- *To prepare for the possibility of a deeper national recession, the Rendell Administration, with input from the private sector and the legislature, should develop contingency plans for larger-scale investment in the future*—in our neglected infrastructure (sewer, water, roads, bridges, public transit and high-speed rail, etc.), in energy efficiency, and in education and training (the human capital or skills infrastructure of the future). Through a Commission on Investment in the Future, required to report to the governor and the legislature by the end of April, Pennsylvania should consider (a) how state government and the private sector can maximize investments that will deliver a double benefit of short-run economic stimulus and long-run improvements in productivity; (b) how to enable unemployed workers to access skills training *and* income support, avoiding the waste and psychological costs that result from traditional unemployment, and positioning Pennsylvania's workforce to compete for the long term; and (c) what the federal government needs to provide, through revenue sharing and innovative skills, energy, and infrastructure policies, to complement creative state action. The work of a Pennsylvania commission should be informed by and complement that activity of a new bipartisan "Building America's Future" coalition of state and local officials unveiled on January 19. (Governor Ed Rendell serves as a co-chair of the group along with California Governor Arnold Schwarzenegger and New York Mayor Michael Bloomberg.) This Coalition will make the case for increased federal investment in infrastructure.

Today's economic troubles stem from an over-reliance on the deregulated market and an under-reliance on government and creative public policy. By responding effectively and creatively to these troubles Pennsylvania policymakers can restore growth more quickly. They can also think in an open-minded and pragmatic way about how new state and federal policies could make Pennsylvania's economy more robust, competitive, environmentally sustainable, and equitable for the long term.

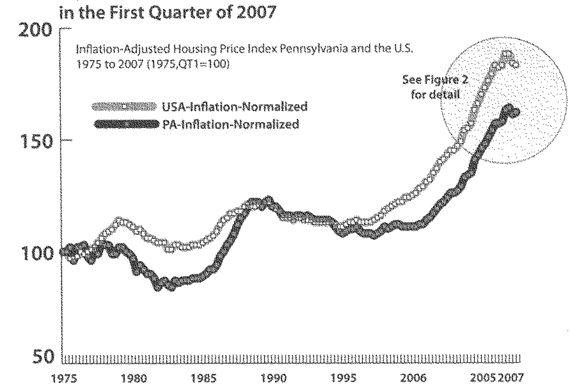
THE HOUSING BUBBLE IN PENNSYLVANIA

Figure 1 displays inflation-adjusted housing prices in the United States and Pennsylvania between 1975 and 2007. Figure 2 magnifies the last 15 quarters of data so that the turnaround in price trends can be seen more easily.

The figures show that inflation-adjusted[3] housing prices increased 52% in Pennsylvania from 1996 to a peak reached in the first quarter of 2007 (Figures 1 and 2).[4]

To be sure, housing prices grew more sharply, and have already declined more, in states like California, Florida and Arizona. Nonetheless, Figures 1 and 2 make clear that Pennsylvania's housing market pattern is

Figure 1. Pennsylvania Housing Prices Peaked in the First Quarter of 2007



Note. Data are for sales and refinance transactions. Inflation-Adjustment based on the CPI-U-All items less shelter. Data for 2007 is through the third quarter.

Source. KRC estimates based data from the Office of Federal Housing Enterprise Oversight (OFHEO)

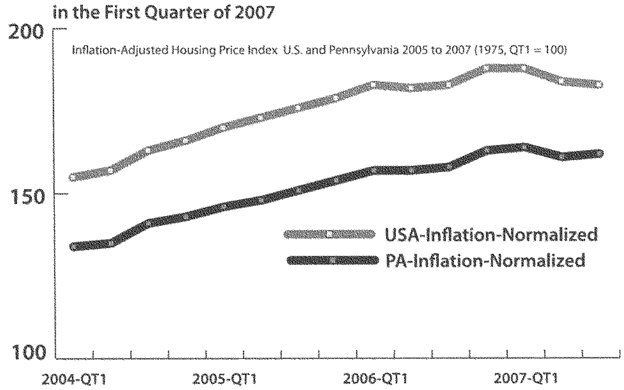
[3] Authors' estimates based on housing price data from the Office of Federal Housing Enterprise Oversight (OFHEO), adjusted for inflation based on the consumer price index for all urban consumers, all items less housing.

[4] From their low point to high point over the same decade (1996 to the end 2006), U.S. housing prices increased by 67%.

indeed a variation on the national trend.[5]

If Pennsylvania continues to follow the national trend, prices will fall a good deal further. U.S. housing prices, on which we have more recent information than Pennsylvania housing prices, fell 10% between October 2006 and October 2007.[6] In testimony before Congress, Harvard University economist Robert Shiller projected another 7% to 13% decline in housing prices between August 2007 and August 2008.[7]

Figure 2. Pennsylvania Housing Prices Peaked in the First Quarter of 2007



Note. Data are for sales and refinance transactions. Inflation-Adjustment based on the CPI-U-All items less shelter. Data for 2007 is through the third quarter.

Source. KRC estimates based data from the Office of Federal Housing Enterprise Oversight (OFHEO)

Shiller's testimony also contains compelling evidence that recent housing price trends reflect a speculative bubble, not a real trend in the underlying costs of construction. He points out that, for the last century in the United States until the mid-1990s, housing prices roughly followed the overall rate of inflation. Since the late 1990s, housing prices have diverged by over 50% from the overall inflation rate. If housing prices were rising because of higher costs, Shiller adds, rents and construction costs since 2001 would also have gone through the roof. They have not. Rents in the Philadelphia metropolitan area, for example, have increased by just 20% since 2001, while housing prices in the region, not adjusting for inflation, grew by 73%.[8] Likewise, between 2001 and 2006, building costs increased by only 22% in the nation and 20% in Philadelphia.[9]

Just as housing price escalation varies among states, it also varies within Pennsylvania. Housing prices since 2001 rose the most, by 52% (this time adjusting for inflation) in the Philadelphia metropolitan area.

