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TURMOIL IN THE U.S. CREDIT MARKETS: EXAMINING RECENT REGULATORY RESPONSES

HEARING

BEFORE THE

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

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

THE STEPS THE REGULATORS HAVE TAKEN TO IMPLEMENT THE HOPE FOR HOMEOWNERS ACT, WHICH PASSED AS PART OF THE HOUSING AND ECONOMIC RECOVERY ACT (HERA), AND THE TROUBLED ASSETS RELIEF PROGRAM (TARP), WHICH WAS AUTHORIZED AND FUNDED BY THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008 (EESA), BOTH WITH REGARDS TO PROVIDING CAPITAL AND LIQUIDITY TO THE FINANCIAL SYSTEM AND PREVENTING FORECLOSURES THROUGH THE EXERCISE OF THE AUTHORITIES PROVIDED

THURSDAY, OCTOBER 23, 2008

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C O N T E N T S

THURSDAY, OCTOBER 23, 2008

WITNESSES

TURMOIL IN THE U.S. CREDIT MARKETS: EXAMINING RECENT REGULATORY RESPONSES

THURSDAY, OCTOBER 23, 2008

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

The Committee met at 10:08 a.m., in room SD–538, Dirksen 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, first of all, thank our witnesses and my colleagues for being here, and thank the audience that has joined us here this morning for this hearing. This hearing is entitled "Turmoil in U.S. Credit Markets: Examining Recent Regulatory Responses," and I am very grateful to all of you for taking the time out. I know you have other matters to be doing, so we are going to try and move along as rapidly as we can. I particularly want to thank Sheila Bair and Neel Kashkari. We have got you working overtime, obviously, and so we don't want to tie you up all day here with this. We will try and move along as quickly as we can.

With that in mind, I am going to make a quick opening statement, turn to Senator Shelby for any opening comments, and then I would ask my colleagues if they could be very brief in their opening comments. Sheila Bair has her board meeting today in town, and so we want to be able to get her back to that meeting, and I understand that, but we have some very important questions.

Senator SHELBY. It could be an important meeting.

Chairman DODD. It could be important. So I will ask my colleagues if they could be very brief or reserve their opening statements for the questioning period when they get to it as a way to get right to our witnesses and have a chance to hear from them, which is critically important to all of us.

With that, let me begin with some brief opening comments and then turn to Senator Shelby.

This morning, we consider the recent regulatory responses to the ongoing turmoil in our national and global credit markets. Those responses have included a series of measures that are in many respects without precedent in our Nation's history. These measures began, for the most part, with the decision in March of this year to commit $30 billion in taxpayer-backed funds to facilitate the acquisition of Bear Stearns by JPMorgan Chase.

They also include the decision by the Federal Reserve through the spring, summer, and fall to establish various facilities and initiatives to promote liquidity in the markets, including in the commercial paper markets. They include the takeover of the Nation's largest insurer, AIG, committing over $120 billion to this effort thus far. They include the decision to put Fannie Mae and Freddie Mac into conservatorship and provide them with $200 billion in Federal backstop.

They include the decisions to guarantee non-interest-bearing deposit accounts at insured depository institutions and to guarantee senior unsecured bank debt for a period of 3 years. And, most recently, they include the decision to invest $250 billion into lending institutions, including some $125 billion in just nine large lenders, in an effort to promote financial stability and liquidity.

According to one report, decisions taken or implemented by Federal regulators in the past 7 months have committed no less than $5 trillion in taxpayer money to stemming the tide of the credit crisis. Five trillion dollars—that is an astounding sum, equivalent to roughly one-third of our annual economy. Taken together, these decisions have made the American taxpayer a guarantor, owner, and shareholder in the financial sector of our economy to a degree never before seen in our Nation's history and rarely seen in any free market economy.

Certainly in recent months, no one can accuse Chairman Bernanke, Secretary Paulson, Chairman Bair, and others of timidity in the face of this crisis. Nearly 15 months ago, Chairman Bernanke pledged to me that he would use all of the tools at his disposal to maintain order, in a meeting we had in my office in August of 2007, in order to maintain order, stability, and liquidity in our capital markets. He has been true to his word. Likewise, Secretary Paulson, Chairman Bair, and Chairman Cox have all acted aggressively in recent weeks. And while the jury is still out regarding the ultimate impact of their actions, few if any doubt that those actions have forestalled the worst-case scenario of a complete seizure in the financial markets.

Nevertheless, one cannot escape hard truths about these regulatory actions. First and foremost is the truth that they have largely addressed the symptoms of the credit crisis rather than its cause. For nearly 2 years, since I became Chairman of this Committee, I have urged forceful and definitive action to reverse the rising tide of foreclosures that began to wash over our economy in 2007. I have not been alone in this call. Colleagues on both sides of the political aisle here have been sounding that same note for almost the same period of time. So have economists and analysts from across the political spectrum, including such distinguished individuals as former Carter and Reagan Fed Chairman Paul Volcker, Nobel Prize winners Joseph Stiglitz and Paul Krugman, former Reagan Chief Economic Adviser Martin Feldstein, and Chairman of President Bush's Council of Economic Advisers Glenn Hubbard, and American Enterprise Institute Resident Fellow Alex Pollock.

