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RECENT DEVELOPMENTS IN U.S. FINANCIAL MARKETS AND REGULATORY RESPONSES TO THEM

HEARING

BEFORE THE

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

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

RECENT DEVELOPMENTS IN U.S. FINANCIAL MARKETS AND REGULATORY RESPONSES TO THEM

TUESDAY, JULY 15, 2008

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RECENT DEVELOPMENTS IN U.S. FINANCIAL MARKETS AND REGULATORY RESPONSES TO THEM

TUESDAY, JULY 15, 2008

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

The Committee met at 12:23 p.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. The Committee will come to order. Let me once again thank Secretary Paulson and Chairman Cox for agreeing to come before the Committee in such an expeditious manner and way. As you know, for the last hour and a half or so, we have had a good hearing with the Chairman of the Federal Reserve. We thank Chairman Bernanke for his involvement, and I am deeply grateful to Senator Shelby and others for allowing us to have this hearing in an expedited fashion, waiving some of the rules that would otherwise be necessary.

Let me just suggest a couple of things. One is, obviously, as we look at these proposals, Mr. Secretary, that have been raised over the weekend, I want to thank you and I want commend you for putting forth some ideas here and how we can deal with this present situation. And so I begin by suggesting that we are all trying to find some common ground and some common answers here that make sense, both in the near term and in the longer term, for economic stability and for restoring confidence and optimism in our country.

Chairman Cox and I had a good chance to talk over the weekend as well, and some of the ideas have become the subject of public debate and discussion over the last 24 ours or so.

It is also important—and I think all of you understand this—that as Members of this Committee, we have been charged with the responsibility of oversight and jurisdiction on these policy matters. And so it is important that we be probative as well of these issues as to how they would work, what the impact could be, what are the implications of what we are suggesting in these various ideas. And so as a part of this hearing, which is unprecedented in many ways because of the circumstances, I want the tone of it to reflect both a welcoming tone in light of the ideas that have been suggested, but also one that is probative, that we examine thoroughly these

ideas and what the implications are. Inaction is not an option, in my view. That may be an option for some. It is not for this Chairman. I do not believe we can do anything and just watch events unfold. I think we have a responsibility to respond.

I think the notion of fresh capital is critically important and we need to act expeditiously, in my view, in how we do that. And so I begin the process by suggesting to you that we have a good discussion here over the next hour or so if we can, with my Members who are here, to engage in this debate and discussion. In a sense, I must say at the outset here that the plan, Mr. Secretary, that has been proposed is somewhat ironic in a way in that for much of the last year or so, those of us who have offered some ideas on how to prevent foreclosures have been labeled as "costly bailouts" for our ideas. And I know that is not the view of everyone, but certainly there were those who suggested that was the case.

We have also gone through the period over the last year or so when this problem became most poignant of going from basically this will correct itself, it is not that big a deal—those were the comments almost a year ago—to the point where obviously we are talking about some unprecedented ideas and suggestions as to how we might move in all of this.

Let me just identify, if I can, as part of the plan and idea that raised some questions. There are those who suggest that what we are looking for here or what the proposal would be amounts to a blank check to buy GSE debt and stock and that could spend an unlimited amount of public dollars to buy such debt and stock. The only limitation seems to be the duration of the plan, at least as some have raised. The purchases would be exempt from the debt ceiling, off budget, concerns about that. The Fed would be consulted. We have been talking around some questions to the Chairman of the role of the Fed in all of this. The bill that is pending now and resolution between the House and the Senate—and I am grateful, again, to those of you here who have been supportive of what we have tried to accomplish here—establishes a very strong regulator for the GSEs.

There are those—I am included here—that would be concerned about, in a sense, substituting that very strong regulator—and I say this respectfully—to the Chairman of the Federal Reserve, given the authority that is being suggested over that strong regulator, making the regulator far weaker in many ways than I think what many of us would like to achieve and see. There are concerns about that as well. And then, of course, there is the proposal that is, as I said, basically dealing with the Fed and giving it that power, a strong role than would otherwise be necessary.

So those are some of the concerns that have been raised. Obviously, this is an important moment, an unprecedented moment, as I said a moment ago, that we need to grapple with and deal with. And we are, again, deeply appreciative of your presence here to be probative, to be supportive of good ideas that will move us in the right direction. I think it is very important that we not contribute to the fear—unwarranted fear, I might add—that exists in too many places. This is a time for calm, for stability, for solid ideas that can get us back on the right track.

And with that, I thank you for your presence here. Let me turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman. I will try to be brief, but I think this is a very, perhaps one of the most, important hearings we have had in the Banking Committee, and we have had others.

We will now, as you mentioned, focus on a very important topic: preserving the viability of our Nation's Government-sponsored enterprises. These entities must be financially strong if we are to work through the housing market correction. Their vitality is also crucial for the future of our capital markets and the economy as a whole. This Committee right here has worked for a number of years to strengthen the regulatory system governing Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System.

Some years ago, as Chairman of this Committee, I presided over a Banking hearing, a markup of GSE legislation that would have created a strong regulator with the authority to assess the risk posed by the enterprises to our financial system. At that meeting I noted that, should one of these institutions encounter significant financial difficulty, the consequences could be grave for the entire economy as well, perhaps, as the American taxpayer.

Regretfully, that legislation was opposed by those who argued that a strong regulator would endanger the GSEs by undermining their financial fundamentals. Goodness. I hope it is now clear that quite the opposite is true.

In recent days, market volatility, as everyone here knows, has affected both the debt and equity holdings for Fannie Mae and Freddie Mac. In response, various public officials have made statements regarding the financial conditions of the GSEs. In particular, an OFHEO statement noted that both Fannie Mae and Freddie Mac hold adequate capital in excess of the statutory minimums, which is probably true. The GSEs have large liquidity portfolios, access to the debt markets, and over $1.5 trillion in unpledged assets. Many would thereby conclude—and many have stated publicly -that each GSE is safe and sound. Goodness again. If the enterprises are operating in a safe and sound manner, it begs the question: What are we doing here today? Well, we all know why we are here.

Over the years, the debate over GSE reform included a great deal of controversy regarding the topic of systemic risk raised by the Federal Reserve Chairman and others before him. In other words, could a GSE judged to be operating in a safe and sound manner pose a broader systemic risk? For some time, a lot of us have argued strongly that it could. I hope recent events have resolved the debate on this question. The GSEs, even when they are deemed safe and sound, can pose systemic risk. We would not be here today discussing taking unprecedented action to shore up their financial condition for the broader purpose of protecting the overall economy if that were not the case.

The administration is now proposing—and we will hear in a few minutes from Secretary Paulson—additional statutory changes in response to developing market conditions. The proposal we will

hear about this morning should raise a number of serious questions for the Members of the Banking Committee and the U.S. Senate. If Congress intends to reaffirm Wall Street's view that the American taxpayer stands behind the GSE's debt, we will undoubtedly harden the so-called implicit guarantee. If that is the case, I think this Committee needs to fully understand why this step must be taken. What exactly would we be getting in taking an ownership stake, or something like it, in the GSEs? What rights would the Government possess as an owner or a guarantor? What impact would such actions have on the dollar and the broader economy, both now and in the future?

Mr. Chairman, I hope that our hearing today provides the Committee with answers to some of these and other important questions. I hope we can take what we will learn today and make whatever changes to any legislation bill that we deem necessary. I fear that we are sitting on a financial powder keg.

Thank you.

Chairman DODD. Thank you very much, Senator Shelby.

Again, let me turn to you, Secretary Paulson and Chairman Cox. We thank you both for being with us. Secretary Paulson.

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

Secretary PAULSON. Good afternoon, everyone. Thank you very much, Chairman Dodd and Senator Shelby and Committee Members, for your leadership and for the opportunity to discuss these very important issues on short notice.

As you know, our financial markets have been experiencing turmoil since last August. It will take additional time to work through these challenges, and progress has not come in a straight line. However, our financial institutions are repricing risk, deleveraging, recognizing losses, raising capital, and seeking to improve their financial positions. And policymakers and regulators are vigilant in their efforts to address the current challenges.

Fannie Mae and Freddie Mac, two of the Government-sponsored enterprises—the so-called GSEs—are also working through this challenging period. Fannie and Freddie play a central role in our housing finance system and must continue to do so in their current form as shareholder-owned companies. Their role in the housing market is particularly important as we work through the current housing correction. The GSEs now touch 70 percent of new mortgages and represent the only functioning secondary mortgage market. The GSEs are central to the availability of housing finance, which will determine the pace at which we emerge from this housing correction.

In addition, debt and other securities issued by the GSEs are held by financial institutions around the world. Continued confidence in the GSEs is important to maintaining financial system and market stability.

Market stability and support for housing finance are among my highest priorities—and they have been for some time—during this period of stress in our markets. Therefore, after consultations with the Federal Reserve, OFHEO, the SEC, and congressional leaders, we are asking Congress, as it completes its work on a stronger GSE

regulatory structure, to also enact a three-part plan to address the current situation. Our plan is aimed at supporting the stability of financial markets, not just these two enterprises. This is consistent with Treasury's mission to promote the market stability, orderliness, and liquidity necessary to support our economy.

Our proposal was not prompted by any sudden deterioration in conditions at Fannie Mae or Freddie Mac. OFHEO has reaffirmed that both GSEs remain adequately capitalized. At the same time, recent developments convinced policymakers and the GSEs that steps are needed to respond to market concerns and increase confidence by providing assurances of access to liquidity and capital on a temporary basis if necessary. The plan we announced will strengthen our financial system as we weather this housing correction and establish a new world-class regulator for the GSEs. It has three parts.

First, as a liquidity backstop, the plan includes an 18-month temporary increase in Treasury's existing authority to make credit available for the GSEs. Given the difficulty in determining the appropriate size of the credit line, we are not proposing a particular dollar amount. Flexibility is the best means of increasing market confidence in the GSEs and also the best means of minimizing taxpayer risk.

Second, to ensure the GSEs have access to sufficient capital to continue to fulfill their mission, the plan gives Treasury an 18-month temporary authority to purchase—only if necessary—equity in either of these two GSEs. Let me stress that there are no immediate plans to access either the proposed liquidity or the proposed capital backstop. If either of these authorities is used, it would be done so only at Treasury's discretion, under terms and conditions that protect the U.S. taxpayer and are agreed to by both Treasury and the GSE. I have for some time urged a broad range of financial institutions to raise capital, and at Treasury we have constantly encouraged the GSEs to do just that. In March, at my request, both the Chairman and Ranking Member of this Committee hosted a meeting with me and the CEOs of the two GSEs where they agreed to raise capital, and you began the effort to move your GSE reform bill, which is now hopefully about to be enacted with the modifications we are recommending today.

Third, to help protect the financial system from future systemic risk, the plan strengthens the GSE regulatory reform legislation currently moving through Congress by providing the Federal Reserve authority to access information and perform a consultative role in the new GSE regulator's process for setting capital requirements and other prudential standards.

Let me be clear. The Federal Reserve would not be the primary regulator. As I have said for some time, the Fed already plays the role of de facto market stability regulator, and we must give it the authorities to carry out that role. This role for the Federal Reserve with respect to the GSEs is consistent with the recommendation made in Treasury's Blueprint for a Modernized Financial Regulatory Structure. Clearly, given the scope of the GSEs' operations in world financial markets, a market stability regulator must have some line of sight into their operations.

We have long maintained that the GSEs have the potential to pose a systemic risk and worked with Congress on legislation to create a GSE regulator with authorities appropriate to the task and on a par with other financial regulators. We must complete this work. The Senate passed GSE reform legislation last Friday, and we urge the House to act quickly to advance this process.

As I have said, we support the current shareholder-owned structure of these enterprises. Our plan addresses current market challenges by ensuring, on a temporary basis, access to both liquidity and capital, while also ensuring that the GSEs can fulfill their mission—a mission that remains critical to homeowners and homebuyers across the country, especially during this housing correction.

I look forward to working closely with you, your colleagues in the House, and congressional leadership in both chambers to enact this plan as part of a complete legislative package as soon as possible.

Thank you, Mr. Chairman.

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

Chairman Bernanke has already indicated he made his statement earlier and does not have a statement to make at this point. Is that correct, Mr. Chairman?

Chairman Cox.

STATEMENT OF CHRISTOPHER COX, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. COX. Thank you very much, Mr. Chairman, Senator Shelby, and Members of the Committee, for this opportunity to describe the SEC's actions to deal with the recent developments in our financial markets.

Since the credit market crisis began with the deterioration of mortgage underwriting standards and a contagion of abusive lending practices, and then spread to the capital markets through securitization, the SEC has used its law enforcement and regulatory powers to contribute to orderly and liquid markets. We have acted in three main areas: the investigation and prosecution of violations of the securities laws; the regulation of problem areas in the markets, including credit rating agencies under recent authority granted to us by the Congress; and accounting and disclosure standards in order to bring hidden risk into the light. Our work in these areas has been both national and international.

First and foremost, the SEC is a law enforcement agency. Our enforcement actions to address the capital markets turmoil have involved not only our Division of Enforcement and each of the agency's 11 regional offices, but also nearly every major SEC division and office, and every area of professional emphasis, through our agency-wide Subprime Task Force. We are also working closely with other Federal and State regulators.

The SEC has over four dozen pending law enforcement investigations in the subprime area. They are focused on the activities of subprime lenders, on the roles of credit rating agencies, insurers, investment banks, and others involved in the securitization process; and on the banks and broker-dealers who sold mortgage-backed investments to the public.

As one example of these initiatives, just a few weeks ago the Commission brought enforcement actions against two portfolio managers of Bear Stearns Asset Management, whose hedge funds collapsed in June of last year and caused investor losses of over $1.8 billion. These cases, and others like them in the subprime area, are making it clear that vigorous investor protection extends to hedge funds, which are by no means unregulated when it comes to fraud.

The same vigorous commitment to investors extends to our jealous protection of the integrity of public disclosure. Because the reliability of information about public companies is so important to market confidence, there have long been clear rules that prohibit market manipulation by knowingly spreading false rumors. But for the entirety of its 74-year history until 2008, the Commission had never brought an enforcement action of this kind. It is probably because of the difficulty in tracing where a false rumor starts, and proving that it was knowingly false, that these cases haven't been brought in the past. But now the same technology that instantly spreads rumors around the globe is also helping law enforcement track down the culprits. As a result, just a few weeks after the demise of Bear Stearns, we successfully sued a trader who used instant messages to other brokerage firms and hedge funds to spread fake information about a pending acquisition. The false rumors that he started caused the stock to drop by 17 percent and caused a wipeout of market capitalization of $1 billion in 30 minutes and led to a halt in trading in those securities on the New York Stock Exchange.