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[5] Pennsylvania housing prices since the first quarter of this year have been growing more slowly than prices for all other goods, up just 1.4% between the 1st and 3rd quarter of this year. After adjusting for inflation housing prices between the first and third quarter of 2007 fell by 1%.

[6] Author's estimates based on the S&P/Case-Shiller Home Price Indices adjusted for inflation using the consumer price index for all urban consumers, all items less housing.

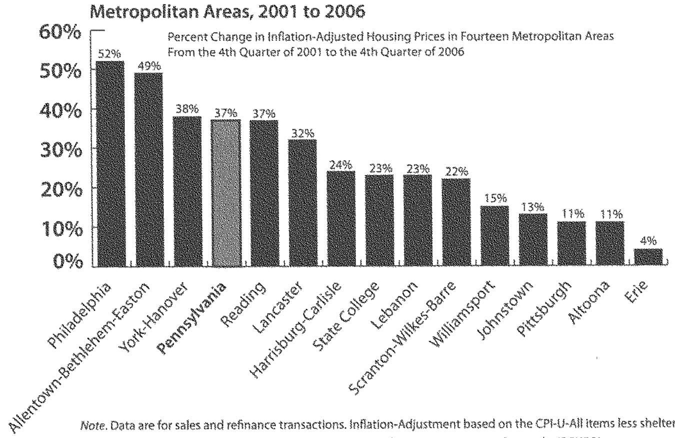
[7] Robert J. Shiller, Testimony before the Joint Economic Committee, September 19, 2007.

[8] The ratio of housing prices to rents in the Philadelphia area is the largest since we have data—1.6 in 2006 compared to an average since 1983 of 1.17. Housing prices and rents have also diverged in Pennsylvania as a whole since 2001. For more on the price-to-rent ratio see John Krainer and Chishen Wei, "House Prices and Fundamental Value," Federal Reserve Bank of San Francisco *Economic Letter*, Number 2004-27, October 1, 2004.

[9] McGraw-Hill Construction/Engineering News Record Building Cost Index. The index does not distinguish between residential and non-residential building costs. Data from the index for only captures trends in building costs in the City of Philadelphia not the metropolitan area.

(Figure 3). Housing prices in the Lehigh Valley increased by 49% adjusting for inflation. Housing prices in the western and central parts of the state grew much more slowly.

Figure 3. Percent Change in Housing Prices in Fourteen Metropolitan Areas, 2001 to 2006



Note. Data are for sales and refinance transactions. Inflation-Adjustment based on the CPI-U-All items less shelter
Source. KRC estimates based data from the Office of Federal Housing Enterprise Oversight (OFHEO)

THE HOUSING MARKET IN PENNSYLVANIA

The Housing Bubble

The U.S. housing bubble was fueled in part by the creation of exotic mortgages that made consumers without sufficient savings for a conventional down payment eligible for a home loan, and by the bundling of these mortgages into securities, or bonds, that promised high rates of return.[10] Money from investors who bought mortgage-backed securities went back to mortgage lenders to finance more home purchases. Like any bubble, rapid housing price increases at a certain point fed on themselves, with increased demand from speculative home purchases sustaining high price increases. The bubble went along with robust growth in new home construction, originally to satisfy demand from an expanded mortgage market, and then financed by developers speculating that demand would continue to expand.[11]

Mortgage Foreclosures

The mortgage foreclosures that first grabbed the media headlines were the growing number of foreclosures in the "subprime" lending market. Subprime loans are high interest mortgages, the rates of which are

[10] Exotic mortgages include those with low introductory or teaser rates, loans requiring no down payment, and loans requiring no proof of income.

[11] Dean Baker, *Midsummer Meltdown: Prospects for the Stock and Housing Markets*, Center for Economic and Policy Research, August 2007, online at www.cepr.org.

justified by lenders based on the "high risk" of the borrowers.[12] In practice, however, as many as half of subprime borrowers could afford more conventional fixed-rate mortgages.[13] They may have purchased subprime mortgages despite this because they did not fully understand that a subprime mortgage becomes less affordable once an initial low (or "teaser") rate resets at a higher level.

Subprime borrowers go into foreclosure more than other borrowers because their mortgage obligations represent a high portion of their incomes and because they are less likely to have savings. Any change in circumstances, such as a jump in the rate of an adjustable rate mortgage (ARM), or an illness or job loss, creates the risk of foreclosure. When housing prices are rising rapidly, homeowners unable to pay their mortgage can escape foreclosure by refinancing their mortgage, taking out a home equity loan to cover their mortgage payments, or selling their home. But when housing prices are flat or falling, as they often are now following the bursting of the housing bubble in many markets, borrowers unable to afford their mortgage payments are much less likely to be able to avoid foreclosure.[14]

Reflecting, in part, the impact of the down shift in housing prices, the Center for Responsible Lending estimates that the foreclosure rate on subprime loans issued in 2006 in Pennsylvania will increase by 53% over the rate for subprime loans issued from 1998 to 2001.[15] The Joint Economic Committee of the U.S. Congress estimates that there will be 45,470 subprime foreclosures in Pennsylvania from the third quarter of 2007 to the end of 2009. That number represents a loss of $2.4 billion in property value.[16] The subprime foreclosure wave could continue all the way to 2010. In 2010, the rate on subprime mortgages issued in the first part of 2007, with a low initial rate for three years, will adjust upwards. (Since the first part of 2007, the subprime market has dried up.)

In some cases, families lose significant accumulated wealth in a house on which a mortgage is foreclosed. Auctions of foreclosed homes often fetch lower prices than equivalent homes sold by owners themselves or by their real-estate brokers. In addition, prices can spiral downwards quickly in neighborhoods where many foreclosures have occurred. As a result, homes that would ordinarily sell at a price greater than the value of the mortgage plus transition costs—and allow the homeowner to extract accumulated wealth—sell for less than this amount.

[12] In the 2nd quarter of 2007 over two-thirds of all loans in foreclosure were subprime loans. Julia Reade, "Foreclosures in Vermont and New England," Federal Reserve Bank of Boston, September 2007, online at http://www.bos.frb.org/commdev/foreclosures/state%20packets%20VT%2012_31_07.pdf.