These and other experts all agree that the key to our Nation's economic recovery is the recovery of the housing market, and that the key to the recovery of the housing market is to reduce foreclosures. Without a solution to this central problem, the record-setting foreclosure rate, more Americans will continue to lose their homes and see the value of their largest asset plummet to the point where homeowners owe more on their mortgages than their homes are worth. Declining home values, vacant properties, and reduced revenues will destabilize more and more neighborhoods. As economist Mark Zandi noted in March of this year, and I quote him, "Only if more homeowners are able to remain in their homes will the negative cycle of foreclosures begetting house price declines begetting more foreclosures be short-circuited. This in turn is necessary to ending the downdraft in the housing market that is weighing so heavily on the economy and financial system."

Without addressing the cause of the crisis as swiftly, aggressively, and decisively as the administration has tackled the symptoms of the crisis, house prices will continue to fall or stagnate, and the value of assets based on mortgages, trillions of dollars of which are on the books of our major financial institutions, will continue to be virtually unknowable. To date, with few exceptions, we have not seen, in my view, the required dedication.

The longer we allow foreclosures to erode family wealth, neighborhood stability, and financial market liquidity, the longer our economy will take to recover from this crisis. The result will be the continuation of volatility and paralysis that our regulatory leaders are working so feverishly to address today.

A number of us have been working very hard on this problem. The Hope for Homeowners Initiative that we created in the Housing Economic Recovery Act was a good start. Ultimately, it holds the promise of helping as many as 400,000 to a million more Americans obtain safe, secure, affordable mortgages. Similarly, the Emergency Economic Stabilization Act, which was signed into law October 3rd, obligates the Treasury to implement a plan to prevent foreseeable and avoidable foreclosures. Very importantly, Section 109 of that legislation authorizes the Secretary to use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures. This slender provision alone could help countless deserving Americans escape the foreclosure trap set up by predatory lenders.

This morning we look forward to asking our witnesses what steps they are taking to implement these and other provisions designed to stop the hemorrhaging in our housing markets that has bled out into the wider economy of our country and across the globe.

We also look forward to asking them what steps they are taking to ensure that the American taxpayer is not just bankrolling the banking industry, but benefiting as well in the form of expanded lending activity. It is beyond troubling to read in recent news reports that those lenders who will be receiving billions of dollars from U.S. taxpayers are considering using those dollars not to make loans but, rather, to pursue some acquisition opportunities and to create a capital cushion, on which they will comfortably sit while the American consumer and small business person struggles. Reading such a report, it is no surprise that a majority of Americans surveyed in a CNN/Opinion Research Corporation poll this past weekend disapproved of the regulators' actions that focus on the banking industry. Doing more for homeowners is the one policy solution that a majority of those Americans said they would support. If there were ever a time that demanded that we think anew, this is it. Now that the administration has taken strong measures to stabilize financial institutions, it is absolutely imperative, in my view, that we apply the same sharp and urgent focus to help the individual homeowners whose plight is at the root cause of this crisis and to the small business owners who are valiantly struggling to stay afloat in these times.

We are very fortunate, as I said at the outset, to have a very distinguished panel of witnesses with us this morning. We look forward, as always, to hearing their thoughts on what steps we can and must take to turn from the failed policies and flawed thinking of the past and instead turn to our hopeful and prosperous future for our country.

With that, let me turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

I believe today's hearing provides an important opportunity for this Committee to conduct much needed oversight of the administration's efforts to address the considerable problems in our financial markets. Foremost among these efforts is the Treasury Department's Troubled Asset Relief Program, or TARP. When first announced, this program was to be used to purchase troubled assets from financial institutions. As market conditions have changed, however, the program has evolved considerably.

On October the 14th, the Department of the Treasury announced that it was going to use $250 billion from the program to purchase equity stakes in financial institutions. Half of this amount has already been used to take positions in nine of the largest domestic financial companies. The remaining $125 billion, it is my understanding, has been set aside and is available for use by thousands of other smaller financial institutions. And while we all recognize that markets move with incredible speed and that circumstances can change dramatically, in purchasing equity stakes in publicly held companies Treasury has deviated significantly from its original course.

We need here to examine closely the reason for this change and to understand how and why the nine specific firms were chosen to receive the initial $125 billion. We also need to understand here in this Committee how the remaining funds are going to be made available to the thousands of firms who may be eligible to receive them. Finally, we must also ensure, I believe, that the appropriate oversight scheme is in place because hundreds of billions of dollars of taxpayer money are at risk here.

The hearing here also gives us an opportunity to examine other recent initiatives intended to address the troubled marketplace. Senator Dodd has already mentioned Hope for Homeowners, but I can tell you—I believe he is on point here—that unless we do something or can do something to address the underlying fundamentals of dealing with the mortgage foreclosures and real estate, we are going to be wasting perhaps a lot of money.