Following our enforcement action, the Commission not only hit the trader with penalties and other sanctions, but also banned him for life from the industry. This was a landmark case, and it will not be unique. If we are successful in bringing future cases like this, I believe the penalties should be commensurate with the enormous amount of shareholder value that is destroyed by this kind of wantonness toward other people's money.

For several months, we have had other active investigations underway concerning the possible manipulation of securities prices through various combinations of manufacturing false rumors and short selling. In addition, the Commission has joined with other securities regulators in undertaking industry-wide sweep examinations that will include hedge fund advisors, aimed at preventing the spread of intentionally false rumors to manipulate securities prices.

In addition to enforcing our existing regulations, the Commission is also using our authority to promulgate new rules. Today, the Commission will issue an order designed to enhance protections against "naked" short selling in the securities of primary dealers, Fannie Mae, and Freddie Mac. The emergency order will provide that all short sales in the securities of primary dealers, Fannie, and Freddie will be subject to a pre-borrow requirement. In addition to this emergency measure, we will undertake a rulemaking to address these same issues across the entire market.

We are also using our new authority under the Credit Rating Agency Reform Act to write sweeping new regulations that will apply to the rating of structured investments. Until the passage of

this landmark legislation, the credit rating industry has been largely unregulated. Now, in the 10 months since the first firms became registered under the new law, they are subject to thorough and ongoing regulation of everything from their public disclosures, to their management of conflicts of interest, to their ability to prevent unfair, abusive, or coercive behavior in the ratings process. The new law also gave us the authority to examine these firms, and we are using it aggressively. As you know, we recently provided to the Committee a complete report of our staff's findings in these examinations.

The subprime crisis was also deepened by problems with disclosure and accounting, and so in recent months, we have has asked financial institutions to provide additional disclosure regarding both off-balance-sheet arrangements and the application of fair value to financial instruments.

Last Wednesday, the Commission held a roundtable to hear from market participants and regulators about the challenges of current fair value accounting and auditing requirements, which will provide the basis for potential new guidance from the SEC, the FASB, and the PCAOB.

Since the events of mid-March that culminated in the Bear Stearns acquisition, the SEC has broadly engaged with other regulators on issues related to capital and liquidity. We have broadly strengthened liquidity requirements, and we are closely scrutinizing the secured funding activities of each CSE firm. Working together with the Federal Reserve, we have developed additional stress scenarios in light of the Bear experience. These scenarios entail a substantial loss of secured funding and assume no access to the Fed's liquidity facilities. Our recently concluded Memorandum of Understanding with the Federal Reserve Board is facilitating this cooperation as well as our joint work in a number of other important areas.

Finally, I note that the subprime crisis has affected markets not only here in the United States but all over the world, and so we have been working closely with our international regulatory counterparts to ensure that our solutions to these problems work across national borders and in other markets.

Thank you, again, Mr. Chairman, for this opportunity to discuss these important issues, and I will be happy to take your questions.

Chairman DODD. Thank you very much, Mr. Chairman, and we appreciate your presence again here today.

I will put 6 minutes on the clock here, and we will move along. Because everyone has shown up here, we will move in a normal seniority system here, as everyone has been for the last 2 or 3 hours.

Let me address, if I can, the very points, Mr. Secretary, that you have raised. Again, this is our responsibility here to be probative and examine these ideas, particularly if we are going to try and act in some expeditious fashion here. Normally, there would be a period of time to really go over these issues in far greater detail, but the sense of urgency is something I think all of us, or at least most of us here appreciate.

Let me begin by, first of all, asking a quick series of questions regarding the issue of the lines of credit, and then I will get to the issue of stock and then the issue of the regulator, if I could quickly.

One, you are seeking an unprecedented grant of authority to purchase GSE debt and stocks. What kind of assurances can we offer taxpayers—because we do not have a number here, this is an unlimited amount we are looking at potentially. What has happened with the $2.25 billion, the present authority that exists from the Federal Reserve? Why aren't we going and just opening the discount window? Institutions that have access to the discount window—and Chairman Bernanke can respond to this as well—use GSE debt as collateral, as a basis of qualifying for borrowing at that discount window. If we do that, why not allow these GSEs to have direct access? That way we do not need legislative authority and would provide that kind of fresh capital we are looking at. Why not just go that route if we are looking for some quick action here that would reassure the markets that there will be adequate capital?

Secretary PAULSON. Thank you, Mr. Chairman. Let me answer that question. First of all, in terms of the size, as you know, when the GSEs were—legislation was set up in 1971 there was a direct line of a back-up credit provided by Treasury of $2.25 billion for each agency. At that time, Freddie Mac had capitalization of $1 billion.

Why are we asking for an unspecified amount? And the reason we are is I have the same objective that you have. What I would like to do is provide stability in the market and do so at the least cost to the taxpayer. And I see it very clearly that the way to minimize the chance that this facility will ever be called upon will be to take any questions off the table and to provide as much flexibility as possible.

Now, to your question relative to the——

Chairman DODD. Can I just interrupt? The big question we are going to be faced with our constituents is how much is this going to potentially cost us.

Secretary PAULSON. Yes, and as I have said, since we believe that the right thing to do is to keep these institutions in their current form, the question which I am answering is that this is a back-up facility, hopefully would never be used; and if you want to maximize the chances it will ever be used, you would have maximum authority for a temporary period of time. We are asking for it for a temporary period of time. All I can do is tell you which in my judgment, what I believe is the best for providing stability, providing confidence, and minimizing the chance it will be used and minimizing the chance that people will lose confidence and draw down the back-up facility.

Now, in terms of the——

Chairman DODD. Why not just the discount?

Secretary PAULSON. In terms of the Fed, the Fed has a number of other very important priorities, and what the Fed did here, which was—and I am very grateful to the Chairman and for the Federal Board, because what they said to me was they said, Hank, if you can, you know, through your consultations with Congress, develop a plan and you believe based upon your conversation with the leaders—and as you know, I talked with many leaders of Congress—and you can get some buy-in in advance that something like

this might be acceptable, then we would be willing to provide a back-up while we are waiting.

But I guess the question I would—the way I would throw it back at you, the Fed has their lender-of-last-resort responsibilities. That is unspecified. Why is it unspecified? It is unspecified because it increases the confidence. Congress in their wisdom set up the Treasury as providing the back-up facilities here. That is what the authority is. They just have not been updated in a long time. So that is why we—that is why we proposed—I consulted with Congress. We proposed this. We think this is the best way to limit the cost to the taxpayer. And, again, I am very grateful that the Fed agreed to be there providing the back-up while we are waiting for Congress to act.

Chairman DODD. Let me ask Chairman Bernanke this. As I understand it, in the past there has been some willingness to allow access to the discount window if the $2.25 billion authority lines of credit has been exhausted. Once that is exhausted, then the possibility of having access to that discount window becomes available. Am I understanding that correctly?

Secretary PAULSON. I would say that is—look at that as sort of a normal working of Government. I provided that, we provided that to the Chairman in the interim. But it was done with the understanding—and the way I worked with the Chairman over the weekend was we worked through the weekend, we consulted. I told him I made the various calls that I had made, that I was optimistic that we would persuade Congress that the back-up facility should be increased. And then on that basis, he went and agreed to fill it in in this period.

Chairman DODD. Well, let me ask Chairman Bernanke the question. In fact, if the GSE debt can be used as collateral for other institutions that come and have access to the window, why not allow the GSEs to have access directly to that?

Mr. BERNANKE. I think the reason has to do with who sets the criteria and makes the decision. The Federal Reserve's lender-of-last-resort function is a very flexible tool. It is very important because we can use it quickly in unanticipated circumstances and provide liquidity in situations where it is needed.

When a policy has potential fiscal implications, it is far better if time and circumstances permit to have the fiscal authorities make that decision.

So I think it is really appropriate for the Treasury Secretary, in consultation with the Congress, and not the Federal Reserve Chairman, to make those decisions, and that is why it would, I believe, make more sense to be the responsibility of the Treasury Secretary.

Chairman DODD. Is there any question in your mind that you have the authority to make that window available to the GSEs if you so decided to do so?

Mr. BERNANKE. We do have the authority, although we have a regulation we would have to address which says only under economic circumstances that are stressed. But, again, I do think that the lending and the decisionmaking ought to be lodged with the fiscal authorities.

I would point out that what the Secretary is proposing is not a simple expenditure. Either a liquidity provision or an equity pur-

chase is a loan or an investment that has an asset on the other side. So it is not quite the same thing as a simple fiscal expenditure. It is a loan as the Government makes in many contexts, or an investment.

Chairman DODD. My time has expired. Senator Shelby.

Senator SHELBY. I want to pick up on what Senator Dodd was talking about. Secretary Paulson, just take us through slowly, step by step, what is the proposal that you have set forth to deal with the GSEs? And what is the potential cost to that? Because this is not an empty gesture. I think you mentioned a minute ago, used the phrase "they might not need this, they might not use this, this would be the best of all worlds." But what if they did? Let's go through the steps of what you are proposing so we can understand this fully. I think it is very important.

Secretary PAULSON. Senator, I want to start off with something you said, which was essentially we did not design this, we are playing the hand we are dealt. Right? And as I see this, that what we have asked for—and I will go through them again—is, first of all, the authority for a temporary period of time, authority for 18 months?

Senator SHELBY. What do you mean by temporary? How long?

Secretary PAULSON. Eighteen months, and I would like to talk about that for a minute, because we asked what is the right period here. And it seemed to me that we did not want to—I could have asked for it for the end of the year. It did not seem like—we do not know what the markets will be like at the end of the year. It did not seem like a great gift to give to my successor, whoever he or she may be, to have something like this expiring right away. And so as we thought about it, we said 18 months or through the end—I guess we said through the end of 2009, that should give time to get the new regulator established, to work through this current, you know, period of turmoil, to have the new administration—give them some time to assess the situation, give them some time to work with Congress, give you all time. And so that was where we came up with asking for it until the end of 2009.

Senator SHELBY. How much money are you contemplating here?

Secretary PAULSON. Well, again, I would say with that there is no current plan, and it would be the expectation, with a facility like this, that, again, a back-up facility is about confidence. And if you want to make sure it is used, make it small enough, and it will be a self-fulfilling prophecy.

And so, again, all I can do is say to you that while I am here, I would—it would be—I would ask for it to be unspecified, and I would plan on doing what you found I have done in everything else, which would be consult extensively.

The next authority we asked for was the authority at Treasury's discretion, but also given, you know, the engagement and mutual support of the GSEs, that Treasury would have——

Senator SHELBY. Is that open-ended? Is that——

Secretary PAULSON. Again, that would be for 18—Senator, that is also for 18 months, because I again think that as I look at this proposal, I believe what we have got here today is something to address the short term and the long term. I am going to get to that

in a minute. So I think we have got a proposal that is going to address the short-term issue and the longer term.

So with regard to, again, the temporary authority—and while I am here, again, I would plan on consulting—you know, consulting with you and the other leaders here before exercising that authority. But I would——

Senator SHELBY. The word "consulting" you are using here, is there any ambiguity to that?

Secretary PAULSON. Well, yes, I would not like it to be a legislative requirement, and the reason I would not is, again, I think to the extent you limit it or take away the flexibility, it then makes it worth less in the marketplace. But, again, the authority to make an equity investment if it is deemed necessary. And, again, if that were done, it would be done with the appropriate protections for the taxpayer.

And then, of course, the third—let me just——

Senator SHELBY. You go ahead.

Secretary PAULSON. Then I will just say the third thing, because you asked for all three, and I think this is important here, because we have all been working—and you, Senator, have been a champion in this area. We have been working to get reform with a world-class regulator. And I think that when that regulator is in place and that regulator is up and going, I think there will be a real opportunity to have the discussion for what is the right size, what are the risk characteristics, capital requirements, business activities. And so I think you are going to be able to address the longer term. and this also addresses the short term.

Senator SHELBY. Secretary, what is the trigger, at what point, in other words, would Treasury exercise this new authority? And what if, for example, the equity price falls below a dollar? We know the consequences of that, I think. Or if debt cannot be issued, or is it at the—is it too wide a spread over the Treasurys? In other words, a lot of these events—you just want to reserve that——

Secretary PAULSON. I think just for that, Senator, you have laid out the reasons why we would be—it would be self-defeating to start putting limitations on that. So I think the way I would see that and the way I would like it to work is temporary and the understanding you would have with me, although we would not have, you know, legislative requirements, the understanding you would have with me, this would be something that I would talk about with the leadership of this Committee and committees in the House before, and it would be if needed. And just remember, as you said in your opening statements, the regulator who we have confidence in has said they are adequately capitalized. The market is saying that there are concerns. And so we—one way of reassuring the market and being ready to respond is to say that—and, again, with the objective of market confidence and having the GSEs play that role which is so important in our housing market right now.

Senator SHELBY. Are you basically saying that this is a temporary involvement by Treasury, it is not open-ended, but it is an involvement to reassure the markets and protect the downside?

Secretary PAULSON. Right. I am saying the first two are exactly right. You said it very well. Temporary, protect the downside, and to make sure that these entities continue to play that role we are

going to need to play to get through this housing downturn. And the third part of this, which is, you know, the strong independent regulator, that is permanent. And that will be—and so as I said, this addresses the short term and the long term.

Senator SHELBY. Thank you.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Let me turn to Senator Carper.

Senator CARPER. Thank you, Mr. Chairman.

I want to go back about 28 years, and we were concerned here—I was State Treasurer of Delaware at the time, but we were concerned about the failure not of GSEs but the failure of one of the Big Three—Chrysler Corporation. And I remember Lee Iacocca calling on the Congress, calling on the President to provide assistance. And what we did in my State and in a number of States, we negotiated a loan to Chrysler, collateralized loans, which we made and ultimately earned interest on. We actually made money on those loans.

Here in Washington, there was an agreement negotiated with Chrysler, which involved, I think, warrants which could ultimately be exercised. And at the end of the day, Chrysler survived, and I believe the Federal Government actually made a dollar or two on the deal.

I do not believe there was a great anticipation 28 years ago that that would happen. We were hopeful that Chrysler would survive. The fact that the money was made on the warrants and also on the loans that we made from our States was, if you will, the icing on the cake.