[13] In analysis of subprime mortgages originated in 2005 and in 2006, and bundled into securities for sale to investors, the *Wall Street Journal* found that more than half of these loans were made to borrowers with credit scores which would have qualified them for lower cost conventional mortgages. Rick Brooks and Ruth Simon "Subprime Debacle Traps Even Very Credit-Worthy," *Wall Street Journal*, December 3rd, 2007, p. A1.

[14] In analysis of the relationship between home prices and foreclosure activity from the third quarter of 2006 to 2007, states with declining housing prices also tended to have the most foreclosure filings. Office of Federal Housing Enterprise Oversight, "House Prices Weaken Further In Most Recent Quarter," November 29, 2007, pages 11-17, online at http://www.ofheo.gov/media/pdf/3q07hpi.pdf. With respect to subprime loans, the Center for Responsible Lending, ("Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners" December 2006) found that even when housing prices were rising there were large numbers of subprime borrowers who were paying off their mortgages while being delinquent on their payments, indicating they were avoiding foreclosure by using rising home prices to refinance their mortgages or by selling their homes outright. With housing prices falling, these options are no longer available.

[15] Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground: Foreclosure in the Subprime Market and Their Cost to Homeowners*, Center for Responsible Lending, December 2006, online at http://www.responsiblelending.org/pdfs/CRL-foreclosure-rprt-1-8.pdf.

[16] Joint Economic Committee of the United States Congress, *The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here*, October 2007, online at http://jec.senate.gov/Documents/Reports/10.25.07OctoberSubprimeReport.pdf.

Subprime mortgage holders are not the only families suffering in the current housing market. In some markets, with home prices declining and access to credit contracting, foreclosures that started with subprime borrowers have spread to the rest of the mortgage market. In addition, foreclosures of mortgages on properties occupied by renters—who are disproportionately low-income—often require families to move and leave them searching for alternative affordable housing.

THE IMPACT OF THE HOUSING MARKET ON THE PENNSYLVANIA ECONOMY

The housing market will affect Pennsylvanians and the Pennsylvania economy through several channels:

- by decreasing consumption spending
- by reducing housing-related employment
- by restricting access to credit.

Falling Housing Prices Constrain Consumer Spending

During the housing bubble, "equity withdrawals"—cash generated when people sell their homes or open home equity lines of credit or refinance their mortgages—became an increasingly important source of consumer spending. Equity withdrawals represented 9% of disposable income in 2006.[17] As of November of last year the national decline in housing prices had already reduced the amount of consumption financed by these sources by nearly one-fourth.[18] An erosion of housing prices in Pennsylvania and the nation will further lower consumer spending.

More Mortgage Foreclosures Could Depress Housing Prices—and Consumption—Further

A rapid increase in foreclosures would further contribute to falling housing prices by depressing the values of nearby homes. In analysis of data on home sales in the city of Philadelphia, researchers from Temple University found that the presence of an abandoned property on a block lowered sales prices on that block by 9.1% on average, with sales prices declining by 15% when there were five abandoned properties on the same block.[19]

The larger the number of subprime loan holders in a neighborhood, the greater the risk that an initial round of foreclosures will put further downward pressure on housing prices, potentially setting off a new round of foreclosures.

One way of gauging vulnerability to foreclosure is by examining the number of subprime mortgages as a share of all mortgages.[20] At the county level, data on new home mortgages originated in 2006 show that

[17] Peter S. Goodman "Homeowners Feel the Pinch of Lost Equity," *The New York Times*, November 8, 2007.

[18] Ibid.

[19] A. Shlay and G. Whitman "Research for Democracy: Linking Community Organizing and Research to Leverage Blight Policy," *City & Community*, Vol. 5, No. 2, June 2006.

[20] The universe of mortgages here is limited to owner-occupied, first lien home mortgages. Subprime is defined as loans with a rate spread in Federal Financial Institutions Examination Council (FFIEC) data. Where the FFIEC defines a first-lien home mortgage as having a rate spread if the difference between the annual percentage rate on the loan exceeds by three percentage

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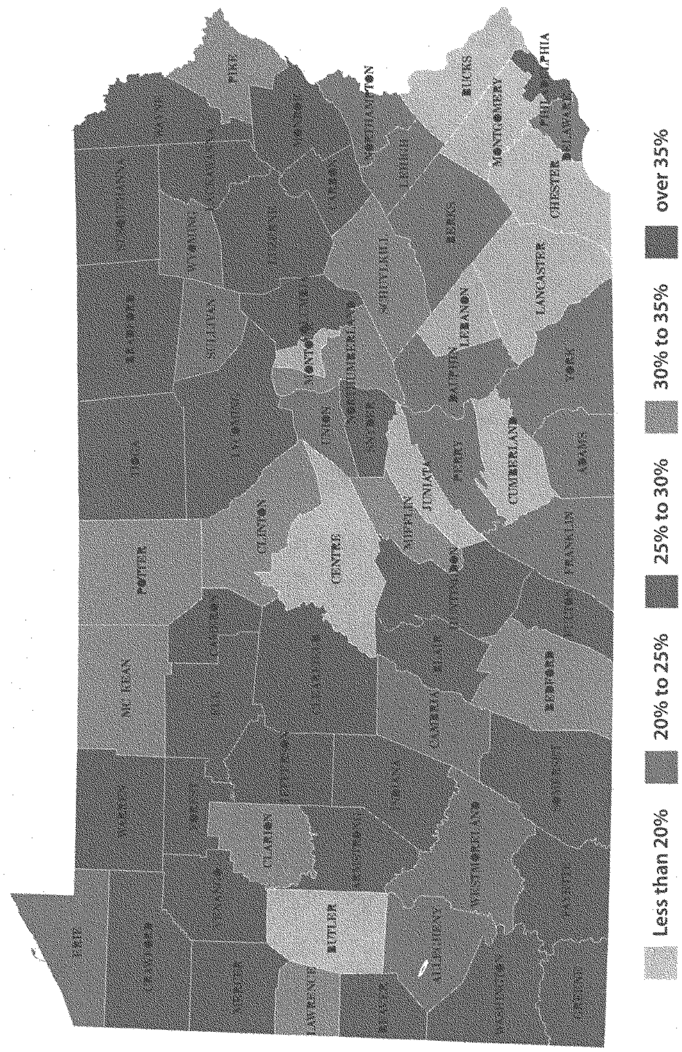
Figure 4. Subprime Mortgages as a Share of All Mortgages, 2006