Mr. Chairman, I look forward to the hearing, and I appreciate your calling it.

Chairman DODD. Thank you very much.

Let me turn to Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Thank you, Chairman Dodd, for holding this important hearing. In addition to the passage of the Emergency Economic Stabilization Act, there has been a rash of other actions by the Treasury, Fed, FDIC, and others to stabilize our economic situation. Today, we will take a closer look at these actions.

There is a common thread between all of the actions taken in recent weeks: they are temporary. While I believe the Government's actions should be "emergency" measures, these are no small efforts. Within a few months, our country will have a new administration, and within a year these measures will expire. These actions make significant changes to our financial services regulatory structure, and this Committee needs to know what the end game is for these steps.

Going forward, it is important to begin reviewing the structure of our financial system and developing regulation to create the kind of transparency, accountability, and consumer protection that now is lacking. I will continue fighting for good, effective regulation that balances consumer protection and sustainable economic growth.

I am concerned we are not yet at the end of the road in terms of financial difficulties, but I am hopeful that the many actions taken in the past weeks will help stem our economic troubles.

Chairman DODD. Thank you very much, Senator.

Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman. As you have requested, I will withhold until the question period.

Chairman DODD. I thank you for that.

Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Chairman Dodd, for holding this important hearing to focus on the financial crisis and the administration's response.

As we made clear in our negotiations with the administration over the Emergency Economic Stabilization Act, congressional oversight is essential in order to make sure the taxpayers' money is being used well and wisely, and these hearings are a vital and important element of that oversight, and I salute you for having them in a timely way.

The unfortunate truth is that the financial crisis we are facing today is not the result of an act of God or a natural disaster, some completely unforeseeable set of entirely unpredictable circumstances. It is the product of two completely avoidable failures: the failure of regulatory agencies to do their job and properly oversee the industries and firms under their purview, and the failure of banks, mortgage brokers, rating agencies, and other financial institutions to appropriately measure risk and to act accordingly.

The collapse of the housing bubble, which is at the root of all of this, as Senator Dodd has mentioned, was not the shock that many people want to make it out to be. There was plenty of evidence we were in the midst of a bubble and plenty of warning from a lot of smart people that it was going to pop sooner or later. But what it comes down to is that too many people were making too much money too easily and too quickly. Mortgage and financial firms started to behave like spoiled teenagers whose parents were on vacation. Once the party started, they didn't want it to end. And if they trashed the house in the process, well, maybe the maid would come and clean it up tomorrow. And they were right about one part of it. Their parents weren't home, because with the exception of Chairwoman Bair, who has been the adult voice in all of this, the regulators who should have put a stop to all of this nonsense before it got out of hand were nowhere to be found.

This was not an accident. The problem at its root was the lack of regulation. Certainly the Government can overregulate and snuff out all entrepreneurial vigor for which this country is known. But that was not the problem of this administration. The explicit policy of this administration for the last 8 years has been the view "Deregulate, deregulate, deregulate." The administration even appointed an SEC Commissioner and tried to elevate him to Chairman of the FTC who wanted to repeal New Deal regulations. And when that is not possible, the administration tries not to enforce the regulations that are on the books all too often.

We need thoughtful, smart, tough, and more unified regulation, which I know under Chairman Dodd and Senator Shelby's leadership we will endeavor to put in place early next year.

Now, of course, we know who is stuck with the cleaning bill for this mess: the American taxpayers. If each of us was left to our own devices, each of us would have designed a different rescue plan. Unfortunately, when left with the choice between acting on this package or doing nothing, there wasn't really a choice at all. We had to act. And Secretary Paulson, Chairman Bernanke, and Chairwoman Bair all deserve credit for not letting the ideology of do nothing, complete laissez-faire, get in the way of working to bring us back from the brink of absolute disaster.

But that does not mean my colleagues and I are happy about what we have had to do, nor does it mean we do not have serious questions remaining about how we are proceeding. I applaud Secretary Paulson for recognizing, despite his initial opposition, that the best approach to this crisis is the direct injection of capital into banks. I have argued from the very beginning that this is clearly the most effective way to support the banks and the financial system more generally. The history of our own Depression Era agency, the RFC, as well as experiences of both Japan and Sweden in the past decades have shown that, when done properly, capital infusions provide the best bang for the buck.

But doing it properly is the key, and I continue to have a number of serious questions about how this program is being implemented. I remain especially concerned that in the Treasury's zeal to make the capital injection program easily digestible for the banks, we are feeding them a little too much dessert and not making them eat enough of their vegetables.

Though you and I have spoken about this, Mr. Kashkari—and I very much appreciate your position and your rising to take this job at this crucial time—I am still not convinced that it makes much sense for banks that accept capital from the Government to continue paying dividends on their common stock. There are far better uses of taxpayer dollars than continuing the dividend payments to shareholders. And the program will only be effective if it is put to good use.