There is a lot of concern here, rightfully so, of the exposure that we put the taxpayers to and the Treasury to by virtue of going down this path. Is there any upside, aside from the fact that we want the GSEs to survive, we want them to be there when the economy—when the market bottoms out, when all those renters across the country say this is the time that they want to start buying a house. And I think that will happen, hopefully sooner rather than later. But there is another upside other than making sure that our mortgage markets are prepared and our housing market is prepared for that recovery.

Secretary PAULSON. Senator, let me mention two things. First of all, the big upside is every homeowner in this country or everyone who wants to buy a home or wants to refinance a home, refinance a mortgage is benefiting. But now let me also explain that unlike the Chrysler situation—and I am old enough to have been around to remember it—this is not what we are recommending. These organizations are very viable. They are playing a very important role. And what we are doing is—I am not here recommending putting taxpayer money in these institutions at this time. I am here recommending that we increase on a temporary basis the back-up facility to provide the confidence to the markets and to minimize the chance, greatly minimize the chance, that the taxpayer would be involved there, and here also to reassure and say that we have the capacity again for a temporary period of time to make an investment if it is needed and if it is in our discretion and the GSEs' agreement, then if that—and only then if that investment is made

will it be made on terms where hopefully we will protect the taxpayer along the lines that you talked about.

But the overriding issue here is the confidence in our capital markets more broadly, our financial system more broadly, the stability of our financial system more broadly, and the fact that the GSEs—really right now this market is the only really working secondary market in housing finance in our country today.

Senator CARPER. One of the proposals that you have suggested is an increase in the Treasury line of credit for Fannie and Freddie. I have some concerns—and I suspect my colleagues do, too—about having no cap, no limit at all. For some of us, it sounds a little bit like a blank check. And I know that is not the intent.

The second recommendation that you have is that the Treasury be authorized to purchase the stock of Fannie and Freddie. If you ultimately do that, and if the value of the stock does go up, is there some potential for Treasury actually making money on this deal?

Secretary PAULSON. Well, let me say two things. First of all, your comment about the blank check, I think I have answered that before.

Senator CARPER. I know you——

Secretary PAULSON. I hope you understand what I said.

Senator CARPER. I did.

Secretary PAULSON. And I know it is—if people have not thought about these issues for a long time, it is counterintuitive. But, really, the greater the confidence, the less likelihood that the taxpayer is actually going to end up paying.

Senator CARPER. And I agree with that.

Secretary PAULSON. And, second, I can assure you that if we decide to make an equity investment in these institutions, we will do so to protect the taxpayer, and, you know, I would believe there would be—but we would have to talk about that at the time. But obviously——

Senator CARPER. Let me interrupt because my time is limited. Let me just interrupt. So you don't think several years down the line when the shares that the Treasury has bought in Fannie and Freddie turn out to be a windfall and we are able to balance the budget, there will not be, like—you will not be heralded and saluted for the role that you played in that?

Secretary PAULSON. No. Again——

Senator CARPER. I say that with tongue in cheek. I say that with tongue in cheek.

Secretary PAULSON. Well, again, what I am saying is—because I really do need to be clear. There is not a plan to do that at this time. I would sure hope, like you, that if there is one, that as our markets recover and if the shareholders put money in, they end up making a lot of money, as was the case in Chrysler. But, remember, this is not Chrysler, and there is not a plan to put equity in these institutions at this time.

Senator CARPER. And if I could, one last quick question. I think you are proposing a more formal role for the Federal Reserve, working in conjunction with the new GSE regulator. How would that work?

Secretary PAULSON. OK. Let me—because I think this is important, and it is something that we have thought about for a long

time, and we suggested it that other countries—the U.K. has taken this up with their central bank. I need to step back and say if you really look at what the market has come to expect, they have come to look at the Federal Reserve and saying if there is an issue that threatens market stability, we expect them to play a role.

And so one of the things we have asked is not that they supplant other regulators. Not at all. That they have other—but have asked that they have some line of sight, they have a visibility and they are able to play a consultative role. So they—and it is only fair when you look at what—and fair to our country, what might happen.

And so what this—to be very specific for you, this is not designed in any way to undercut the authority of the new regulator. This regulator has got to be world class, got to be a strong regulator. You will be working with a new regulator. You will be working with a new regulator to address the issues that so many people have talked about. But I would warrant that you and other Americans and people around the world will feel more confident—I sure will—knowing that the Fed is there to play a consultative role and be able to give their comments also. And that is the purpose.

Senator CARPER. All right. Thanks so much.

Chairman DODD. Thank you very much.

Senator Bennett.

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

Mr. Secretary, going to your testimony on the second page, you say, "Let me stress that there are no immediate plans to access either the proposed liquidity or the proposed capital backstop." And you have made that very clear, and I think appropriately so. Then this sentence: "If either of these authorities is used, it would be done so only at Treasury's discretion, under terms and conditions that protect the U.S. taxpayer and are agreed to by both Treasury and the GSE."

Can you help us understand a little bit more the specifics of the terms you have agreed to with the GSE? Or are there any——

Secretary PAULSON. There are no terms because we have not—as I said, there are no plans to use it as yet. I said "if needed." And so if needed—and we would obviously be consulting, and we would look to work something out that was mutually agreeable. But it would have to be, you know, on terms that would protect the U.S. taxpayer.

And so I cannot—it is a little bit like Senator Shelby said, that you could think of so many contingencies or what-ifs, it would be pretty hard to design those terms, you and I sitting here today.

Senator BENNETT. Well, I am assuming if the GSEs felt, OK, we are in trouble, and then they came to you, that would be the triggering event that would cause you to look at it?

Secretary PAULSON. That could be one triggering event, absolutely. It could be another triggering event that—we or the marketplace, you know, could be a triggering event. So I would not want to say to you the only basis on which we would talk to the GSEs about capital is if they came to us.

Now, my own belief—and let me say——

Senator BENNETT. I assume you will be in conversation with——

Secretary PAULSON. Yes, let me say we have been—and I just would compliment—I just want to say something about both of these organizations. I agree with Senator Shelby that there are systemic risks, and no one today who has looked at this could argue that there isn't. But I would also say that when you look at the way they have run their operations, the reason we have these issues is they have got one line of business, there has been a housing correction. I would say that their standards and underwriting standards as we have gone through this period have been good relative to what we have seen many other places. And I would also say that they have worked with me, you know, not only over the weekend but leading up to the weekend, in a very constructive way. And so I would have every belief that, you know, the question you asked would play out that we would be in dialog, we would be in consultation. I think it will be very unusual if we suddenly say we think you need equity and no one else does, OK? I think this is something that we would work on together.

But, again, to protect the Government, I cannot say that the only trigger is the GSEs come to us and ask for it and we give it to them. You would not want me to do that.

Senator BENNETT. I understand that. And your discretion means they come to you and ask for it, you may say no. That could also be——

Secretary PAULSON. My discretion, that is right, we may say no or we may say these are the terms we think. But I think what you are going to find is it has got to be at our discretion. I was very clear with them when we talked over the weekend that this was not going to be something that we were going to be forcing on them. This would be something we would have to work on together, and it would be done mutually.

Senator BENNETT. That is what I wanted to get clarified, and I think you are in exactly the right place.

Chairman Cox, I was interested in your comments—you will not be surprised when I raise this, given our past history on the issue. I was interested in your comments about naked short selling and the steps that you are taking. I want to commend you. Your staff has been to see me with a list of all of the steps they are taking with respect to naked short selling. I want to stress again I am not opposed to short selling. Short selling is an essential part of maintaining an orderly market. But I am satisfied that there are circumstances where people sell short without, in fact, having located the stock that they are selling short, and then hope that the confusion in the marketplace covers up that fact and that they never get—the failure to identify the shares that they are selling short never catches up with them. And I congratulate you on the work that you have done there.

May I make a suggestion, and this comes out of a completely separate kind of experience, but as I watched the Winter Olympics in Salt Lake City, I discovered something that I had never understood before. At the end of a luge run or a bobsled run, or whatever it might be, before the athlete gets out of the luge, he reached into a basket that is filled with colored balls, and he pulls out a ball. And it is orange or red or whatever it might be. If it is black, the athlete is instantly taken to a place where there is a drug test so

that the athletes know that there is always the possibility, even if it is completely random, that he or she will be subjected to a drug test.

Might I suggest that you set up a SWAT team of some sort that can drop into a brokerage house completely unannounced, completely at random, on no particular tip, to simply say we want to pick out a couple stocks and look to see if within your brokerage house somebody has been in engaged in naked short selling. And it is completely random. You walk away with an orange-colored ball or a red ball and whatever. You are completely clean. There is no stigma attached to it. But I think the people who are engaged in naked short selling might be a little nervous if they thought there are a dozen people in the SEC that just might show up at our doorstep and start looking at this kind of thing.

So I use the opportunity of your being here to make that suggestion to you, even as I commend you and your staff for the great strides you have made in this area in the past.

Mr. COX. Well, I thank you, Senator. As I mentioned, in addition to the emergency action that we are taking today, which will have a 30-day life, we are also contemporaneously going to be starting a rulemaking focused not only on the primary dealers and on Fannie and on Freddie, but on the broader market. And in that connection, the kind of sweep examination that you were talking about, which is part and parcel of what the SEC routinely does, will help inform our decisions. And so I very much appreciate your suggestion.

Senator BENNETT. Thank you very much.

Thank you, Mr. Chairman.

Chairman DODD. Let me underscore that point as well. We had a conversation over the weekend, and just the mere announcement of where you are moving may have the desired effects that we are talking about. Just announcing things can have certain implications. I think this is very smart and very wise. I remember very distinctly in our hearing on Bear Stearns/JPMorgan Chase. I think I am quoting you exactly when you were asked a question—I think by Jon Tester it may have been—on this matter, you said certain matters are too big to miss, and we appreciate the fact that the agency seems to be responding to that.

Mr. COX. We have been very busy on this for many months, Senator.

Chairman DODD. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you all for your testimony. I hope we have been listening to the Three Wise Men of the Economy here and that what you are telling us is going to steer us in a different direction. But I have some concerns. You know, I have in the past at some of these hearings suggested that we seem to be behind the curve instead of ahead of it; that we seem to be constantly reactive instead of proactive. And I am just wondering, you know, we seem to be in a pattern that is developing where our regulators suddenly realize an emergency on a Friday, and then hastily formulate a rescue plan at the 11th hour during the weekend. We saw this happen with Bear Stearns, and now we are talking about this as it relates to Freddie and Fannie. And we saw what happened at IndyMac. And I am just concerned that

what we have here is the equivalent of last-minute cramming regulatory action. And that puts us in a process of expediency over well-thought-out policy.

You know, I wonder, Mr. Secretary, how is it that knowing what has happened with reference to companies that have been shaken dramatically, that have securitized loans over the past year, why we thought that Fannie and Freddie would be insulated from the very same market conditions that have crippled other companies that specialize in loan securitization. That is one question.

The second question is: I hear you when you say that it is your intention or desire and hope not to use the very power that you are asking for, but I am concerned, you know, all of us here play a fiduciary role to the taxpayers not only of our States, in the country. And as you just mentioned a moment ago, it is counterintuitive to say give us a blank check or a blank authority as the best way to ensure that taxpayers are not on the hook. That is certainly counterintuitive.

And the difficulty is, having just seen the Bear Stearns process that we went through, where it has now had about $1 billion of asset loss since March, which now puts us into the area where, in fact, the Federal Government—i.e., the taxpayers—begin to come into play in terms of responsibility for picking up the tab if this decreases further, I know it is not your intention to use it, but by the same token, you know, there is no safeguard under your proposal for us to create some limits of those liabilities should you have to use it.

And, finally, I am concerned about that while I know it is not your intention to use it and you think that this is the best way to avoid taxpayer liability, just look at what Wall Street basically did in terms of when the plan was announced. You know, it pushed Fannie's stock up by 20 percent, Freddie by more than 15 percent in early trading. And then it closed down 8, and Fannie was off 5 product at the end of the day. So it almost seems to be saying—they seem to be saying it is just not enough. So did they want some guarantees here? And if you want guarantees, that means more than just the possibility for 18 months. It may mean more.

So I hope you can address those issues. Why did we not see this possibility coming? How is it that, in fact, we go back and tell the taxpayers there is absolutely no way you are going to be put on the hook here, and, third, when we have lost $1 billion already in the Bear Stearns process?

And then, finally, let me put the last question out there and let you answer it. It would be to Chairman Cox. I appreciate that you said, first and foremost, the SEC is a law enforcement agency. And I appreciate a good part of your written testimony talking about going after market manipulation where in one case the false rumors in Bear Stearns caused the stock to drop by 17 percent and wiped out $1 billion of market capital in the first 30 minutes and had the stock exchange halt the trading in the company's securities. Can we expect you to vigorously pursue more enforcement activities of that type going in the days ahead?

Those are the questions I would like to hear answered.

Secretary PAULSON. Yes, Senator, let me respond.

First of all, on not foreseeing this. I would say to you, from the day I set foot in Washington, I started work to get GSE reform. I was told you got no chance of getting it. There are people on each side. It is a holy war. And the best you are going to have is what we currently have.

Every time I testified, when I testified before this Committee before, and I got asked about various housing proposals, I said they are important but this is by far the most important. I did everything I knew humanly possible to move this through Congress.

In terms of raising capital, again with the authorities we had, which was just really talking, pushing, even having meetings with the Chairman and the Ranking Member and the GSEs to raise capital.

In terms of the plan, it could just as easily have come together during the week as over the weekend. We have been working on this. This was not a Bear Stearns situation. This is something that will be helpful at calming the markets.

In terms of the unspecified line of credit, what I meant to say was not that it was counterintuitive to sophisticated people who are in markets all the time and used to thinking about it. What I said is if you are not used to thinking about these issues it seems counterintuitive. But if you are used to thinking about the issues, it is very intuitive, that if you have got a squirt gun in your pocket, you may have to take it out. If you have got a bazooka and people know you have got it, you may not have to take it out. You are not likely to take it out.

I just say that by having something that is unspecified, it will increase confidence. And by increasing confidence it will greatly reduce the likelihood it will ever be used.

And then I think that answers the questions. Chris?