Note. Data limited to first lien, owner-occupied mortgages
Source. KRC Estimates based on Federal Finanical Institutions Examination Council data

the counties with the greatest share of subprime mortgages were Forest (46%), Cameron (40%), Venango (39%) and Fayette (38%) (Figure 6). To see maps showing the share of subprime mortgages in 2006 in each census tract within each Pennsylvania county, visit www.keystoneresearch/pahousingcrisis.com.[21]

Vulnerability to foreclosure is also related to how much property values over-inflated and how much the construction market over-heated during the housing bubble. Lastly, vulnerability is critically influenced by unemployment: areas that did not have a large housing price increase may nonetheless face high rates of foreclosure because families lose jobs and income. (See Box 1).

Box 1.
Housing Crisis and a Stagnant Economy:
A One-Two Punch *The Case of Ohio and Michigan*

Housing prices increased more in the nation, and in Pennsylvania, than they did in either Ohio or Michigan. Despite that, in the third quarter of 2007, Fannie Mae, which finances or guarantees one of every five home loans in the United States, wrote off five times as much (because of loans with no chance of being recovered) on home loans in Ohio and Michigan than in the states most closely associated with the housing boom, California and Florida.[1]

The key difference for Ohio and Michigan is the deadly cocktail of job losses combined with growth in subprime mortgage lending. (Michigan also had a run up in housing prices from 1995 to 2005, followed by a decline in housing prices in the last six quarters.) For policymakers and for Pennsylvanians, the lesson should be clear: **A recession that generates job losses similar to those in Ohio and Michigan could lead to a further spike in home foreclosures.**

1 Associated Press, "Ohio, Michigan face different foreclosure crisis: Economy, not speculators and adjustable mortgages, is depressing market," December 17, 2007. The exact figures for Fannie Mae losses were 185 million in Michigan, $101 million in Ohio, $30 million in California, and $21 million in Florida.

Declines in Housing-Related Jobs

The 2001 recession precipitated a period of unusually low job growth in Pennsylvania and the nation. In part because overall growth was slow during the 2001-06 period, a robust residential construction industry contributed substantially to job growth. Between 2001 and 2006, a full 29% of job growth in Pennsylvania occurred in three housing-related industries, even though, in 2001, only 2.5% of the state's employment was in these industries.[22, 23] (In the stronger economy of 1996-2001, housing-related

points the interest rate on Treasury securities with comparable maturity periods.

[21] Ira Goldstein of The Reinvestment Fund has produced estimates of the number of prime and subprime loans in delinquency and presale foreclosure by zipcode in Pennsylvania as of July 2007. See Ira Goldstein, "Update On Mortgage Delinquencies and Foreclosures in Pennsylvania," September 25, 2007; online at www.trfund.com/resource/downloads/staffwritings/PAR_Presentation.pdf.

[22] Housing-related industries include *real estate* (NAICS 531), *residential building construction* (NAICS 2361), and *residential specialty trade contractors* (NAICS 238XX1). This definition does not include the mortgage banking sector, which was likely a big factor in job growth since 2000 but is not identifiable in current employment data sources. Our estimates thus understate the contribution of housing-related jobs to total job growth.

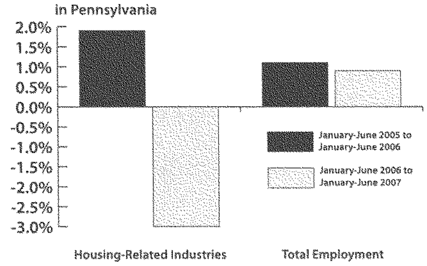
[23] Some economists use the term "net job growth" to describe the increase in the total number of jobs in the economy or in a

industries accounted for 5% of Pennsylvania job growth.)

In the first half of 2007, however, trends in housing-related employment abruptly reversed. Between January and June 2007, the number of housing-related jobs declined by 3% (Figure 5). In the previous year, housing-related employment increased by 1.9%.[24]

Nationally, between March and December of 2007, the economy shed 203,000 construction jobs. (Employment figures are seasonally adjusted unless otherwise stated.) Most of the jobs lost—161,000—were in residential construction. In a worrisome development, however, employment in non-residential construction was down by 41,800 from March to December (Figure 6).

Figure 5. Housing-Related Job Growth Has Slowed in Pennsylvania

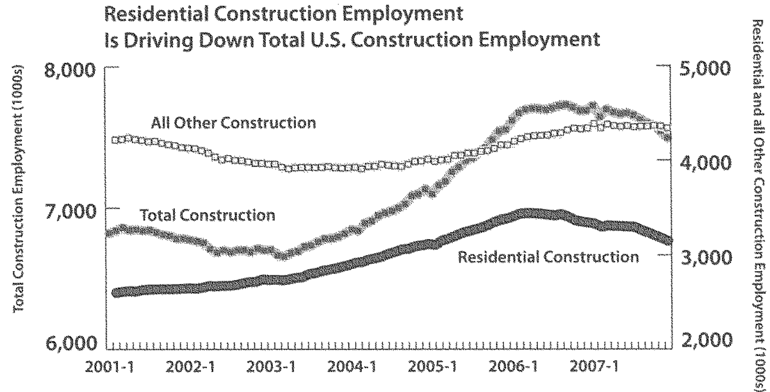


Note. Housing-Related industries include real estate (NAICS 531), residential building construction (NAICS 2361) and residential specialty trade contractors (NAICS 238XX1).