With that in mind, I, along with my colleagues Senator Jack Reed and Senator Menendez, have been urging the Treasury Department to issue guidelines—not hard rules, not legal regulations, but standards that will help guide institutions' behavior now that taxpayer money has been invested. First and foremost, I believe there should be guidelines on the use of this capital. I would like the Treasury to set out goals, perhaps based upon an institution's previous lending history, for the amount of lending that each institution that receives capital injection should be doing. This will help prevent institutions from hoarding Government capital against future losses and get the money quickly out to Main Street, which has been our stated goal all along.

On the flip side of that coin, I think Treasury and the financial regulators should issue guidance to discourage institutions from using this funding to engage in the kinds of risky and exotic financial activities that got us into this mess. We are not investing in these institutions just to see the financial wizards go back to playing their high stakes game, this time with some taxpayer money.

Third, and finally, stronger standards of care for loan modifications are needed. Chairman Bair has led the charge on this front, and the rest of the regulators and Treasury should follow her lead. There should be a requirement that any institution receiving assistance under the TARP should have to adopt a systematic and streamlined approach to loan modifications, modeled on the approach that the FDIC has utilized in institutions that it controls. Declining home prices are the root cause of this economic crisis, and avoiding foreclosures through loan modifications is perhaps the single greatest step we can take to alleviate the current situation.

Finally, last but not least, I would like to see stronger guidance issued to companies with regard to executive compensation. Even under the rules issued by Treasury, in some cases a great deal of discretion is left in the hands of the compensation committees of each institution. The Treasury Department should provide clarification and oversight for the implementation of its own rules and also begin the process of determining compensation best practices on a broader scale.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator.

Senator Hagel.

Senator HAGEL. No, sir.

Chairman DODD. Senator Menendez.

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman.

You know, Mr. Chairman, I woke up this morning and read a quote from Secretary Paulson that said, "I could have seen the subprime problem coming earlier, but I am not saying I would have done anything differently.”

Not done anything differently.

As one of the Members on this Committee who in March of last year said at a hearing that you held we are going to have a tsunami of foreclosures and the administration said that was an exaggeration, I am concerned now that we are not dealing with this much differently. The spark that led to this economic fire was the housing market, and unless we attack it at its root, it is not going to stop the wildfire that we are in.

In the month of August, over 9,800 homes entered foreclosure every day. If this statistic was that 9,800 Wall Street jobs were being lost every day, we would have ended this a long time ago.

And today we learn that the number of foreclosure filings grew by more than 70 percent in the third quarter of this year compared with the same period in 2007. And, unfortunately, Mr. Chairman, in New Jersey the news was even worse. It rose to 95 percent in foreclosure filings in the same period.

I believe, Mr. Chairman, we can no longer sit back and hope that lenders do the right thing. We can no longer simply encourage loan modifications. That clearly does not work. We cannot ask them nicely to do this. That does not work. I had one case in which a community development entity went to save a home of someone. There was $175,000 owed on it. They made an offer to the bank for $160,000. The bank turned it down. They went to the foreclosure sale with the $175,000 check, certified check to pay it off in full, and the bank bid it up to $180,000.

The Securities and Exchange Commission expected Wall Street to regulate itself and got burned. Now we are expecting lenders to modify loans on their own. Do we really expect a different result?

I do not believe Treasury is doing what is necessary to modify loans in exchange for the infusion of taxpayer dollars. And I think banks have to understand that these funds are not a gift. If they do not want to play by our rules, then they certainly do not need to cash the check. That is one set.

And then, finally, Mr. Chairman, the other set is people and businesses on Main Street are counting on the banks to use their capital that we have infused to free up lending, to prevent foreclosures, and to stimulate the economy. If used correctly, they are going to help small businesses stay open, keep their employees on the payroll, help students get college loans, families get auto loans, and homeowners modify mortgages. But if, in fact, they do not use it as we hope and unless we give them direction, if they stuff it under the mattress, then ultimately we may have made a CEO’s sleep at night comfortable where we have done nothing about stimulating Main Street.

Finally, Mr. Chairman, I do appreciate Mr. Kashkari’s efforts on minority participation here. I think it is critically important, and we are going to continue to monitor that.

And, last, I am gravely concerned about a situation where banks are taking advantage of AIG’s low credit rating to make a windfall off of transactions they have with the Nation’s mass transit agencies. And we are asking Treasury—and we will submit a question for the record, but because of the urgency of it—to have someone senior work with our Nation's transit agencies to make sure that they and the taxpayers' money are being protected.

And with that, Mr. Chairman, I look forward to the witnesses.

Chairman DODD. Thank you very much, Senator.

Senator Corker.

STATEMENT OF SENATOR BOB CORKER

Senator CORKER. Mr. Chairman, I will honor the not making a long statement. I am troubled by some of the comments that I have heard. I do appreciate the way some of the witnesses have interacted with us over time, and I do not think we would be having these hearings if it was solely because the housing market had collapsed, which any reasonable person would have expected that to do. The exuberance here was ridiculous. I think it is because of the financial wizardry, and I hope that we will not move off of focusing on that and try to focus on the wrong things.