Mr. COX. Senator, I think you are absolutely right that more of these cases need to be brought. As I mentioned, they have not been brought in the history of the Agency largely because it has been, in the past, so difficult to parse where rumors start and where they are just being spread about in our increasingly efficient information society. But the tools that we now have with technology are permitting us to trace back in many cases, through e-mails, through instant messages and so on, to the very individuals that have manufactured intentionally false information that is designed to manipulate securities prices. And that goes to the bread and butter of what SEC law enforcement has always been about.

Just for the record, I want to make clear that the example that I gave in my testimony of the first ever case that we brought came right in the wake of, just weeks after, Bear Stearns. But it was not Bear Stearns securities. It was Alliance Data Systems securities where that $1 billion drop in market cap occurred in 30 minutes as a result of the rumor.

Senator MENENDEZ. Just one, Mr. Chairman. So do you expect to pursue more enforcements of this type?

Mr. COX. Yes, we do. This will not be unique. And we have other investigations of this type underway.

Senator MENENDEZ. Thank you.

Chairman DODD. Thank you. Senator Hagel.

Senator HAGEL. Thank you, Mr. Chairman.

For the record, as the distinguished SEC Chairman noted, I want to just briefly respond to a comment that Secretary Paulson made in response to the distinguished Senator from New Jersey about what happened.

I recall 6 years ago, Mr. Chairman, that I worked with then-Congressman Baker from Louisiana in the House on GSE regulation. And I introduced legislation based on Congressman Baker's bill. And I could not get one cosponsor from my party or the other party on this issue. And I was informed by a number of people that this was so far beyond the realm of possibility, as we talked then and now are dealing with that reality today, systemic risk, what would happened? Would the taxpayers be saddled with this possibility.

So Secretary Paulson's answer is correct. In fact, when Secretary Paulson and I first became acquainted, I think the first conversation we had was about this issue.

Now on to other issues more current in dealing with this reality.

Let me ask the three of you, I am going to read a list of companies that you are all quite familiar with: Citigroup, AIG, Merrill Lynch, Wachovia, UBS, Bear Stearns, Morgan Stanley, MBIA, and there are others. What do they all have in common? Well, one thing they have in common is that their senior management has taken responsibility for what has happened to each of their company's stock as it has gone down. And we know the rest of the story.

Now here is the question: the current management of Freddie Mac and Fannie Mae, as far as I know, are well compensated. Their board is actually well compensated. And my question to each of you is how much responsibility should be placed on the management, on the management of Fannie Mae and Freddie Mac?

We have been gliding over this issue for some time. I have not heard anyone address that today. Maybe someone has. I have not been here for every minute of the hearing.

But should the management be held accountable? Let us start with you, Secretary Paulson.

Secretary PAULSON. Yes. I would say, as a general proposition, I believe management should be held accountable and compensation should match performance. But I would say in these instances, again, these are companies that have a single line of business. It is housing. We have quite a significant—you would have to go back a long period of time to see a correction like we have had in the housing market.

I believe that their lending standards have not been lax, certainly not compared with many others in the marketplace. The issues that you and I are concerned with have to do with systemic risk and reform and all of the things that will be debated with a new regulator.

So my—and again, there is no proposal today to inject Federal funds in these companies at this time.

So my experience with management has been a construction experience and a constructive experience as we are working through this. And my experience with the boards, I would say that I talked directly with the Freddie Mac board, did not talk with the Fannie Mae board but had very good discussions with Dan Mudd. And they all were very constructive.

So I am not looking for scapegoats here. I am looking to get this done and I am grateful for the service that board members are providing and that management is providing.

Senator HAGEL. Well, I am going to ask each of you as well, I am not looking for scapegoats, either. I am looking for accountability. And if the American taxpayer——

Secretary PAULSON. I know you are, sir.

Senator HAGEL. Mr. Secretary, if the American taxpayer is going to fulfill the plan that you have laid out, if we need to do that, then I consider them investors. Somebody has got to pay the bill. It seems to me accountability somewhere along the line here has to be brought forward. And I understand what you are saying.

But this is not a new issue, Mr. Secretary, just as you presented that issue to me when you came to see me when we talked about your confirmation.

Mr. Chairman, how do you respond?

Secretary PAULSON. I would just say one additional thing, because you are right. If and when—and again, there is no plans to do it. But if Government funds go in, then I think we need to look carefully at the ways to protect the taxpayer, the appropriate terms and conditions, and think all of that through.

Senator HAGEL. Well, the only comment I would make about that, then it is too late.

Mr. Chairman.

Mr. BERNANKE. Well, I was going to just say that if the investment is made, just like any investor there would be terms and conditions. And if management changes or part of what the assessment was at that point in time, then that would certainly be something that the Treasury Secretary would be able to bring to the table as a possible condition.

Senator HAGEL. Mr. Chairman.

Mr. COX. Senator, I am going to interpret your question as not a difficult one. Management in the private sector needs to be accountable to the board of directors and to the shareholders. And to the extent that both Fannie and Freddie are going to be private companies, the degree to which that accountability exists will be a measure of the degree to which they are successful in that respect.

Senator HAGEL. Well, I have got 30 seconds here over and I would just add this as I end, Mr. Chairman. The real issue is going to be, should be, and it will be the next hearing, I suspect. I was reflected in a Washington Post editorial today, which I suspect you all read, The Perils of Paulson.

The real issue is do GSEs work? I mean, what we are dealing with here just did not come out of the night, a bolt of lightening. We have been dealing with this issue for the last few years as far as not what Moody's did today in cutting the preferred and say they may cut it more for these so-called whatever they are, agencies.

So the question we are really going to be dealing with, the next president, the next set of Government managers and regulators, is this a model that works anymore? Because we are not going to be able to keep coming back and back and back to the taxpayer and no confidence in all that now is integrated into this system.

Now that if for another hearing another day, I understand. But I do not think we can walk away from the larger picture here.

Secretary PAULSON. Can I just say, Senator, because you and I agree. I think, as I said, there is two parts to this. One is addressing the current situation and the other is the long-term. And I believe this plan has got both parts. And you get the strong regulator in place, you will have the opportunity. With that regulator there will be a time and a place, with that regulator in place, to address all of the issues that you want to address. Time, in terms of size, risk, business activity.

But my comments were—had to do with the GSEs in the current model, the current form. And I am certainly not looking to be an apologist for management. But I just wanted to say that it would have been surprising to me if there were not some of these issues, given the size and given what is happening in the housing market, when they are in the housing market.

Chairman DODD. Thank you.

This will be a subject of longer discussion, but let's remind ourselves, this began with predatory lenders out there marketing products that borrowers could not afford. GSEs, Fannie and Freddie, were never bottom feeders. They had some Alt-A, they had some subprime, but nothing to the extent these other institutions had. That is where the problem lay, the failure to actually oversee, to regulate, to monitor that effectively, is where the problems began.

We had legislation adopted 14 years ago for which a regulation was never promulgated to protect against deceptive and fraudulent practices. Had that been done, had cops been on the beat, going after these people who are marketing these products as they were as aggressively, we would not be here today.

This was not a natural disaster. This was malfeasance and misfeasance, in my view, that created this mess that we are in today.

Senator Reed.

Senator REED. Thank you, Mr. Chairman.

Mr. Secretary, recently the Federal Reserve and the Securities and Exchange Commission entered into a memorandum to coordinate their supervision of the consolidated supervised entities. I do not believe there was a specific legislative requirement that they do that, they consult, or anything else. So why is it necessary to have a legislative requirement that this new super regulator consult with the Federal Reserve?

I would think it would happen or could happen in the course of the common interest of both regulators. And the downside I think has been expressed by some of my colleagues, is if we have the super regulator, if he is looking over his shoulder every moment, even for—as your language requires—even for guidelines or directives concerning prudential management operations, that would involve the Federal Reserve I think in the routine decisions on a daily basis.

Secretary PAULSON. Let me just say first thing is I think that is something confused there because it would certainly not be what the role of the Fed we would be suggesting.

But let me get back to the specific question. The way the Fed and the SEC have come together underscores a very important point. We have a regulatory structure, in my view, that is out-

moded in this country. It is not just that we do not have a world class regulator with all the necessary powers for the GSEs. We have a regulatory structure that does not work the way we would like it to work for our financial system today.

So while we are waiting for Congress—and it is going to take some time because these are going to take time to work through these issues and to deliberate. What you have seen is regulators have been able to come together and work cooperatively for the good of the system. And that is what you saw happening with the Fed and the SEC. In consultation with Congress, working together, using the SEC, working with the FED.

There is now, while we are putting something in place, which is hopefully going to be a permanent long-term solution in terms of a strong independent regulator, we have made the case and I think it makes sense, and for the reasons I have articulated, not to be the primary regulator, not to look at appointment of directors, but to consult when you look at capital and issues of risk, and to formalize that.

And that is, as I said, what we have suggested more broadly. And I think it is a good model.

Senator REED. Well, Mr. Secretary, this is, I think, your language that coordination with the Board of Governors of the Federal Reserve prior to issuing any proposal or final regulations, guidelines or directives concerning the prudential management and operations standard and safe and sound operation of end capital requirements.

That seems to be a rather expansive consultative process.

Secretary PAULSON. Well, the idea is when you are going to consult, again, when you are consulting on prudential issues and capital issues, that is what we would like. And I would like to understand how that could be a negative, to have the Federal Reserve, which our country has come to look at on a de facto basis—and let me say, when the powers were put in place many years ago, we did not have GSEs. Our regulatory structure was set up when this country was primarily about banks.

When you look at the importance that other financial institutions play, the thought is strong independent regulators. But to have one entity that we are looking to anyway for systemic risk, to be able to have a line of sight and to consult on matters of prudential regulation of capital. So that is just——

Senator REED. Thank you, sir.

Mr. Chairman, do you have the capacity to consult on a daily basis about directives that this new super regulator will be giving? Or the willingness?

Mr. BERNANKE. Well, our understanding, as the Secretary said, is that there would be a strong independent regulator, which would——

Senator REED. Who would turn to you——

Mr. BERNANKE [continuing]. Not be the Federal Reserve.

Senator REED [continuing]. For guidance on directives.

Mr. BERNANKE. The Federal Reserve already has a good working relationship with OFHEO, as do many other regulators. And we are prepared to cooperate, assist in any way that the Congress thinks is helpful.

Senator REED. Well, it seems to me that one of the problems we have seen over the last several months, the regulatory response to many of these issues, was that the Federal Reserve was making statements and giving speeches about subprime, there were different actors. But there was a lot of consulting going on, but there was not a lot of regulating going on.

I think one of the purposes that we have been striving for these many months is a regulator that—in the military parlance—unity of responsibility and command. They are the where the buck stops.

I think we have to just consider this very carefully. I am not dismissing the merit of having an overarching regulator but I think we have to look carefully at capacity and also about making sure that the underlying regulator is not constantly looking over the shoulder on operational details, but is consulting where it counts, at the top in terms of risk, in terms of systemic risk.

Secretary PAULSON. That is the intent here. And again, I would just say to you, and I just feel so strongly about this, that we have a fragmented system and with multiple regulators. And the regulators need to be strong. And we have fought to have this regulator be as strong and powerful as possible.

But again, to have an overarching regulator with overarching responsibility for systemic risk being able to have a line of sight information, to be able to consult on these very important matters is something that we have recommended, and I believe something that would give the market great confidence.

Senator REED. Thank you.

Chairman DODD. Thank you very much.

Senator Bunning.

Senator BUNNING. Well thank you, Mr. Chairman.

First of all, let me tell you, Secretary Paulson, and my good friend Chris Cox, the Honorable Chris Cox, that I am going to be here after you leave. You are going to be gone. And we are going to be responsible to the taxpayers.

The taxpayers have reacted and the market has reacted to your plan, Secretary Paulson, by driving down Fannie Mae shares 26 percent today, right now. And Freddie Mac's are down 29 percent as of this moment, just in case you are interested on how the market is reacting to your wonderful plan on bailing out Freddie and Fannie.

Oh, but you may not do it because it is only as a backstop. Well, do you know in the same bill that you would like to attach this to there is a tax on Fannie and Freddie from $500 million to $800 million per year for a housing trust fund? Do you know that? You do not. Well, it is in the bill——

Secretary PAULSON. Senator, would you like me to respond to both your points? First of all——

Senator BUNNING. Well, I have got—go ahead, respond.

Secretary PAULSON. Well, first of all, I would say I assume you would like to see a strong regulator for the GSEs?

Senator BUNNING. Yes, I sure would. And we passed that 2 years ago and it got dumped between the Committee and the floor.

Secretary PAULSON. And I assume you would want to get this GSE reform bill done.

Senator BUNNING. The other part is the part I do not like, the $300 billion other.

Secretary PAULSON. Well, I have got to tell you, in terms of the housing trust fund, it certainly was not my idea. It is certainly not something I am pushing for.

Senator BUNNING. But it is in the bill.

Secretary PAULSON. It is. It is in your bill. But I would say to you that I would like to get a bill done. The housing trust fund is not the priority. And in terms of the stability for the stock price, it is not something I do not think any of us can do is stabilize the stock price. We are focused on the underlying credit and——

Senator BUNNING. Are you trying to stabilize Freddie and Fannie?

Secretary PAULSON. We are.

Senator BUNNING. Well, your plan is not being accepted.

Secretary PAULSON. Well, I would say this, with all due respect Senator, the credit spreads are very strong and holding in there. I think there is confidence in the market. It is going to take time for shareholders to figure out what the value of those equities are.

I do not think government can——

Senator BUNNING. Well, that is exactly what your proposal is, that Government be the backstop.

Secretary PAULSON. Our proposal, again Senator, is that—well, you have heard me answer. If you have got a better idea, I would like to hear it.

I think our idea is that by having the Government provide an unspecified backstop, the odds are very low that it will be used and the cost to the taxpayers will be minimized.

Senator BUNNING. Well, there are a lot of us who would like to believe what you are saying. But we are a little skeptical. Because every time we propose and do something, it always gets used. And you want an unlimited amount used. And none of us at this table like that idea. Or some of us at this table do not like that idea of an unlimited sum of Federal dollars being backstopping two GSEs which are already assumed to be backstopped by the Federal Government to start with. They are price stock and they are equity.

Do you really think, do you think that we can believe exactly what you are saying, Secretary Paulson?

Secretary PAULSON. Well, I can tell you what you can believe. You can believe I believe everything I say and that I have been around markets for a long time and that I——

Senator BUNNING. So have I.