Source. KRC analysis of QCEW data

In Pennsylvania, data on total construction employment are available for more recent months than is "housing-related" employment. (However, we cannot separate residential and non-residential construction

Figure 6. The Sharp Downturn in U.S. Residential Construction Employment Is Driving Down Total U.S. Construction Employment



Source. KRC estimates based on Current Employment Statistics (CES)

sector. They do this to distinguish net job growth from "gross job growth"—i.e., the total increase in employment at expanding companies. Net job growth is gross job growth minus the total of job losses at shrinking or closing companies. We use job growth rather than net job growth because job growth is commonly used in the media and policy discusses of job trends and also because the term "net" may confuse some readers.

[24] One in four housing related jobs is in residential building construction. Employment in this sector declined by 2,527 jobs or 6.9% between March 2006 and March 2007. Residential specialty trade contracting, which accounts for 46% of all housing related employment, declined by 1,766 jobs, or 2.7% between March 2006 and March 2007. Real estate, which accounts for 29% of housing-related employment, shed 100 jobs between March 2006 and March 2007.

in the most recent Pennsylvania data.) Total construction employment in Pennsylvania declined by 6,000 jobs between March and December 2007, roughly following the national trend.[25]

Overall Job Growth Slows

Because construction related employment was such an important portion of overall job growth in Pennsylvania, as employment growth in the state's housing sector has slowed, it has lead to slower overall employment growth. According to the most current data available, total employment increased by 0.9% between first half of 2006 and the first half 2007, down from a 1.1% increase between the first half of 2005 and the first half of 2006 (Figure 5).

Construction Unemployment Turns Back Up

The unemployment rate in the Pennsylvania construction industry fell to 6.5% in 2006, a low average annual rate in an industry with high unemployment in the coldest months. The unemployment rate jumped back up to 9% during the first three quarters of 2007.[26] Examining just

Box 2.
How the Mortgage Crisis Can Trigger a Credit Crunch

When institutions, investors, and individuals withdraw their assets from lending institutions that hold mortgage-backed securities, those lending institutions can no longer provide credit, and a credit crunch can result. Here in more detail is how a credit crunch happens.

Mortgage-backed securities are like a massive carton that holds thousands of eggs, where each egg represents a home mortgage. Bundling mortgages together was thought to lower the risk to investors who bought the securities, based on the assumption that no more than a few mortgages would go bad. While housing prices were rising, these securities did provide high returns at what appeared to be low risk. But as more and more mortgages have gone into foreclosure, it has become apparent that these securities are much higher risk than first thought. Furthermore, as housing prices continue to decline, and as increasing numbers of the low introductory rates on subprime loans expire, fear has grown than some mortgage-backed securities will plunge in value.

This fear, in turn, can lead lenders to withdraw funds or restrict lending to institutions holding significant numbers of mortgage-backed securities, or even to institutions feared to hold substantial mortgage-backed securities. For example, an investment pool operated by the State of Florida on behalf of local governments and school districts invested a relatively small portion of its assets in the mortgage market. When local officials from all over Florida learned this, they scrambled to withdraw from the fund. Like a bank run of the 1930s, the rush of investors to withdraw money nearly caused the fund to collapse.[1] On a global scale, the reluctance of investors to loan money to financial institutions out of concern about those institutions' exposure to housing related losses can lead to a credit crunch. This threatens the broader economy to the extent that it translates into less investment capital available—for example, from the State of Florida investment pool—to finance business investment.

[1] Michael M. Grynbaum, "Fund Crisis in Florida Worrisome to States," *New York Times*, December 5th, 2007.

[25] Total construction employment from March to November 2007 was down 2.2% in Pennsylvania and 2.6% nationally. It is likely that national estimates of construction employment—and national estimates of recent construction employment declines—are understated due to the prevalence of undocumented immigrants in the construction labor force.

[26] Unemployment estimates are not seasonally adjusted. Unemployment in the Pennsylvania construction labor market is highly seasonal, with rates typically peaking in the first quarter, declining through the end of the third quarter, and trending up through the end of the year. The biggest increase in unemployment rates in 2007 compared to the same period in 2006 occurred in the third quarter at the height of construction demand. In the third quarter of 2006 the construction unemployment rate was 4%; in the same period in 2007 the unemployment rate was 7.5%.

the most recent quarter of data—the normal seasonal peak of construction demand in Pennsylvania from July to September—the unemployment rate among construction workers was 7.5%, nearly twice the 4% rate that prevailed in same period in 2006.

A Credit Crunch Threatens All Sectors of Pennsylvania's Economy

Another critical danger to the broader economy from the housing crisis is that it will lead to a shortage of credit (Box 2 explains how). If it does, some manufacturers with increased export opportunities because of the falling dollar may be unable to finance expansion to meet this increased demand. Other credit-worthy businesses and individuals will also find it harder in some cases to borrow for investment or consumption.

Central banks around the world, including the U.S. Federal Reserve, have moved aggressively on several occasions to increase the availability of credit to financial institutions. A credit shortage is the most uncertain and the largest of all the threats facing the economy because it affects every sector of the economy.

POLICY RECOMMENDATIONS

The subprime mortgage crisis, the bursting of the housing bubble, and the slowdown in the economy are problems that affect the entire nation, not just the state of Pennsylvania. Moreover, when it comes to crafting solutions, the federal government has more power than state officials; it can, for example, deficit spend and set interest rates through the Federal Reserve Bank. In the weeks just prior to the publication of this report, the Federal Reserve Bank, U.S. Congress, and Bush Administration recognized these realities and awakened to the need for action to stimulate the national economy.

We can expect an extended debate about the scale of stimulus needed to boost the national economy and the specifics of that stimulus.[27] Basic economics suggests a number of guidelines:

- First, direct government spending stimulates the economy more than tax cuts. The basic reason: government injects every dollar of an increase in its spending into the economy, whereas consumers typically inject only a portion of what they receive in tax cuts.

- Second, tax cuts—or other approaches to putting money in the pockets of consumers—stimulate the economy more if they target low- and moderate-income families. Why? Because these families spend more of any increase in income than higher-income groups.[28] Two ways to target low-income families would be through increased or extended unemployment benefits or more generous food stamps.