I am very concerned about many of the statements that have been made, and I hope this hearing will shed light on the direction that we ought to be going. But thank you very much for having this hearing.

Chairman DODD. I thank you, Senator.

Let me thank our colleagues, by the way, on both sides of the aisle for making the effort to be here today, too, as well, only 12 days away from our national election. The fact that people are back from their States and participating in this very important hearing is something I appreciate, taking time away from their campaigns in the case of several people, actually candidates on a ballot. So being here is something that I am deeply grateful to my colleagues for as well.

With that, Sheila, we will begin with you, and let me just briefly introduce everybody so we can move quickly. Sheila Bair, as everyone knows, is the Chair of the Federal Deposit Insurance Corporation, no strange to this Committee at all. As Chair of the FDIC, she has taken a very proactive and very helpful role. I think several Members have made this point, and I want to add my words as well. Everyone has been working very hard, but in addition to hard work, you have been very creative and imaginative, I think, in terms of ideas that are coming forward, and I am going to be focusing my questions to you on the ideas you have, talking with Mr. Kashkari as well, about Treasury's response, the legislation we adopted, the authorities given. So just to have you be thinking about this, there are a lot of issues, and Bob Corker is absolutely correct. That is not the only subject matter. But certainly in my view, dealing with foreclosure issues is a critical one, so we thank you very, very much for being here.

Neel Kashkari is the Interim Assistant Secretary for Financial Stability and Assistant Secretary for International Affairs at the U.S. Department of the Treasury. That is a long title, for the fact that you have been asked to sort of handle this large issue and the Troubled Asset Relief Program, the TARP program. And I want to note that Mr. Kashkari played a very critical role in negotiating the details of these. We spent a lot of hours together over 13 days beginning on September 17th to October 1. The 13 days of September are ones that none of us will ever forget in terms of what happened, and you were very influential and supportive of those efforts that Senator Schumer has talked about earlier this morning.

Our next witness is the Honorable Brian Montgomery, again, no stranger to the Committee—Brian, we thank you for being here—the Federal Housing Commissioner and Assistant Secretary at the U.S. Department of Housing and Urban Development. Mr. Montgomery is currently responsible for the FHA program, which creates stable homeownership opportunities. He oversees FHASecure and Hope for Homeowners as well, designed to help families avoid foreclosure. I spoke yesterday to the Bristol, Connecticut, Chamber of Commerce, and several people stood up and had great reviews to say about the modernization of FHA and how FHA is working today. So people out in the street across the country are reacting to what has been going on. So we thank you for your work as well.

Jim Lockhart is the Director of the Federal Housing Finance Agency, assumed that position with the signing of the Housing and Economic Recovery Act in July of this year; and prior to that, he was the Director of the Office of Federal Housing Enterprise Oversight, or OFHEO. I would be remiss if I did not mention that Mr. Lockhart is also a native of Connecticut. Politics is always local, Mr. Lockhart, right? I welcome you here.

And our last witness, Elizabeth Duke, is the Governor of the Board of Governors of the Federal Reserve System. She took her office on August 5, 2008, and is serving out a term that expires on January 31, 2012, and we thank you as well, Ms. Duke, for being with us this morning.

We will begin with you. All statements, all supporting documents will be included in the record, and we welcome your statements.

STATEMENT OF SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE COMPANY

Ms. BAIR. Thank you, Mr. Chairman, Senator Shelby, and members of the Committee. I appreciate the opportunity to testify on recent efforts to stabilize the Nation's financial markets and to reduce foreclosures.

Conditions in the financial markets have deeply shaken the confidence of people around the world in their financial systems. The events of the past several weeks are unprecedented, to say the least. The Government has taken a number of extraordinary steps to bolster public confidence in the U.S. banking system.

The most recent were the measures last week to recapitalize our banks and provide temporary liquidity support to unlock credit markets, especially interbank lending. These moves match similar actions taken in Europe. Working with the Treasury Department and other bank regulators, the FDIC is prepared to do whatever it takes to preserve the public's trust in the financial system.

Despite the current challenges, the bulk of the U.S. banking industry remains well capitalized. What we now face is a confidence problem, largely caused by uncertainty about the value of mortgage assets, which has made banks reluctant to lend to each other, as well as to consumers and businesses.

Our efforts at the FDIC have been focused on liquidity. Last week, the FDIC Board and the Federal Reserve Board recommended that the Secretary of the Treasury invoke the "systemic risk exception," which he did, after consulting with the President. The FDIC Board then used the authority to create a Temporary Liquidity Guarantee Program. This program has two features. The first guarantees new, senior unsecured debt issued by banks and thrifts and by most bank and thrift holding companies. This will help the banks fund their operations. Both term and overnight funding of banks have come under extreme pressure in recent weeks, with interest rates for short-term lending ballooning to several hundred basis points over the rate for comparable U.S. Treasuries. The guarantee will allow banks to roll maturing senior debt into new issues fully backed by the FDIC.