Secretary PAULSON [continuing]. Share your frustration at not getting GSE reform legislation done. I share your frustration with certain parts of it. Again, all I can say to you is what I have said earlier, that——

Senator BUNNING. Where will the money come from if, in fact—where will the money come from if, in fact, we have to use the backstop?

Secretary PAULSON. As I said to you, that it is my very strong belief that the way we can minimize the cost to the taxpayer, the way to minimize that cost——

Senator BUNNING. Is not to do it.

Secretary PAULSON [continuing]. And likelihood is to be unspecified and enhance the confidence in the market. So that is my answer, it continues to be my answer.

Senator BUNNING. But it does not answer the question. Where is the money going to come from if you have to put it up?

Secretary PAULSON. Well, obviously, it will come from the Government. But I would say——

Senator BUNNING. And who is the Government?

Secretary PAULSON. The taxpayer. And what I am looking to do is the same thing you are, Senator, to minimize the cost to that taxpayer. And I think the surest way to do that is——

Senator BUNNING. Secretary Paulson, I know you are very sincere in your proposal.

Secretary PAULSON. Yes.

Senator BUNNING. But come January, you will be gone.

Secretary PAULSON. Right.

Senator BUNNING. And the rest of us will be sitting at this table, or at least most of us. And we have to be responsible to the taxpayer for what we have done. And I do not think this is a responsible——

Secretary PAULSON. Then Senator, you will vote against it in all your wisdom.

Senator BUNNING. I will do everything I can to stop it.

Secretary PAULSON. And maybe you will have a better plan, but——

Senator BUNNING. Yes, I had one about 2 years ago.

Secretary PAULSON. But I am about getting something done that can get done that will make a difference, and in my judgment is in the best interest of the taxpayer and will minimize the cost to the taxpayer.

Senator BUNNING. Thank you, Mr. Chairman.

Secretary PAULSON. You and I, respectfully, disagree.

Chairman DODD. Thank you.

Senator Tester.

Senator TESTER. Thank you, Mr. Chairman.

Secretary Paulson, for a number of decades you were a banker. You probably wish you were back in that realm once more. But I just want to lay out a scenario for you and put on your old banker hat for a minute.

If I were to come into you and ask you for an 18-month line of credit, unlimited, to be able to use any time I chose to use it within that 18 months with little or no assets backing it up, what would you say?

Secretary PAULSON. Senator, what I am asking for is unspecified 18 months. I have said I will consult with you. And if I was sitting where you are and you were asking me for what I am asking for, I would say yes because given my experience in the markets, I understand what market confidence is all about.

As I said, you all have had more experience than I have had in Government. You have had more experience watching these GSEs, playing your Congressional role as it relates to them.

I can just tell you, given where we are now, that if I were sitting where you were, I would say yes.

Senator TESTER. I appreciate the fact you brought forth a solution. I will go back to what the Chairman said. There has been a total—from my perspective—lack of oversight in the industry and it has gotten away. But let us just lay out the scenario. Let's say you have to use that. Let's say we do not do anything. In which case we hit a point where reserves versus loans in the GSEs hit a critical point and then the Federal Government steps in anyway. Isn't that correct? Isn't that the way the current law is? I believe it is.

Secretary PAULSON. I would say that the current law we have a backstop credit facility which is $2.25 billion. Like so many other things that I found in Government, the architecture was set a long time ago, the market changed, the architecture did not change. That was put in place in 1971 when Freddie Mac had $1 billion of capital.

Senator TESTER. So it is $2 billion period?

Secretary PAULSON. Yes.

Senator TESTER. And once that money is gone things tend to fold up pretty quickly; correct? What impact is that going to have on our credit rating, on the Treasury's credit rating?

Secretary PAULSON. What is it you were asking?

Senator TESTER. What happens if we do nothing and the reserves to loans becomes improper proportion? What happens to our Treasury credit rating when that happens?

Secretary PAULSON. As I said, we have no intent to nationalize——

Senator TESTER. No, I am talking if we do nothing and you spend the $2 billion, what I am asking is what happens? What is the downside?

Secretary PAULSON. Well, the downside, the least of the downside if you spend that and nothing happens, the least of the downside is the $2.25 billion. We are talking about, Senator, two huge organizations.

Senator TESTER. But it has got to be bigger than that. You are talking about potentially spending $1 trillion here. I mean, whoever you, or whoever the next Secretary of the Treasury is, if we pass this you are giving temporary authority to spend any amount of money that you want or whoever sits in your chair wants. It could be $1 trillion.

And the question is if we are not—I am trying to give you a chance to explain what happens if we do nothing. If we do nothing, if this body does nothing, what is on the law right now you said is there will be a $2 billion expenditure. And then what happens? What happens to our credit rating in the Treasury? What happens to the housing market, people's availability to get money, interest rates? What happens?

Secretary PAULSON. Rather than speculating about a lot of things, what I will say to you is this: first of all, these entities are essential right now to the housing markets. I tried to explain that earlier. They are essential to homeowners. They have got securities all over the world. The confidence in their securities are essential to confidence in our capital markets.

Senator TESTER. I am going to put that question in writing for you, because truthfully, if I am going to vote to allow you or who-

ever sits in your chair the ability to spend an unlimited amount of money, I want to know what happens if I do not allow you that ability. I want to know. I do not want to know what projected interest rates are going to be and how long—you are in the business—how long you project them to be hi or low or no money available in the credit market, and the list goes on and on and on. Or what happens to our credit rating in the Treasury notes. All those things.

I mean, I think they are really important. I mean, you might not want to speculate. But the truth is that you guys are the professionals. You guys deal with this issue every day. And if you had not been confirmed and were not in this position, it is a position of leadership. And we need to know what you think.

That is all. I am not being critical.

I do want to go back to what Senator Hagel said, though, about accountability, and accountability of the people who run the GSEs. Because right now what we saw, what we have seen from my perspective is a housing downturn, the banks start doing all sorts of funky stuff, going belly up and that kind of thing.

And then you have got the GSEs who are supposed to be a backstop to them, if I see the picture correctly. And they are in as bad a shape or worse than some of the banks that they are supposed to be the backstop for. How did this happen?

Secretary PAULSON. Again, first of all, I do not buy into the proposition that these institutions are not viable, that these institutions are playing a very major role right now in the economy.

Now in terms of what has happened, I tried to address that earlier in a couple of other questions. In many ways, you would be better off asking the CEOs directly. But from my perspective, you have large entities, a single line of business, home finance. You have an event where a major downturn in home prices. So it should not be surprising to anybody that they would have some issues to work through.

And they have been working through those issues. They have been playing a very important role in our housing market.

Senator TESTER. OK, my time is done. I am sorry, Mr. Chairman, for using more time than I should have.

I will have some more questions for the record. I appreciate all three of you being here today. I am sorry I could not ask questions to you, Chairman Cox. I do have some questions about how the investigation is going. We need to visit again. You talked about a previous person who is—on a different issue—who was nailed. I would like to know how this is proceeding because the longer it goes the more people tend to forget. But that is all.

Thank you very much, Mr. Chairman.

Chairman DODD. Thank you, Senator, very much.

Senator Dole.

Senator DOLE. Thank you, Mr. Chairman.

Chairman Bernanke, like Senator Hagel, I have been concerned about the health of these entities long, long before we got here today. In fact, I am sponsoring with Senator Hagel legislation to reform the GSEs since my first year in the Senate.

Now let me try to look down a little different path to shift to another future focus. Last week, in a speech that you delivered at an

FDIC forum, you stated that since 2005 the Federal Reserve Bank of New York has been providing leadership for a major joint initiative by the public and private sectors to improve arrangements for clearing and settling credit default swaps and other over-the-counter trade derivative contracts. Furthermore, I believe that the offices at the Department of the Treasury and at the SEC have been looking at ways to improve the clearing of CDS.

Could each of you tell us more about how regulators are attempting to make the CDS and other OTC derivatives markets more transparent?

Mr. BERNANKE. Let me start. This is a very important part. It is an unglamorous part but it is an important part of the financial system to make sure that contracts are honored, that there is good record keeping and so on.

The Federal Reserve Bank of New York has convened a group of public and private regulators and private industry participants to try to improve the speed and accuracy with which these contracts are recorded and they have made substantial progress in that respect.

They have also extended this to some other instruments like equity derivatives, as well. It is very important, in times like these when the situation can change quickly, that everyone understand exactly what their positions are, who their counterparties are, and so on. And that is what this effort is all about.

The New York Fed is also working with the private market to work toward a central counterparty who could take both sides of these trades and create the certainty that both sides were—that the contract would be honored, so it would not have to be bilateral and over-the-counter.

Other changes are being made, for example providing for cash settlement in case the bond in question is not available. And as you indicated, improving transparency to provide more information to the public and to the market about the transactions that are taking place, and so on.

The objective is to move our infrastructure in a direction where there is more standardization, more central counterparty activity, cleaner resolution in case of a problem, and better transparency. We think, by taking those steps, that the fragility of the system will be reduced and will make it much better to deal with stressful situations like the ones we have experienced recently.

Senator DOLE. Mr. Secretary?

Secretary PAULSON. The Chairman did such a great job, I am only going to underscore what he said and say, to really emphasize that I think of all of the recommendations that came out of the President's Working Group on Financial Markets after this turmoil, this was the most important one. That it is strengthening that infrastructure. We have too much complexity, not enough standardization. And getting the protocols right, getting these contracts so they know that they will perform under stress is just critical to having our financial system work the way we need it to work.

Senator DOLE. Mr. Chairman.

Mr. COX. I am sorry, Mr. Secretary, are you still——

Secretary PAULSON. I was just going to say one other thing that I had not said, Mr. Chairman, at the start which is I do believe—

and just to underscore what you said—given what is going on in the world, people all around the world are watching us. And I think this is something that should be done quickly in terms of the GSEs. And I think this is something that will be a great confidence builder throughout the world, to see Republicans and Democrats, both houses, come together and do something quickly here.

Chairman DODD. I agree with that.

Senator DOLE. Earlier this month, the Financial Times published an editorial suggesting the need for regulators to begin to explore implications of the rise of equities trading. This is in an off-exchange trading environment, what is called dark pools.

As we have seen across the derivatives market during this current credit crisis, the collapse of confidence in pricing these structured products has led to serious issues that the financial markets are still grappling with as we sit here today.

I am concerned that down the road the equities market could inadvertently suffer a similar lack of price transparency by way of these dark pools. Could I ask each of you to comment on whether you have been tracking these entities and what your reaction is to transparency concerns in this area?

Mr. COX. Senator, the dark pools, of course, can only function to the extent that they have a reference price in an open and transparent market. So at least, so long as they are operating at the margin, there can be efficiencies with internal matching of trades.

But I think your point is a very, very important one. As our markets continue to become more global and we are exposed to more and more, different participants in the markets that are lacking in transparency, we have to worry as regulators that the basic function of our markets, price discovery, will not occur in the most efficient fashion unless all of the information that is necessary for that to occur is transparent.

And so we have a very, very weather eye to these developments and we want to make sure that in every corner of the market, including equities, that transparency will be maintained for the benefit not only of the efficiency in the markets and pricing, but also investor confidence and the investors' willingness to participate in these markets.

Chairman DODD. Thank you, Mr. Chairman.

Thank you very much, Senator.

Senator Casey.

Senator CASEY. Mr. Chairman, thank you very much. I think I might be the last questioner. I know those that have been waiting a long time will be happy to hear that.

I want to thank all three of you for your testimony today as witnesses. But my questions will be directed at Secretary Paulson. I had a chance earlier to ask some questions of Chairman Bernanke. And Chairman Cox, I hope I can get to you on another day, if not today.

I wanted to pick up on something the Chairman said earlier, that all of this began with predatory lending. I think all of us would agree on some of the origins of our problems here. In the State that I represent, Pennsylvania, when you are just looking at it from the perspective of the subprime market in terms of our housing challenges, it is really remarkable. A report done in the early part of

2008, when you look at the rate of subprime mortgages, just the existence of those mortgages at a very high rate, it was not just a big city like Philadelphia. The other 8 counties cited in the top 9, really, were all rural or relatively rural counties. I mentioned this, I think, to Secretary Paulson before.

In light of that, though, I just wanted to let the Secretary know, I have sent a letter today to HUD Chairman Preston and I have copied you on this letter. You can react to it or not, because you have not seen the letter. But I want to highlight what the letter is about.

It is an attempt to provide some answer, some one solution to part of our subprime crisis.

In Philadelphia, a new program called the Philadelphia Residential Mortgage Foreclosure Diversion Pilot Program—a long name for a program which does two or three things basically. No. 1, it requires face-to-face meetings between borrowers and lenders and no owner-occupied home can be sold at a sheriff's sale without the owner first getting an opportunity to take part in a "conciliation session" with lenders. That is part one.

Part two is the homeowner must participate in a free counseling session to develop a proposed payment schedule to present to their mortgage company.

And finally, the third point, the Philadelphia Inquirer reported that approximately 200 Philadelphia lawyers—you do not hear too much about lawyers in this context—200 Philadelphia lawyers have donated their time to the program. And out of 600 homeowners who are in danger of losing their homes, approximately 325 were able to avoid foreclosure and eviction.

I say that really to all three of you, but in particular to Secretary Paulson because I know you have worked a lot of months now on this problem and you have been determined and dogged and creative and resolute about it. And I would ask you to take a look at that letter and see if there is anything Treasury could do to—if you can endorse it and highlight it.

Basically, what we are asking is to take a share of the counseling money and use it for a program like that. I do not know if you have any reaction to that.

Secretary PAULSON. Senator, it sounds like a good idea and we will be on it. You have been particularly constructive in working with us and helpful and appreciate the ideas. And this is one we will very much look at carefully and follow up on.

Mr. Chairman, could I just say one other thing? That when we were talking about——

Chairman DODD. I am not sure Senator Casey is through. Are you through?

Senator CASEY. I just have about two more minutes.

Secretary PAULSON. I am sorry, Senator.

Senator CASEY. I wanted to ask you about—you had a couple of questions that were posed to you today regarding the GSE reform. And in particular in your testimony the second part of your proposal talks about 18 month temporary authority to purchase only if necessary equity in either of the two GSEs.

Am I correct in understanding that that authority, the dollar amount would be unlimited?

Secretary PAULSON. Yes, Senator. On that, again, we were not sure how to size that, what would be necessary. Again, the reason we did not want to put a specific number on it, we thought if we were unspecific it would be more confidence inspiring and it would put the Government in a stronger position and minimize, again, the cost to the taxpayer.