- Third, increases in government spending should include revenue sharing for states and localities so states and localities do not have to slash services sorely needed in an economic downturn.

[27] Good sources for the most up-to-date information on the national stimulus debate are the web pages of the Center for Economic Policy and Research (www.cepr.org), the Economic Policy Institute (www.epinet.org), the Center on Budget and Policy Priorities (www.cbpp.org), and the Center for American Progress (www.americanprogress.org).

[28] For evidence from the 2001 tax cuts, see D.J. Johnson and N. Souleles, "Household Expenditure and the Income Tax Rebates of 2001," *American Economic Review 96*, December 2006, pp. 1589-1610.

- Fourth, increases in government spending should also focus on public goods that make sense independent of the short-run need for stimulus—investments that pay off in the form of higher productivity and living standards, a cleaner environment, a better quality of life. Examples include many infrastructure investments, investments (or tax credits) that pay for energy conservation, and investments in human capital—improving the skills of the workforce.

The importance of the national stage does not preclude action at the state level. State government also has powers and creativity that can help keep Pennsylvania's homeowners and economy above water. In light of this, the rest of this section focuses primarily on the state level. In addition to acting directly on the state stage, Pennsylvania policymakers have the ability to shape national debates—as already recognized by the new "Building America's Future" coalition that brings together state and local officials to make the case for federal investments in infrastructure.

Turning to specifics, the discussion below outlines four areas in which Pennsylvania policymakers should take action.

Reducing the Number of Future Mortgages at Risk of Foreclosure

Even before housing prices began to stagnate and fall, the Department of Banking and state legislators developed regulatory and state legislative proposals to reduce "predatory" (unethical) lending and the growing number of Pennsylvania families with exotic mortgages that they could not afford.

- In 2005, a study commissioned by the State Department of Banking estimated that the foreclosure rate on prime loans in Pennsylvania was the ninth highest in the nation, and the foreclosure rate on subprime loans the fourth highest.[29] To lower foreclosure rates, the Department of Banking proposed new regulations that would create new requirements for lenders to disclose terms to mortgage borrowers and consider borrowers' ability to pay.

- In addition, the Pennsylvania General Assembly introduced a reform package of six bills.[30] This package would require licensing of mortgage brokers and prohibit penalties for paying off loans early (which can lock homeowners into adjustable rate mortgages with high rates). It would tighten the regulation of appraisers to reduce the chance of appraisers colluding with brokers and valuing homes at more than their market value. The reform package would, further, require mortgage holders to notify the borrower and the state about impending foreclosures.

The worsening subprime mortgage situation underscores the importance of enacting these regulatory and legislative reforms immediately.

It should also be recognized that the subprime lending explosion in the state and the nation was, in part, a symptom of the lack of affordable housing. Many homeowners relied on exotic mortgages because homes available in their area were too expensive to be affordable with more conventional mortgage products. By design, regulatory reforms would restrict the access of some low-income families to exotic mortgages that expose them to undue risk and the possibility of devastating losses. But these reforms must be coupled

[29] The Reinvestment Fund, "Mortgage Foreclosure Filings in Pennsylvania" <www.trfund.com/resource/downloads/policypubs/Mortgage-Forclosure-Filings.pdf>.

[30] For more on these bills, see www.housingalliancepa.org/news/view.php?news_id=185

Box 3.
The Subprime Borrower Protection Plan

Under Dean Baker's Subprime Borrower Protection Plan, the federal government or Pennsylvania legislature would give homeowners facing foreclosure the right to rent their home indefinitely at the fair market rent. This rent would be determined by an independent appraiser, appointed by a court. The appraiser would determine the fair market rent in the same way that appraisers determine the market value of a home before a bank issues a mortgage. (Especially in markets where housing prices have risen much faster than rents, fair market rents could end up substantially less than the monthly payment on an ARM, so that the former homeowners could afford the rent even though they could no longer afford the original mortgage payment.)

In some cases, Baker's plan would ensure that current homeowners could at least keep a roof over their head. If they like the home, the neighborhood, and the schools for their children, they would have the option to stay in their home as long as they wanted. More importantly, this change in the foreclosure rules would give lenders a strong incentive to renegotiate the terms of mortgages. Most lenders will not want to become landlords. They would have the option to sell the home, but the buyer would remain bound by the commitment to accept the former homeowner as a tenant indefinitely, reducing the resale value. Since a lower resale value would make the foreclosure option less attractive, lenders will be more likely to negotiate terms that allow current homeowners to remain in their houses as homeowners.

According to Baker, his plan requires no taxpayer dollars or new bureaucracies. It would be administered by a judge in the same way that foreclosures are already overseen by judges. It simply changes the rules under which foreclosures can be put into effect. In addition, the proposal does not in any way bail out lenders who made predatory mortgages or risky gambles in the secondary market. The plan could be capped at the value of the median house price in a metropolitan area, so that it does not benefit high-income homebuyers but only the middle class. By allowing homeowners to stay in their house as renters, this plan also aims to prevent the sort of blight that often afflicts neighborhoods with large numbers of foreclosures.

with an expansion of affordable family housing—for example, through the creation of the Housing Trust Fund proposed by the Pennsylvania Housing Alliance. This fund could be financed by a 2% charge on homeowners' property insurance—an average cost of $1 or less per month that would raise an estimated $85 million. (If federal-state revenue sharing were re-instituted, that might also provide resources to set up a housing trust fund.)

Protecting Families Currently at Risk of Foreclosure

Reform to avoid future abuses is important, but reform should also include a plan to deal with the nearly 50,000 subprime mortgage holders who will face foreclosure by the end of 2009. The financial threat posed by these foreclosures extends well beyond individual homeowners losing their homes. It encompasses entire neighborhoods. The Joint Economic Committee (JEC) of the U.S. Congress estimates that foreclosures cost up to $80,000 for all stakeholders combined: $7,200 in administrative charges to the borrower, $50,000 to the lenders, $20,000 to the city or locality, and thousands of dollars in lost property values of neighboring homes.[31] Foreclosures can also be contagious, with "For Sale" signs at one or two foreclosed properties depressing nearby property values and leading to a wave of other foreclosures,

[31] The Joint Economic Committee of the Congress of the United States, *Report on the 2007 Economic Report of the President: Majority Staff Reports—Sheltering Neighborhoods from the Subprime Foreclosure Storm*, Washington D.C., December 18, 2007, pp. 39-41.

as has already happened in neighborhoods in Cleveland, Ohio.[32] The JEC estimates that foreclosure prevention costs about $3,300 per household, compared to the $80,000 cost of each foreclosure. In light of this, federal and state governments should not be penny-wise and pound-foolish; they should act wisely to help families avoid foreclosure.