The second feature of the new program provides insurance coverage for all deposits in non-interest bearing transaction accounts at participating institutions. These accounts are mainly for payment processing, such as payroll accounts used by businesses. Frequently, they exceed the $250,000 insurance limit and many smaller, healthy banks had expressed concerns about major outflows from these accounts. This guarantee, which runs through the end of next year, should stabilize those accounts and help us avoid having to close otherwise viable banks because of deposit withdrawals.

This aspect of the program allows bank customers to conduct normal business knowing that their cash accounts are safe and sound. This is the fundamental goal of deposit insurance, safeguarding people's money, and it is vital to public confidence in the banking system.

It is important to note that the new program does not use taxpayer money or the Deposit Insurance Fund. Instead, it will be paid for by direct user fees.

We also remain focused on the borrower side of the equation. Everyone agrees that more needs to be done for homeowners. We need to prevent unnecessary foreclosures and we need to modify loans at a much faster pace. Preventing unnecessary foreclosures will be essential to stabilizing home prices and providing stability to mortgage markets and the overall economy.

As you know, a number of steps have already been taken in this direction, but I think it is clear by now that a systematic approach is needed to help us finally get ahead of the curve. The FDIC is working closely and creatively with Treasury on ways to use the recent rescue law to create a clear framework and economic incentives for systematically modifying loans. The aim is for loan servicers to offer homeowners more affordable and sustainable mortgages.

In sharing ideas with Treasury, we have drawn from the program that we are using for modifying loans at IndyMac Federal Bank since we took control of that bank in July. We have introduced a streamlined process to systematically modify troubled home mortgages owned or serviced by IndyMac. As we have done in some past bank failures, we initially suspended most foreclosures in order to evaluate the portfolio and to identify the best ways to maximize the value of the institution.

Through this week, IndyMac has mailed more than 15,000 loan modification proposals to borrowers. More than 70 percent have already responded to the initial mailings in August. More than 3,500 borrowers to date have accepted the offers and thousands more are being processed.

The hope is that our mortgage relief program can be a model and a catalyst to spur loan modifications across the country. It is a process that most servicers can use under existing legal arrangements.

In conclusion, the FDIC is fully engaged in preserving trust and stability in the banking system. The FDIC remains committed to achieving what has been our core mission since we were created 75 years ago in the wake of the Great Depression, protecting depositors and maintaining public confidence in the financial system.

Thank you very much.

Chairman DODD. Thank you very much.

Mr. Kashkari.

STATEMENT OF NEEL KASHKARI, INTERIM ASSISTANT SECRETARY FOR FINANCIAL STABILITY AND ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF TREASURY

Mr. KASHKARI. Chairman Dodd, Senator Shelby, and members of the Committee, good morning and thank you for the opportunity to appear before you today.

I would like to provide you with an update on the Treasury Department's progress implementing our authorities under the Emergency Economic Stabilization Act of 2008. My written testimony includes a much more detailed description of where we are, but I am going to give a summary right now.

Every American depends on the flow of money through our financial system. They depend on it for car loans, for home loans, for student loans, and to meet their basic family needs. Employers rely on credit to pay their employees. In recent months, as you know, our credit markets froze up and lending became extremely impaired.

Congress, led by this Committee and others, recognized the threat the frozen credit markets posed to Americans and to our economy as a whole. Secretary Paulson is implementing the Department's new authorities with one simple goal: to restore capital flows to the consumers and businesses that form the core of our economy.

The Treasury has moved quickly since enactment of the bill to implement programs that will provide stability to our markets, protect the taxpayers to the maximum extent possible, and help our financial institutions to support our consumers and businesses across the country.

Since the announcement of our capital purchase program, we have seen numerous signs of improvement in our markets and in the confidence of our financial institutions. While there have been recent positive developments, our markets remain fragile.

I would like to spend just a quick few moments outlining steps we have taken to implement the TARP. We have seven policy teams driving forward and they are making rapid progress.

First, our mortgage-backed securities purchase program. We selected the Bank of New York Mellon to serve as a custodian and expect to hire asset managers in the coming days. A Treasury team has been working around the clock to design the auction, identify which mortgage-backed securities to purchase, and to determine how best to reach the thousands of financial institutions who may be bidding.

Two, whole loan purchase program. This team is working with bank regulators to identify which types of loans to purchase first, how to value them, and which purchase mechanism will best meet our policy objectives. They also expect to hire asset managers very soon.

Third, insurance program. We are establishing a program to insure trouble mortgage-related assets. We have submitted a request for comment to the Federal Register and are seeking the best ideas on structuring options for that program.

Four, equity purchase program. Treasury worked very closely with the four banking regulatory agencies to design and announce a voluntary capital purchase program to encourage U.S. financial institutions to raise capital to increase the flow of financing to U.S. businesses and consumers and to support the U.S. economy. Treasury will purchase up to $250 billion of senior preferred shares on standardized terms. This is an investment. The Government will not only own shares that we expect will result in a reasonable return, but will also receive warrants for common stock in participating institutions.