Senator CASEY. So the reason for the unlimited nature of it is to send a signal to inspire confidence?

Secretary PAULSON. It was to send a signal, inspire confidence, no specific plans.

But again, to get back the other topic we talked about with the backup facility. As I said before, in 1971 Freddie Mac, Treasury was given a $2.25 million line of credit for a backup facility. And then Freddie had $1 billion of assets. Today, at the end of 2007 they had $794 billion.

Again, we are asking for this for the whole system. There was a $4 billion line of credit for the Federal Home Loan Bank System. And today it is, in 1980 they had $54 billion of assets. Today they have got $1.3 trillion.

With Fannie Mae in 1971, again $2.25 billion Treasury facility. Today they have got $883 billion. Then it was $19 billion.

So again, I just think this is another example of what I have found throughout Government, a regulatory structure, a system, architecture that was set up to deal with a world that existed at one time not being updated to deal with the world we have today.

Senator CASEY. One more point. I am just about out of time. This is not in the form of a question. But I was struck by something you had in your testimony. I am looking at the second page under the second part of your proposal. This just jumped off the page at me, where you conclude that section—and I do not say this to be argumentative. I say it to ask you to deliver a message to the person that you report to.

You conclude by saying, you conclude this section by saying when you are talking about GSE reform bill, "hopefully about to be enacted with the modifications we are recommending today." The word enacted jumped off the page.

Because look, if we are going to meet the goal that you have set forth of enactment, and we all want something enacted, the President of the United States, President Bush, has to show some leadership on this. And what we have gotten so far on this particular legislation are veto threats. And in particular, he is talking about vetoing this legislation probably for several reasons. But the one reason that he keeps identifying is CDBG money, Community Development Block Grant money, not the modifications that you are recommending.

So I would ask you to tell the President that if this is to be enacted as you want, and I want, and a lot of other people, he has got to help us here. He cannot just be a partisan fighter on this. He has got to help us get this passed.

Secretary PAULSON. Senator, let me say the President is very committed to getting this passed. The focus has been on GSE reform modernization. We, in the Administration, have taken the view which is a strong view that the CDBG block grant is not called for. And it has been my expectation all the way along that

when the bill got to the President's desk it would not have that as part of it.

And I think that continues to be my expectation. And again, I just hope we can get this done quickly, that we do not take hostages. It just would be a great signal for the whole world to move this through quickly.

Senator CASEY. Thanks very much.

Secretary PAULSON. Thank you.

Chairman DODD. Senator Schumer.

Senator SCHUMER. Well, thank you. And I apologize to the witnesses. As I am sure people have mentioned, we have our Democratic and Republican Caucus lunches, and so I had to be there.

First I just, not my main point of questions, but I wanted to underscore what Senator Casey said. We are going to need broad bipartisan support to get this done. There is already word that one Republican senator said he would do everything he could to block it, which then means we need 60 votes. So we have to do this in a bipartisan way. And we just need your commitment and the President's, that they are going to do everything they can to get this done and done quickly.

I, for one, think that you have put together a good plan. And you are sort of in a funny situation here. I mean, markets always get overconfident. That is the history of them. That is why we have booms and busts. But in this world of universal knowledge, everyone gets overconfident at once. And it is not one corner of a State or then one corner of a country or even one country in the world, but everybody.

And so when the problem occurs and everyone thinks OK, we can all do no doc mortgages because housing values will always get up, everybody gets in trouble. And that means you need broad solutions.

And so I, for one, think that the irony here is the more limits we put on this, the more worried the markets be. And if the real issue here is not the fundamental strength of Fannie and Freddie, low as their stock price is, but rather the psychology, in a certain sense the more open-ended the power, the ability—not the use but the ability, as I think you said, it is a bazooka in your pocket that you hope you do not have to use—the better.

So I hope we can move this quickly and I think we ought to be careful before imposing various limitations in terms of giving the markets confidence that if, God forbid, something bad happens—and I do not think it will—the Government will be there. So I salute you on that.

The two kinds of limitations that I think are appropriate are one, in time. You have had 18 months. Maybe it should just be a year and we will renew it if, God forbid, it is still bad.

The second, and you have done some of this, is to make sure the Government comes first over the shareholders, that the Government is fully repaid before the stockholders and other financial interests get repaid. Can you assure us that the plan we put together will keep that limitation, which I think is a reasonable limitation that will not spook the markets in any way, is there?

Secretary PAULSON. Yes, Senator. As we had a discussion and Senator Shelby raised some issues there and said that, as we went

through it, it is very difficult out how to structure something when we have not even made a decision. And there is no decision, no intent, at this time to put money in.

I would say if we do, we will be very mindful of structuring something in a way in which it protects the taxpayer.

Senator SCHUMER. And you know, Freddie's debt offering yesterday, as I understand it, was oversubscribed and they were able to borrow at low rates?

Secretary PAULSON. Yes.

Senator SCHUMER. I do not think that would have happened without this plan being there in the back of people's minds. And that, I think, attests to the need for it, the need to do it quickly, and the need not to spend too much time just arguing about limitations and delaying it for a couple of weeks. Because even if there is a 5 percent chance, if you are at the precipice, you do not want to even risk falling over. Do you agree with that?

Secretary PAULSON. Thank you for your support. Thank you.

Senator SCHUMER. Yes, OK.

The second question I have to Chris Cox. This is on short selling. I asked Chairman Bernanke at the first half. I am hearing from more and more responsible people that some kinds of limitation should be placed on short selling. Not to eliminate it. It is a fundamental part of the market. We need it. And it does a lot of good things. A lot of short sellers prove companies are overstating or being too optimistic.

In the old days we had the uptick rule, which seemed to work pretty well. And then we went from selling stocks in eighths, and an eighth of a point uptick was significant, to selling it in hundredths and a one-hundredth of a point is not very significant.

But what would be wrong with reimplementing the uptick rule, not for one uptick but for say 12 upticks, so you are back to where you were before? Particularly, and I think I talked about this with Chairman Bernanke, for financial stocks, which seem to be under particular assault, and also are more subject to the psychology we talked about than those who make tangible goods?

Mr. COX. Well, Senator, I think you are right on several respects. First, our rule 10a–1, which goes back to 1938, had much more of a real life meaning when stocks were trading in eighths than after decimalization.

The effect or lack of effect of this rule was studied more carefully by economists within and without the SEC than I think anything that the Commission has done in recent years. And it was just very clear that that rule no longer mattered, that everybody was trading around it, it did not have any point.

What we do know, however—and this is a second point on which I agree with you. What we do know is that the combination of short selling and other manipulation in the market can be a very, very volatile mix. Indeed, it is a witch's brew of very dangerous activities. So we want to make sure that the combination of short selling and the intentional spread of false information can't occur in our markets. We are doing a lot of enforcement around that.

The emergency action that we announced today is going to have a lot more effect than the price test which economists have told us did not do anything.

Senator SCHUMER. No one believes you will be able to track down purveyors of false information very often. So it is not very—it is true, we should do it. But it is not very effective.

Mr. COX. No, the emergency action I am talking about is—although the enforcement piece——

Senator SCHUMER. No, I know that.

Mr. COX [continuing]. I think we will get better at. But what I am talking about is a hard locate requirement, a pre-borrow requirement for——

Senator SCHUMER. Just tell me for a minute, why would that be more effective than a modified uptick rule, which seemed to work pretty well for the decades before we went to decimalization?

Mr. COX. One of these is aimed at preventing naked short selling. If you are really trying to drive a stock down and you want to do it in a manipulative fashion, combining false information or rumors or what have you with the ability to put so much pressure on the stock that you are using shares that might not even exist, is the sort of thing that I think investors have a right to have the Federal Government guard against.

But another thing that the Commission is going to be looking at, in addition to broader rulemaking on the naked short selling side, is the question of whether some other kind of a price test that is not in pennies, that is not related to a tick, might be useful for circumstances such as we find ourselves in now. We are very open to that and, in fact, we are going to be doing it.

Senator SCHUMER. Secretary Paulson, do you have any comments on that, given your broad experience in the markets?

Secretary PAULSON. I would have the following comment: you are very right that the regulatory architecture did not keep up with the change in markets. When you went to decimalization the uptick rule became meaningless. A stock is at 100, someone can bid it up to 100.01 and then short it. I would say that is No. 1.

No. 2, I can tell you that Chairman Cox has been focused on many things that are making a big difference. And he has been focused very hard on this area and I am very supportive of the steps he has taken.

Chairman DODD. Thank you very much.

Senator Shelby.

Senator SHELBY. Thank you, Senator Dodd, Mr. Chairman.

I just want to recapitulate here, just for the record and for our knowledge base, that you are proposing, Secretary Paulson. These are your words.

First, as a liquidity backstop—that is No. 1—the plan includes an 18-month temporary increase in Treasury's existing authority to make credit available for the GSEs. You also do not want to put a dollar amount on it.

Now I understand sometime the reason for ambiguity, not stating things. But I think you could be risking the taxpayer's dollar here. I think we had better look at this. We will consult with you on this. But to give you, and we have a respect for you as Treasury, a blank check I am not sure. But I understand why you do not want to put a dollar amount on it. I think I do.

Second, your other set of your proposal is to ensure that the GSEs have access to sufficient capital to continue to fulfill their

mission. I think that is very important. And this gives Treasury an 18-month temporary authority to purchase, if necessary, equity—in other words stock—in the two GSEs. And there is no dollar amount on that, either, and so forth.

Third is something we have been working at a long time, dealing with the GSE reform, and that is to bring about a strong regulatory reform and so forth. And a strong regulator of GSEs.

Now, are you basically proposing a stand-alone, as Senator Dodd and I have, regulator over the GSE with a lot more power than they have had in the past, which you have indicated. And then a role for Treasury and the Federal Reserve here. But you are not making yourself and recommending to yourself, I hope, and for the Fed, you would be kind of co-regulators. Am I correct?

Secretary PAULSON. I was not even—I do not believe that—I do not see a role for Treasury in the consultative regulatory process.

Senator SHELBY. OK.

Secretary PAULSON. That would not be my proposal. But for the Fed it would be. And so again, as you have stated, it would not be co-regulator. Not at all. It would be, we would have a strong independent regulator. And then the Fed would have a consultative role, as we are suggesting more broadly across the whole economy but for the reasons that I have stated before.

But again, I am not suggesting that role for Treasury.

Senator SHELBY. Well, I think the Fed will obviously play—since they are the central bank here—they will play a role in any kind of a rescue package or whatever you want to call it.

On the other hand, we have not reached the point of legislation to fulfill some of your recommendations on what role the Fed will play in the future in our financial regulator, what role the SEC will play, or what role Treasury will play, and so forth. So I think these three things, Senator Dodd and I would recommend, Senator Dodd as just a member of the Committee, that we try to work with you on this. And that we also try to protect the taxpayer and see where we are going, Mr. Chairman.

Secretary PAULSON. And I would just very respectfully say I think if you institutionalized a consultative role for the Fed on something this important, it would inspire market confidence and it would help protect the taxpayer.

Senator SHELBY. Thank you.

Chairman DODD. Let me wrap up here. First of all, let me thank the three of you very, very much, particularly Chairman Bernanke, who has been tremendously patient here for a long time before this Committee this morning. But I do not think anyone would argue—I cannot think of another moment in time, certainly in my tenure, when there is as much at stake as the decisions we have to make in the coming days.

And let me end where I sort of began, Secretary Paulson, by commending you and others who worked over the last number of days in proposing some ideas here. Inaction is not an option. And clearly, we need to consider some steps that need to be taken.

Having said that, I also want to emphasize to you and I understand the need for moving expeditiously. But I want to make very sure to the extent possible we have thought about this to the extent we have to here, going through this.

There are a couple of issues that come to mind and Senator Shelby and I are going to sit down. I will be talking with my members of the Committee to go through these steps and think it through carefully.

For instance, just as a suggestion I say to you here—and I realize a statement is not a legislative proposal. So I understand the distinction between the remarks you have made here and what has to be drafted if, in fact, we are going to include some things. But on this issue involving the equity interest here, at least the language in your proposal talks about consulting with the GSEs. But I think you are going to have to spell out specifically, if the GSEs are going to be directly involved, that needs to be covered.

It cannot be the sole discretion of Treasury, in my view, or you are going to have the private markets react negatively. I happen to agree with Senator Schumer that probably the Federal Government ought to be protected. I suspect that that is going to have an undesirable reaction by the private market if they feel as though they are going to come in second at a time we are trying to get private capital into this.

So we have got to think this through. This is not a contradiction to get what needs to be done. But I want to sit down and talk with people to make sure that before we draft stuff here we are not going to do something that we are going to regret.

Now you do not intend that, and I know that.

I want to ask you, Chris, we have not asked you about this. And you have got, your job is to protect investors. What are your reactions to this? You are a talented individual. You served with us up here in the Congress. You know these issues pretty well. What is your reaction to this? This is important, to get some views that you would have on this.

Mr. COX. As you know, the SEC has had its own involvement with Fannie and Freddie, with enforcement actions. In fact, very recently, in the last year, bringing actions that have nearly broken records for penalty size and so on because of accounting.

We want to make sure that as Freddie now becomes a reporting company, so both Fannie and Freddie will be reporting companies. As you consider whether or not to maintain an exemption under the 1933 Act for their debt and their mortgage-backed securities or whether they should be treated like other private companies, that they do in fact start to look like other private companies.

My recommendation to this Committee before and again today is that that exemption be discontinued and that they become reporting companies essentially like any other private entity.

I would hope that in addition to what we are doing right now, which is in extremis, that we keep in mind the end state that we are trying to achieve and that we quickly learn the lessons of the moment, which include the fact that the systemic risk that has been able to be located in here, in part because of the Government embrace or the perception of a Government embrace of them, that that no longer be the case in the future.

I think the combination of socialized risk and private profit is a very suspect model. And so I hope that the Congress takes as much advantage of this opportunity as you possibly can to treat those problems, as well as the immediate problems. And I think given

the fact that Fannie and Freddie together comprise about $5.3 trillion out of the $12 trillion U.S. mortgage market suggest that we have not any choice but to deal with them in the near term as we are doing because of that implicit Government guarantee that has always been there.

Chairman DODD. So this idea that you have heard the Secretary talk about is one that you think makes some sense?