The Bush administration has secured an agreement with mortgage lenders to freeze interest rates for up to five years for a subset of subprime loans that had low introductory interest rates but were set to adjust upward in 2008.[33] For those eligible to participate in this rate freeze, this proposal represents important relief. Estimates suggest, however, that the plan would benefit only some 90,000 of the two million people across the nation who need help. Many who benefit would still be at risk of foreclosure as soon as the freeze is lifted.

In Pennsylvania, at the end of October 2007, Governor Ed Rendell unveiled two new programs to help homeowners near foreclosure: REfinance to an Affordable Loan (REAL); and Homeowner Equity Recovery Opportunity (HERO). The REAL program offers refinancing to homeowners whose adjustable-rate or other exotic mortgage has become unaffordable. A network of 72 lending institutions handles REAL program loans for the Pennsylvania Housing Finance Agency (PHFA). HERO offers loans for homeowners who, because of credit or other issues, can't afford their current mortgage payments and are not eligible for other programs that could save their homes from foreclosure. Unlike the REAL program, HERO loans are directly made by PHFA, which may negotiate with current mortgage holders to reduce the amount owed on applicants' properties. But as currently funded, these programs are projected to help a total of only 500 homeowners, roughly 1% of those Pennsylvanians holding subprime mortgages and expected to suffer foreclosure between now and 2009.[34] REAL and HERO must be much more adequately funded to meaningfully cushion the impact of the mortgage crisis. (Again, perhaps, funding could come from federal-state revenue sharing.)

Another option whose legality should be explored at the state level is the "subprime borrower proection plan" proposed by Dean Baker of the Center for Economic Policy and Research (Box 3). The goal of this proposal is to create a situation in which lenders have an incentive to renegotiate mortgages at risk of foreclosure, but there is no government bailout of lenders. Baker's plan seeks to do this by giving homeowners in foreclosure the option to rent the home indefinitely at the fair market rent. He suggests that this would lead mortgage lenders and homeowners headed toward foreclosure to work out mortgage terms that reflect current market conditions, rather than the inflated prices that prevailed during the housing bubble.

Accelerating the Timetable for Public Construction

A common-sense response to falling construction employment would be for public agencies at the state and local levels to move up their planned construction so that more of it falls during the next several years of likely recession and slow job growth. Coordination of accelerated public construction could be overseen by a new statewide Construction Industry Partnership staffed by the Pennsylvania State Workforce Investment Board (see Box 4).

[32] Nelson D. Schwartz "Can the Mortgage Crisis Swallow a Town?" *The New York Times*, September 2, 2007

[33] Edmund L. Andrews and Vikas Bajaj, "Lenders Agree to Freeze Rates on Some Loans," *The New York Times*, December 6, 2007.

[34] WHYY reported on 11/30/2007 that the Pennsylvania Housing Finance Agency has received 1200 applications for assistance under its two programs designed to help homeowners heading toward foreclosure. The agency has refinanced 112 loans since the programs were announced at the end of October.

Box 4

Pennsylvania's Industry Training Partnerships: A Resource for Creative Responses to the Construction Industry Downturn and for Broader Skill Upgrading in Recession

Since the 2005-06 state budget, the Commonwealth of Pennsylvania has invested in building and delivering training through a network of 86 Industry Partnerships (IPs)—workforce training consortia connected to regional industry clusters (such as construction, health care, logistics and transportation, metals, and other manufacturing clusters) and governed by industry itself (sometimes with unions). These Industry Partnerships provide a vital and previously missing link between educators and trainers and the economy. They continually assess the real skill gaps and workforce challenges (e.g., high turnover, lack of career advancement opportunities) of key Pennsylvania industries and design training or other interventions to plug skill gaps or solve workforce challenges. About 10 of these Industry Partnerships link with regional construction industries. Some of these currently focus on recruiting and training diverse populations to qualify for construction apprenticeship programs, filling skill gaps created by the retirement of older workers.

As the construction industry confronts a possible recession, the state's Industry Partnerships could be a powerful tool for cushioning the impact on workers and the industry. Industry Partnerships could help with workforce planning to accelerate the timetable of public projects, in the process boosting a slow economy. IPs could develop and diffuse tools for assessing the skills of displaced residential construction workers and incorporating them, with credit for past work-based learning, into high quality apprenticeship programs. IPs could assist with skill development for energy conservation retrofits on Pennsylvania public buildings, businesses, and residences. They could work with community groups and local government to identify infrastructure improvement and community enhancement programs that can ramp up quickly to keep construction workers gainfully employed in socially useful work. To facilitate the collaboration of regional construction Industry Partnerships with recession response efforts the Commonwealth should establish a statewide Construction Industry Partnership staffed by State Workforce Investment Board personnel.

Industry Partnerships in other industries could also assist a comprehensive human capital initiative during a recession. IPs could get employer input on how to fund such an initiative. They could assist with implementing new programs once funded, enabling employers to end the recession with more of the skills they need for global competitiveness. If a deep recession requires direct public job creation, Industry Partnerships in many industries, not just construction, could help with the identification, planning, and implementation of projects that deliver social benefits and also upgrade workers' skills.