The program is available to qualifying U.S. depository institutions. We are working very hard to publish the legal documentation required so that private banks can participate on the same terms as public institutions. We have allocated sufficient capital so that all qualifying banks can fully participate.

Treasury and the banking regulatory agencies have announced a streamlined and systematic process to apply for the capital program. Financial institutions should first consult with their primary Federal regulator and then use the single standardized application form that's available on their regulator's website. Once the regulator has reviewed the application, they will send the application to the Treasury Department. Treasury will give considerable weight to the recommendations of the regulators and decide ultimately whether or not to make the capital purchase. All completed transactions will be announced to the public within 48 hours, but we will not announce any applications that are withdrawn or denied.

No. 5, homeownership preservation. We have begun working with the Department of Housing and Urban Development and HOPE NOW to maximize the opportunities to help as many homeowners as possible while also protecting the taxpayers. We have hired Donna Gambrell, who is the Director of the Community Development Financial Institution Fund and former Deputy Director of Consumer Protection and Community Affairs at the FDIC to oversee this effort and serve as our interim Chief of Homeownership Preservation.

When we purchase mortgages or mortgage-backed securities, we will look for every opportunity possible to help homeowners.

No. 6, executive compensation. Companies participating in Treasury's programs must adopt the Treasury Department standards for executive compensation and corporate governance.

And No. 7, compliance. Treasury is committed to transparency and oversight in all aspects of this program. We have been meeting regularly with the Government Accountability Office to monitor the program and GAO is establishing an office onsite at Treasury. The Financial Stability Oversight Board has already met several times and they selected Chairman Bernanke to serve as Chairman of the Oversight Board. The Administration is also working to identify potential candidates to serve as Special Inspector General. In the interim, Treasury is working with our own Inspector General to monitor our progress.

Now let me spend just a moment on procurement. Our approach to procurement is based on the following strategy: first, in order to protect the taxpayers, we will seek the very best private sector expertise to help us execute this program.

Second, to the extent possible, opportunities to compete for contracts and to provide services should be available to small businesses, veteran-owned businesses, minority, and women-owned businesses.

And third, we are taking appropriate steps to mitigate and manage potential conflicts of interest. Firms competing to provide services must disclose their potential conflicts of interest and recommend specific steps to manage those conflicts. Treasury will only hire firms when we are confident in our ability and their ability to successfully manage those conflicts. Our Chief Compliance Officer will be responsible for making certain that firms comply with the agreed upon mitigation steps.

Chairman, as you can see, we have accomplished a great deal in a short period of time, but our work is only beginning. A program as large and complex as this would normally take months or even years to establish. But we do not have months or years. Hence, we are moving to implement the TARP as quickly as possible while working to ensure high quality execution.

Thank you.

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

Mr. Montgomery.

STATEMENT OF BRIAN MONTGOMERY, FEDERAL HOUSING COMMISSIONER AND ASSISTANT SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. MONTGOMERY. Chairman Dodd, Senator Shelby, members of the Committee, thank you for the opportunity to address you this morning on the role of the Department of Housing and Urban Development and, more particularly, the Federal Housing Administration, in addressing the mortgage crisis.

I would like to focus my brief remarks this morning on the recently launched Hope for Homeowners program, as well as a counter cyclical role that FHA plays in the market, starting with the latter.

It was just 2 years ago that FHA was viewed as all but irrelevant. Subprime and Alt-A loans were the products of choice and we at FHA were left standing on the sidelines, hoping that the first time home buyers, who would have been better served by FHA, would find the means to survive the risky and costly products they chose instead.

As you well know, we voiced our concerns throughout this period, publicly asserting that families who could not qualify for prime rate mortgage products should access market rate financing through the FHA rather than paying more in their interest rates.

As you know, unfortunately, the crisis overtook the market and FHA became important once again as a result of the overall tightening and private conforming and the evaporation of non-prime products.

As a result of this contraction, in just the last 2 years FHA's market share has grown from 2 percent to 17 percent of the mortgage market. That is overall mortgage market. Specific to new construction, our market is now 25 percent. Let me put this increase in perspective with real numbers. In fiscal year 2007, we endorsed about 425,000 single family loans, including purchase loans, by the way, and refis. In fiscal year 2008, we endorsed more than 1.2 million, including 632,000 purchase loans. If you think about it, in the middle of this turmoil, we did 632,000 purchase loans last fiscal year.

In other words, our overall business has more than doubled this year. And we project that next year that number will be about 1.4 million. In fact, we have pumped close to $200 billion of much needed liquidity into the mortgage market during that time.

Let me just also say that our application rate is on a trajectory of 3 million applications a year, and these are levels that we have not seen in more than 10 years.