Mr. COX. Well, obviously, there is a big distance between this proposal of making clear to the market that the Government is going to stand behind Fannie and Freddie and how you in Congress choose to execute it. And I think it is important simply for the SEC, as the investors' advocate, as the administrator of our rules and regulations for disclosure and so on, to observe that to the extent that you can make Fannie and Freddie fit in with the rest of that system, as they have been moving toward in any case, and accomplish that in the bargain, so much the better.

Chairman DODD. Well, we may want to call upon you or your staff in the next matter of hours and so forth as we look at all of this to get some thoughts on this.

I tried to think, if I could, of another example in my 27 years where we had one regulator have to consult—at least in the language you have used here, Hank, and the way we describe the Fed's role here. I could not think of another example of where we had one regulatory statutorily—as Jack Reed was asking the question. We sort of expect that, as the Chairman pointed out he consults all the time with the SEC, I presume with the Treasury, on matters. That goes on every day.

But statutorily requiring it takes this to another level. And I am just uneasy about what we are trying to achieve here. You know, I want to hold some hearings at some point here on the architecture for financial services and the regulatory needs of the 21st century. And that needs to be done.

I am not sure I want to get to a financial services administration model yet that Great Britain has. And I respect that model. I think it works well for them. But I want to, as the Chairman of this Committee, listen to a lot of different ideas as to how we ought to create that architecture.

I wonder if we are back-dooring this a little bit here, in trying to get to that point in a moment like this, and whether or not we ought to be——

Secretary PAULSON. This is obviously your decision, and this is a major decision. And again, in terms of the U.K., we suggested it. I believe they are moving to adopt it. OK. I do not say they have this now.

I think the thing you need to ask yourself, and you need to ask yourself long and hard, is when we have a system that was developed when commercial banks were not only the dominant, the predominant financial institution. And now we have a system where we have got the GSEs. We have got hedge funds. We have got investment banks. And it is going to be a long time, no matter how many hearings you hold, before the regulatory structure of this country is changed in a way in which it meets up with the world in which we live in.

And so, as we have noted, that if people look increasingly to the Fed to play a clean up role, to me we need to put ourselves in a responsibility where we minimize the likelihood that we get into situations like this. And one way to do that is to have one regulator across the whole economy—not to supplant the other regulators. But to be able to look at risks to the system. And when they see risks to the system, be able to get the information, see the risks, and play a role.

But as you rightfully point out, which is very fair, we have presented this idea and presented the idea. And what we are doing is bootstrapping it onto something which we felt would be the right move and would inspire market confidence and is an obvious step. But you may choose not to do that now, but that is——

Chairman DODD. Listen, I am more in agreement with your overall needs, in fact, and how we ought to look at the architecture down the road. That is a very legitimate question. I know there are a lot of different ideas as to what that ought to look like.

Let me ask you, Mr. Chairman. I know your answer is look, whatever Congress decides to do, you accept those conclusions. But I need to ask you whether or not you would want this role that has been described over the GSEs. In your view of the role of the Federal reserve bank, is this—put aside whether or not we decide to give it to you or not, I want to know whether or not you think you ought to have it?

Mr. BERNANKE. Well, it bears, to some extent, on this overall architecture. We need to think about the whole system and whether you want to have this kind of centerfield, safety or whatever position. And if so, what appropriate authorities would be to go along with that responsibility.

So as the Secretary points out, this is just a portion of the overall structure that the blueprint recommends. If we do only that piece, then it really is not doing the whole approach. And so in that context, it would really be ratifying, to some extent, what we already do which is talk to other regulators and we talk to OFHEO.

I do think that we could be helpful to them. They could provide information to us. And we are willing, if it is deemed valuable to do it.

But I think doing that is not the same thing as accepting this overall model that Secretary Paulson's blueprint puts forward. As I have said, I think that is a very interesting direction worth discussing. But being risk-averse, I would want to make sure that if the Federal Reserve were given such overarching authority or responsibility that the authorities that it received would be commensurate and allow it to fulfill that responsibility.

Chairman DODD. I understand that.

In other words, if I am understanding you correctly, obviously the consultative role as I understand it—we all understand the word consultative role. But I also, I think I hear you saying you do not want veto power over OFHEO?

Mr. BERNANKE. No, I do not think so. But I think—again, we can discuss it in the context of a broad reform. In this context, again we will do whatever Congress wants.

Chairman DODD. I understand.

Mr. BERNANKE. But I think the most valuable thing would be for us to be in a consulting/discussion/information exchange type of relationship.

Chairman DODD. But not a veto role?

Mr. BERNANKE. No.

Chairman DODD. Not the super regulator?

Mr. BERNANKE. That is not my thought at this moment, but we would want to think about the whole system.

Secretary PAULSON. Mr. Chairman, let me just add one thing to what Ben said, which is something we have talked about extensively obviously.

As part of the overall regulatory architecture if you decide to do that in the months ahead, to make this work for the Fed they would have to have—with the overarching responsibility—they would have to have certain authorities. They would have to have—they would not become the regulator for any of these entities, but they would have the power to get information, to disseminate information, to consult on the capital rules. And then, if they find a real deficiency, they would need to have the powers to deal with that, corrective powers.

So what the Chairman is saying is the idea that has been proposed, which would be part of something that would be much broader that you would do if you decide to do it, which would be—because we have no one today that looks across entire financial architecture and to be able to have responsibility for saying OTC derivatives, as the Senator pointed out are a problem, or to be able to look at one thing or another.

So what we have done here was just proposed a portion of that.

Chairman DODD. You are asking us to act expeditiously on something that clearly needs some urgent attention. This is an issue that deserves a lot of thought and consideration. There is a broader question. And I just do not want to have us graft on to a problem we need to address in the next few days with something that is far more far-reaching, that deserves a lot more thought and consultation before we move in that direction.

And I am, as I say, relatively sympathetic to the direction you want to move in. I do not think we want to do exactly the models we look at in some other places, but clearly some additional thought on the overall architecture. That is my concern.

Yes, Chuck?

Senator SCHUMER. Yes, thanks. I think this is a great discussion and I appreciate your leading it.

But the big conundrum we have in our financial system is it has evolved, as the Chairman has said, away from just commercial banks. Systemic risk is far more interrelated to the relationships between these hundreds and thousands of entities. And the responsibility for systemic risk is chopped up in different pieces. I mean, Bear Stearns is a classic. The authority involved for systemic risk was the Fed. But the authority that looked at Bear Stearns was the SEC. And it sort of did not add up.

And so I, for one, have been pretty strongly of the view a single regulator, particularly in regards to systemic risk, but in general makes sense. Or at least more unified regulation. And at least to my way of thinking, and I could not agree with you more, Mr.

Chairman, to take this aspect, which is looking at the GSEs and then bootstrap it and say we should do it for everybody would be a mistake.

On the other hand, when the GSEs present such systemic risk problems, you need somebody to do this. And you know, I do not think OFHEO, for instance, has the ability to look at the systemic problems that the GSEs would cause given their—so I do not—I think if we took your admonition in mind, be careful that this does not bootstrap it to everybody, but did not shy away from doing it—because I think we do have to do it with the problems the GSEs had—I think that may be a way to cut this knot as opposed to just not doing it at all.

Chairman DODD. Because the point we have made in the strong regulator is because today we have not rationalized this. We have HUD involved. We have had obviously OFHEO involved. We have others. So to try to get some consolidation with that strong regulator that is in the bill that passed the Senate last week was specifically designed to do this.

What I am leery of a little bit is having done that with this legislation we now begin to bifurcate it once again at a critical moment when we need exactly what you have said over and over again today, that very strong regulator here.

So that is the point I wanted to make. But this has been worthwhile.

Senator SHELBY. Mr. Chairman.

Chairman DODD. We will end on this note.

Senator SHELBY. I do not know who will be the answer. Will the Fed be the answer here? But it is obvious just from our discussion here that more taxpayer exposure, I think, brings about and necessitates more taxpayer protection. We are potentially layering taxpayer resources on top of massive systemic risk. And how do we balance that? How do we go? I think the Chairman will, I am sure, hold a lot of hearings on this.

Chairman DODD. We will do that, as well.

This has been very worthwhile. Again, my compliments to all of you for your involvement and your sharing some thoughts.

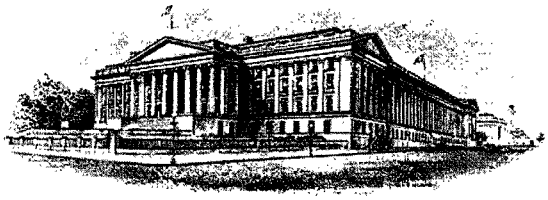
We are going to be in very close touch with you now the next couple of days here. We have got to make some decisions that will be very, very important.

So I say to my Committee members as well, and your staffs here, we need a lot of work on this over the next few days.

Thank you all very much.

[Whereupon, at 2:46 p.m., the hearing was adjourned.]

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



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL, 11:30 a.m., (EDT), July 15, 2008
CONTACT Brookly McLaughlin, (202) 622-2920

TESTIMONY BY SECRETARY HENRY M. PAULSON, JR. ON GSE INITIATIVES BEFORE THE SENATE BANKING COMMITTEE

Washington, DC— Good morning. Thank you Chairman Dodd, Senator Shelby and committee members for your leadership and for the opportunity to discuss these important issues.

As you know, our financial markets have been experiencing turmoil since last August. It will take additional time to work through challenges and progress has not come in a straight line. However, our financial institutions are repricing risk, de-leveraging, recognizing losses, raising capital and seeking to improve their financial positions. And policy makers and regulators are vigilant in their efforts to address the current challenges.

Fannie Mae and Freddie Mac, two of the government-sponsored enterprises (GSEs), are also working through this challenging period. Fannie and Freddie play a central role in our housing finance system and must continue to do so in their current form as shareholder-owned companies. Their role in the housing market is particularly important as we work through the current housing correction. The GSEs now touch 70 percent of new mortgages and represent the only functioning secondary mortgage market. The GSEs are central to the availability of housing finance, which will determine the pace at which we emerge from this housing correction.

In addition, debt and other securities issued by the GSEs are held by financial institutions around the world. Continued confidence in the GSEs is important to maintaining financial system and market stability.

Market stability and support for housing finance are among my highest priorities during this time of stress in our markets. Therefore, after consultations with the Federal Reserve, the Office of Federal Housing Enterprise Oversight (OFHEO), the Securities and Exchange Commission (SEC) and Congressional leaders we are asking Congress, as it completes its work on a stronger GSE regulatory structure, to also enact a three-part plan to address the current situation. Our plan is aimed at supporting the stability of financial markets, not just these two enterprises. This is consistent with Treasury's mission to promote the market stability, orderliness and liquidity necessary to support our economy.

Our proposal was not prompted by any sudden deterioration in conditions at Fannie Mae or Freddie Mac. OFHEO has reaffirmed that both GSEs remain adequately capitalized. At the same time, recent developments convinced policymakers and the GSEs that steps are needed to respond to market concerns and increase confidence by providing assurances of access to liquidity and capital on a temporary basis if necessary.

The plan we announced will strengthen our financial system as we weather this housing correction and establish a new world class regulator for the GSEs; it has three parts.

First, as a liquidity backstop, the plan includes an 18-month temporary increase in Treasury's existing authority to make credit available for the GSEs. Given the difficulty in determining the appropriate size of the credit line we are not proposing a particular dollar amount. Flexibility is the best means of increasing market confidence in the GSEs, and also the best means of minimizing taxpayer risk.

Second, to ensure the GSEs have access to sufficient capital to continue to fulfill their mission, the plan gives Treasury an 18-month temporary authority to purchase – only if necessary – equity in either of the two GSEs.

Let me stress that there are no immediate plans to access either the proposed liquidity or the proposed capital backstop. If either of these authorities is used, it would be done so only at Treasury's discretion, under terms and conditions that protect the U.S. taxpayer and are agreed to by both Treasury and the GSE. I have for some time urged a broad range of financial institutions to raise capital and at Treasury we have constantly encouraged the GSEs to do just that. In March, at my request, both the Chairman and Ranking Member of this Committee hosted a meeting with me and the CEOs of the two GSEs where they agreed to raise capital and you began the effort to move your GSE reform bill, which is now hopefully about to be enacted with the modifications we are recommending today.

Third, to help protect the financial system from future systemic risk, the plan strengthens the GSE regulatory reform legislation currently moving through Congress by providing the Federal Reserve authority to access information and perform a consultative role in the new GSE regulator's process for setting capital requirements and other prudential standards. Let me be clear, the Federal Reserve would not be the primary regulator. As I have said for some time, the Fed already plays the role of de-facto market stability regulator and we must give it the authorities to carry out that role. This role for the Federal Reserve with respect to the GSEs is consistent with the recommendation made in Treasury's Blueprint for a Modernized Financial Regulatory Structure. Clearly, given the scope of the GSEs' operations in world financial markets, a market stability regulator must have some line of sight into their operations.

We have long maintained that the GSEs have the potential to pose a systemic risk and worked with Congress on legislation to create a GSE regulator with authorities appropriate to the task and on par with other financial regulators. We must complete this work. The Senate passed GSE reform legislation last Friday, and we urge the House to act quickly to advance this process.

As I have said, we support the current shareholder-owned structure of these enterprises. Our plan addresses current market challenges by ensuring, on a temporary basis, access to both liquidity and capital, while also ensuring that the GSEs can fulfill their mission – a mission that remains critical to homeowners and homebuyers across the country, especially during this housing correction.

I look forward to working closely with you, your colleagues in the House, and Congressional leadership in both chambers to enact this plan as part of a complete legislative package, as soon as possible. Thank you.

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Testimony Concerning
Recent Developments in U.S. Financial Markets and Regulatory Responses

by Chairman Christopher Cox
U.S. Securities and Exchange Commission

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

July 15, 2008

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

Thank you for this opportunity to describe the SEC's actions to deal with the recent developments in our financial markets.

Since the credit market crisis began with the deterioration of mortgage origination standards and a contagion of abusive lending practices, and then spread to the capital markets through securitization, the SEC has used its law enforcement and regulatory powers to contribute to orderly and liquid markets. We have acted in three main areas:

- Investigation and prosecution of violations of the securities laws;
- Regulation of problem areas in the markets, including credit rating agencies under recent authority granted us by Congress; and
- Accounting and disclosure standards to bring hidden risk into the light.

Our work in these areas has been both national and international.

First and foremost, the SEC is a law enforcement agency. Our enforcement actions to address the capital markets turmoil have involved not only our Division of Enforcement and each of the agency's 11 regional offices, but also nearly every major SEC division and office, and every area of professional emphasis, through our agency-wide Subprime Task Force. We are also working closely with other federal and state law enforcement agencies.