Maintaining stable construction demand is particularly important over the next several years because the construction industry faces a long-term shortage of skilled workers. A sharp downturn could decimate emerging new initiatives to attract and train a new and more diverse young workforce, leaving the industry with a more severe shortage of skilled labor when recovery takes place. Expanding near-term public construction could provide employment security for older workers while maintaining investment in new outreach, assessment, and pre-apprenticeship programs that target minorities and women and feed into high-quality apprenticeship programs. Another benefit of counter-cyclical construction for the public sector is that prices come down sharply during periods of slack demand—roughly 20% based on one large-scale national study of school construction costs.[35]

[35] Hamid Azari-Rad, Peter Philips, and Mark Prus, "Making Hay When It Rains: The Effect Prevailing Wage Regulations, Scale Economies, Seasonal, Cyclical and Local Business Patterns Have on School Construction Costs," *Journal of Education Finance* 27 (Spring 2002): 997-1012.

A Pennsylvania Commission for Investment in the Future

What if our national downturn turns into a deep recession, as an increasing number of economists predict?

To plan for this contingency, we propose the formation of a Pennsylvania Commission for Investment in the Future charged with assembling a list of key infrastructure, energy efficiency, and human capital investments that could be made over the next several years. Such investments would enhance the long term competitiveness of the state's economy while lowering the human costs of a deep downturn.

It is no secret that Pennsylvania's infrastructure is in disrepair and that additional investments in the future need to be made. According to a study released a year ago by the Pennsylvania Economy League (PEL), "Pennsylvania's transportation systems are in bad shape – both physically and financially." [36][37] The same is true of the state's water and sewer infrastructure in many parts of the state. The state also needs to repair dilapidated schools, upgrade the campuses of community colleges (and build new ones in rural areas), and invest in energy efficiency (as proposed in the Energy Independence Initiative). The case for increased infrastructure investment, in Pennsylvania and nationally, is outlined in the initial materials released by the Building America Coalition at its January 19, 2008 unveiling.[38]

As well as infrastructure and energy efficiency, a Pennsylvania Commission for Investing in the Future should consider how to fund expanded education and training during a recession, including income support for trainees. It makes no sense to have many Pennsylvanians who need to upgrade their skills sit at home during a recession. In the past, eligibility for unemployed benefits and for training programs have been handled separately. Many workers receiving unemployment benefits cannot access affordable training. Many workers eligible for training programs have no access to income during training. This often limits them to short-term programs less likely than one- or two-year programs to raise their incomes or improve their value to employers. The current disconnect between training and income for the jobless originated because many unemployed factory workers return to their old jobs after a downturn; they were thought not to need training. But what might have made sense in the 1930s does not make sense in a skill-intensive 21st century economy. Now is the time for Pennsylvania to serve as a laboratory for the policy innovations and programs that will replace "unemployment insurance" with "employment insurance"—skills training and income support, a trampoline rather than a safety net.

In light of the urgency of the current economic situation, the Pennsylvania Commission for Investment in the Future should form by the end of February and issue a first report by the end of April. This report should consider (a) how Pennsylvania government and the private sector can finance, in a recession, investments that will deliver a double benefit of economic stimulus and long-run improvements in productivity; (b) how to enable underemployed workers to access skills training *and* income support, avoiding the waste and psychological costs that result from traditional unemployment while positioning Pennsylvania's workforce to compete for the long term; and (c) what the federal government needs to provide—in the form of revenue sharing and innovative skills, energy, and infrastructure policies—to complement creative state action.

[36]

[37] The Pennsylvania Economy League, *Investing in Transportation: A Benchmarking Study of Transportation Funding and Policy*, Harrisburg, October 2006

[38] Building America's Future, *Building America's Future* and accompanying "Fact Sheets" on infrastructure needs in the United States, Pennsylvania, California, and New York City, January 19, 2008.

Be Prepared

Now, even more than in usual times, the economic picture is uncertain. The resilience of the Pennsylvania and U.S. economies, and the increased demand for U.S. exports, because of the decline of the dollar, may enable us to weather the housing storm without slipping into a recession.

On the other hand, a recession is a clear possibility. Given that reality, policy makers should, like the Boy Scouts, "be prepared."

They should put in place policy responses equal to the scale of the challenge.

They should put in place policy responses that leave Pennsylvania's infrastructure, workforce, and economy stronger at the end of an economic downturn—and poised to compete in ways that deliver to Pennsylvanians rising living standards, flourishing communities, and high profits for the next generation.

In this sense, a potential downturn presents an opportunity as well as a challenge—Pennsylvania can not only reduce the human cost of a recession but also bring more of the state's public policies and infrastructure up to date with the needs of a 21st century economy. A Pennsylvania Commission for Investment in the Future can help the Commonwealth to seize this opportunity.

APPENDIX A

Table A1. Subprime loans as a share of mortgages originated in 2006

% Subprime	County	% Subprime	County
22%	Adams	28%	Lackawanna
25%	Allegheny	18%	Lancaster
29%	Armstrong	31%	Lawrence
29%	Beaver	20%	Lebanon
32%	Bedford	25%	Lehigh
24%	Berks	30%	Luzerne
28%	Blair	26%	Lycoming
27%	Bradford	31%	Mckean
16%	Bucks	28%	Mercer
17%	Butler	35%	Mifflin
24%	Cambria	38%	Monroe
40%	Cameron	16%	Montgomery
30%	Carbon	19%	Montour
16%	Centre	22%	Northampton
14%	Chester	35%	Northumberland
35%	Clarion	22%	Perry
36%	Clearfield	36%	Philadelphia
33%	Clinton	35%	Pike
27%	Columbia	35%	Potter
29%	Crawford	35%	Schuylkill
17%	Cumberland	28%	Snyder
24%	Dauphin	30%	Somerset
24%	Delaware	22%	Sullivan
30%	Elk	29%	Susquehanna
25%	Erie	26%	Tioga
38%	Fayette	24%	Union
46%	Forest	39%	Venango
25%	Franklin	37%	Warren
27%	Fulton	26%	Washington
30%	Greene	29%	Wayne
29%	Huntingdon	25%	Westmoreland
30%	Indiana	25%	Wyoming
38%	Jefferson	23%	York
18%	Juniata		

Note. Data limited to first lien, owner-occupied mortgages
Source. KRC estimates based on Federal Financial Institutions Examination Council data