The SEC has over four dozen pending law enforcement investigations in the subprime area. They fall primarily into three broad categories: first, subprime lenders; second, investment banks, credit rating agencies, insurers and others involved in the securitization process; and third, banks and broker-dealers who sold mortgage-backed investments to the public.

We are investigating whether mortgage lenders properly accounted for the loans in their portfolios, and whether they established appropriate loan loss reserves. In connection with the sale of mortgage-backed securities and collateralized debt obligations, we are investigating the role of the various parties involved in the securitization process. Among

other things, we are focused on whether lenders adequately disclosed the risk profiles of underlying loans, whether they valued their portfolios appropriately, and whether they made adequate risk disclosures to investors.

We are also investigating whether investment banks and broker-dealers defrauded retail customers by making false representations, or by putting investors into unsuitable mortgage-backed investments.

As one example of these initiatives, just a few weeks ago the Commission brought enforcement actions against two portfolio managers of Bear Stearns Asset Management, whose hedge funds collapsed in June of last year. We allege that they deceived their investors and institutional counterparties about the financial state of the hedge funds, and in particular the hedge funds' over-exposure to subprime mortgage-backed securities. The collapse of the funds caused investor losses of over $1.8 B. These cases, and others like them in the subprime area, are making it clear that vigorous investor protection extends to hedge funds, which are by no means unregulated when it comes to fraud. Those who commit fraud at the expense of investors will always be the target of a relentless SEC.

That same vigorous commitment to investors extends to our jealous protection of the integrity of public disclosure. Because the reliability of information about public companies in the marketplace is so important to market confidence, there have long been clear rules in place that prohibit market manipulation by knowingly spreading false rumors. But for the entirety of its 74-year history until 2008, the Commission had never brought an enforcement action of this kind.

It is probably because of the difficulty in tracing where a false rumor starts, and proving that it was knowingly false, that these cases haven't been brought in the past. But now the same technology that instantly spreads market rumors across the globe is also helping law enforcement track down the culprits. As a result, just a few weeks after the demise of Bear Stearns, we successfully sued a trader who used instant messages to other brokerage firms and hedge funds to spread fake information about a pending acquisition. The false rumors that he started caused the stock to drop by 17%, and wiped out $1 billion of market cap in the first 30 minutes. That caused the NYSE to halt trading in the company's securities. Following our enforcement action, the Commission not only hit the trader with penalties and other sanctions, but also banned him for life from the industry. If we are successful in bringing future cases like this, I believe the penalties should be commensurate with the enormous amount of shareholder value that is destroyed by this kind of wantonness toward other people's money.

For several months, we have had other active investigations underway concerning the possible manipulation of securities prices through various combinations of manufacturing false rumors and short selling in a number of cases that may have contributed to the increase in market volatility that is impacting so many ordinary investors. In addition, the Commission has joined with other securities regulators in undertaking industry-wide sweep examinations that will include hedge fund advisors, aimed at preventing the spread

of intentionally false rumors to manipulate securities prices. Our examiners will focus on whether firms and advisers have proper controls in place, and whether those controls are reasonably designed to prevent the intentional creation or spreading of false information intended to affect securities prices, as well as other potentially manipulative conduct.

In addition to enforcing our existing regulations, the Commission is also using our authority to promulgate new rules to address serious issues that have arisen in the subprime crisis.

We are using our new authority under the Credit Rating Agency Reform Act to write sweeping new regulations to deal with one of the most significant problem areas that led to the spread of the subprime crisis. Until the passage of this landmark legislation, the credit rating industry has been largely unregulated. Now, in the 10 months since the first firms became registered under the new law, they are subject to thorough-going regulation of everything from their public disclosures, to their management of conflicts of interest, to their ability to prevent unfair, abusive, or coercive behavior in the ratings process.

The new law also gave us the authority to examine these firms, and we have been aggressively using it. Our examinations have focused on the rating agencies' processes for rating subprime residential mortgage-backed securities and collateralized debt obligations. We've looked at whether they followed impartial procedures for determining credit ratings, or instead diverged from their stated methodologies in order to publish higher ratings. As you know, we recently provided to the Committee a complete report of our staff's findings in these examinations. The report describes serious shortcomings in the three largest credit ratings agencies, including a lack of disclosure to investors and the public, inadequate policies and procedures to manage the rating process, and insufficient attention to conflicts of interest.

All of the issues that we identified in these examinations are being squarely addressed through real-time supervision, and through new rulemaking. Our proposed new rules directly address concerns about the integrity of the firms' ratings procedures and methodologies. They also address conflicts of interest and require disclosures that are specifically designed to increase the transparency and accountability of the firms and their ratings. Our proposed rules also require that a rating agency differentiate the ratings it issues on structured products from those it issues on corporate bonds through the use of different symbols, or by issuing a report explaining the differences. The new rules would also clarify for investors the limits of credit ratings, and the purposes for which they're suited.

Even before these new rules take effect, the firms themselves have committed to the SEC that they will make changes in their own procedures. Each of the firms we recently examined has agreed to take remedial measures as recommended in our report. In addition to following up with these firms to evaluate whether they have in fact complied, we will also initiate examinations of each of the other credit rating agencies registered with the SEC in the coming months.

The subprime crisis was also deepened by problems with disclosure and accounting. In recent months our Division of Corporation Finance has asked financial institutions to provide additional disclosure regarding both off-balance sheet arrangements and the application of fair value to financial instruments. The Division also provided suggestions to improve the transparency and content of this disclosure to investors. It encouraged disclosure about the types of events that could require consolidation of off-balance sheet arrangements, as well as the implications of consolidating if it were to occur. And it encouraged disclosures that would help an investor understand the significance of fair value measurements, including how they were determined by management and the judgments used by management. Financial institutions have improved their disclosures in subsequent public filings by taking into consideration these suggestions.

A related set of issues concerns the application of accounting rules to balance sheet consolidation and fair value accounting. The Commission's Chief Accountant has asked the Financial Accounting Standards Board to revisit the underlying accounting guidance to determine whether the subprime experience points to the need for changes. This review by the FASB is currently underway.

Yet another pathology of the subprime crisis has been the difficulty of applying fair value accounting rules to assets for which there is no current market. Last Wednesday, the Commission hosted a Roundtable to hear from market participants and regulators about the challenges of the current fair value accounting and auditing regime. While the consensus of the panelists was that fair value standards provide important discipline for market participants and important information to investors, there were calls for additional information on how best to implement these standards at the margin, and especially in today's challenging market conditions. We are now working with both FASB and the PCAOB to tackle that challenge.

Since the events of mid-March that culminated in the Bear Stearns acquisition, the SEC has broadly engaged with other regulators on issues related to capital and liquidity. The lessons from recent market events were clear when it came to both securities regulators' and bank regulators' analysis of the adequate levels of both capital and liquidity. The SEC has broadly strengthened liquidity requirements for the largest investment banks. We are closely scrutinizing the secured funding activities of each CSE firm, to encourage the establishment of additional term funding arrangements and to reduce their dependency on "open" transactions.

Working together with the Federal Reserve, we have developed additional stress scenarios in light of the Bear experience that are focused on shorter duration but more extreme events. These scenarios entail a substantial loss of not only unsecured funding, but secured funding as well. They also assume no access to the Fed's liquidity facilities. And we are continually discussing with CSE senior management their longer-term funding plans, including specifically their plans for selling risky assets and raising new capital -- both equity and long-term debt.

Our recently concluded Memorandum of Understanding with the Federal Reserve Board is facilitating this cooperation as well as our joint work in a number of other important areas, including anti-money laundering, bank brokerage activities under the Gramm-Leach-Bliley Act, the regulation of transfer agents, and clearance and settlement in the banking and securities industries.

This cooperative focus on clearance and settlement is especially important when it comes to the over-the-counter derivatives markets, where the investment banks the SEC supervises are some of the most active participants. To enhance their operational capacity, we are encouraging the firms to reduce their gross exposures by tearing up, or netting, offsetting positions. And they are doing this -- both bilaterally with trading partners, and multilaterally through vendor-provided solutions. The SEC, the Fed, and other regulators are also discussing whether and how the market for OTC derivatives contracts might benefit from a central clearing party for the credit default swaps market. In our view, this could serve to handle spikes in transaction volume, and promote certainty of contract settlement. It would also reduce the negative effects of misinformation and rumors that can occur during high volume periods.

The subprime crisis has affected markets all over the world, and so for months we have been working with our international regulatory counterparts to ensure that our solutions to these problems work across national boundaries. As Chairman of the Subprime Task Force of IOSCO, I have had an exceptional opportunity to coordinate with other national regulators both on diagnosing the problems that led to the current distressed market conditions, and on the best regulatory solutions. Since March we have been working with the Basel Committee to amend the capital adequacy standards to deal explicitly with liquidity risk. And because the American credit rating agencies are relied on around the world, we have worked closely with our overseas counterparts to revise the international code of conduct for rating agencies.

The SEC's mission to protect investors, maintain orderly markets, and promote capital formation is more important now than it has ever been. We will continue to work not only within the SEC but in close cooperation with our regulatory counterparts to promote the continued health and vibrancy of our markets. Thank you again for this opportunity to discuss these important issues. I am happy to take your questions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM CHRISTOPHER COX

PROTECTING ANY FEDERAL GOVERNMENT INVESTMENT IN THE GSES

Chairman Cox, presently Fannie Mae and Freddie Mac are exempt from the registration and disclosure provisions of the Federal Securities Laws.

Q.1. If the Federal government purchases GSE debt or stock as set forth under Secretary Paulson's proposal, should the exemptions for the GSEs be removed so that U.S. taxpayers have the full protection of the Securities Laws?

A.1. Whether or not the Federal government purchases GSE debt or stock, it is my longstanding recommendation to the Congress that both Fannie Mae and Freddie Mac should be required to become public companies essentially like any other private entity. I believe this will benefit the strength and liquidity of the market by ensuring the timely availability of information for investors and other market participants and help to restore overall market confidence in these entities.

CORPORATE GOVERNANCE

Chairman Cox, you have testified previously to this Committee about the corporate governance issues raised by sovereign wealth fund investments in U.S. companies. By an unfortunate turnof-events, today we are talking about investments in U.S. companies by the U.S. government.

Q.2. Would you please discuss the problems raised by government investments in private corporations?

A.2. Neither our market economy nor the authorities given to government agencies to regulate it are premised on government ownership of commercial enterprises. Government's role as regulator necessitates an arms-length relationship to commercial entities and their competitive concerns. Conflicts of interest necessarily arise when government is both the regulator and the regulated. Rules that might be rigorously applied to private sector competitors may not necessarily be applied in the same way to the sovereign who makes the rules and whose interest becomes, in part, protecting its own investment. Use of taxpayer funds also heightens demands for political scrutiny, which further weakens the independence of regulation that is normally a strength of our system.

Q.3. What protections should be considered to address these problems in connection with any investments by the Treasury Department in Freddie and Fannie?

A.3. Any government investment should be designed to minimize the duration of that investment. To encourage rather than discourage private sector investment in these entities, the government's investments should be on the same terms as private investors, so that the goal of government intervention is not seen as threatening the interests of private investors.

FED-SEC MEMORANDUM OF UNDERSTANDING

Chairman Cox, the Fed and the SEC recently signed a memorandum of understanding regarding information sharing and coordinating oversight of primary dealers. In the agreement, the SEC and Fed agreed to cooperate with each other in setting capital requirements for primary dealers. The Federal Securities Laws, however, confer on the SEC alone the authority to regulate the capital requirements of all broker-dealers.

Q.4. Chairman Cox, would you please explain why the SEC considered it necessary to relinquish its authority over the regulation of broker-dealers?

A.4. The SEC has not relinquished any authority over the regulation of broker-dealers. The SEC-Federal Reserve Board Memorandum of Understanding (MOU) which was signed on July 7, 2008, explicitly states that nothing in the MOU modifies in any way the ability and responsibility of the Commission to enforce its statutes and regulations. (Article II, Paragraph 4) The Federal Reserve likewise retains all of its authority. The MOU clearly states that the SEC is the supervisor of the Consolidated Supervised Entities. The MOU is aimed, rather, at cooperation among regulators.

Q.5. Does conferring authority on both the Fed and the SEC for the regulation of primary dealers risk increasing the costs of regulation and make it difficult to hold regulators accountable for their oversight of primary dealers?

A.5. Primary dealers are banks and broker-dealers that trade in U.S. Government securities with the Federal Reserve Bank of New York These banks and broker-dealers are regulated under the same regulatory regime as other similarly constituted financial institutions (some as CSEs, and some as ANCHCs). There is no regulatory regime applicable solely to primary dealers since the disbandment in 1992 of the Federal Reserve's dealer surveillance unit. For these reasons, there is no increased regulatory cost or particular accountability issues raised by these firms' primary dealer status.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR TESTOR FROM CHRISTOPHER COX

At an April 3, 2008 hearing, you told me that if market manipulation or insider trading played a role in the rapid demise of Bear Stearns, "The rumors surrounding the activity you described are too big to miss, and our Enforcement Division is very active for a number of reasons." While I understand that this is a law enforcement issue, I hope this matter will be resolved promptly.

Q.1. Would you care to update the Committee on any proceedings the SEC is undertaking in this situation?

A.1. On July 13, the Commission announced that the SEC and other securities regulators are conducting sweep examinations aimed at the prevention of the intentional spreading of false information intended to manipulate securities prices. The examinations are being conducted by the SEC's Office of Compliance Inspections and Examinations, as well as the Financial Industry Regulatory Authority, Inc. and New York Stock Exchange Regulation, Inc. The sweeps include both broker-dealers and hedge fund advisers. And on April 24, the Commission brought its first-ever case of securities fraud and market manipulation for intentionally spreading false rumors.

Q.2. With your recent actions to limit certain types of short selling on major financial firms, do you believe that types of short selling may have played a role in distorting the market over the past few weeks? Did it possibly play a role in the demise of Bear Stearns leading up to its March 2008 merger with JP Morgan Chase?

A.2. The Commission's staff is currently preparing a detailed analysis of the events surrounding the distressed sale of Bear Stearns to JPMorgan Chase. That analysis is looking at the full range offactors including the role played by market rumors, novations in the over-the-counter derivatives markets, short sales, and general conditions in the credit markets. That study has not yet reached any conclusions.