A lot of this business has been coming in through the FHASecure product, which many of you are familiar with. I remember testifying before this Committee about a year ago that I thought we might reach 240,000 borrowers in fiscal year 2008. I was off with that estimate. Since we announced the FHASecure product a little more than a year ago close to 400,000 families have refinanced out of a burdensome mortgage into a safe, affordable FHA product. We think that number will push close to 500,000 by the end of the calendar year.

Let me just talk briefly about what we have done to help our FHA-insured borrowers who are experiencing troubles. In fiscal year 2008, FHA servicers completed more than 100,000 loss mitigation actions. Of these, 96,500 are currently retaining homeownership. This is an 11.5 percent increase in homeownership retention over 2007. And overall the expected retention rate of these borrowers is 87 percent. In fact, our loss mitigation efforts by HUD have helped more than 300,000 families over the last 3 years.

I am happy to say that we also now have the Hope for Homeowners refinance rescue product available. The Oversight for H4H, as we call it, composed of the agencies represented here today, accomplished the goal of getting this program up and running by October the 1st, only 60 days after passage of the law.

As a result of this tremendous team effort, we now have the additional rescue program available to the lending community and to borrowers alike.

I'm sure you are wondering when we will see the first loan insured, the first family saved, and another tool to help us see the beginning of the end of this crisis. Let me say that I know that all of us up here today testifying before you feel the same sense of urgency. But it will take time for the lending community to get the program up and running. The unique statutory requirements make the program very different from any other FHA product and require lenders to take additional time and care to set up the program and the operations in a way that supports the program fully.

We have devoted a lot of resources over the last 2 weeks, reaching out and educating the lending community and counselors about this program. This is what we have heard from them: while they are all very interested in offering the product, they need to be vigilant and want to be vigilant about the implementation process. Lenders and counselors alike need to train staff. They need to change protocols, modify systems, and take other steps to ensure that their companies are complying with the terms of the new program.

In addition, lenders must modify their internal IT systems and protocols to ensure that they support the product fully before they move to full implementation. This kind of activity is time consuming and we should all embrace the efforts by the lending community to handle this program in a way that ensures its success.

I feel very confident that FHA will continue to play a critical role in helping families in need of refinance loans to save their homes, and also families who need safe market rate financing to purchase a home.

I thank you for the opportunity to testify here today.

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

Mr. Lockhart.

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

Mr. LOCKHART. Chairman Dodd, Senator Shelby, and members of the Committee, thank you for the opportunity to testify on the Federal Housing Finance Agency's response to the turmoil in the credit markets.

I will begin by talking about our activities as the regulator of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, and then turn to TARP.

There is no doubt that the mortgage market pendulum swung extremely widely toward easy credit, poor underwriting, risky mortgages, and even fraud. The market had to correct. But we need to prevent the pendulum from swinging too far in the other direction. Fannie Mae, Freddie Mac, and the 12 Federal Home Loan Banks have played a critical role in dampening that pendulum swing.

In mid-2006, their market share of all new mortgage originations was less than 40 percent. With the demise of the private label mortgage-backed security market, their share is now 80 percent.

On September 6th, FHFA placed Fannie Mae and Freddie Mac into conservatorship. Market conditions, compounded by a weak regulatory capital structure, meant that they were unable to fulfill their mission of providing stability, liquidity, and affordability to the mortgage market.

A critical component of the conservatorship was the three Treasury facilities that were put in place. The most important one is a Senior Preferred Agreement, which ensures that the Enterprises always will have a positive net worth. These $100 billion each facilities, which have not been withdrawn on yet, are well over three times the statutory minimum capital requirements and last until all liabilities are paid off. Effectively, it is a government guarantee of their existing and future debt in mortgage-backed securities. Both can grow their portfolios by over $100 billion, which will further support the mortgage market, as will Treasury's mortgage-backed security purchase facility.

Treasury has also provided the Enterprises and the Federal Home Loan Banks credit facilities to provide liquidity if needed. The Federal Home Loan Banks counter-cyclical capital structure has allowed them to play a critical role in supporting financial institutions and mortgage lending over the last year. Their secured advances to financial institutions have just reached $1 trillion, which is about 58 percent up from June of last year.

The new legislation added the Enterprises affordable housing goals and mission enforcement to the responsibilities of the agency. I have instructed both CEOs to examine their underwriting standards and pricing. Earlier this month, Fannie Mae and Freddie Mac canceled a planned doubling of an adverse market delivery fee. I expect future changes to reflect both safe and sound business strategy and attentiveness to their mission.

A critical component of stabilizing the mortgage market is assisting borrowers at risk of losing their homes by preventing foreclosures. Keeping people in their homes is critical, not only for the families and the neighborhoods, but for the overall housing market.

Through August, the Enterprises have done $130,000 in loss mitigation activities, but they have to do a lot more. A more systematic approach to loan modifications is essential. Well before the conservatorship actions, we had asked the Enterprises to accelerate their loan modifications with features that included potential principal write downs and forbearance. We encouraged them to join the FDIC's IndyMac loan modification program. I expect loan modifications to be a priority, both as a matter of good business and supporting their mission.

During this difficult time in our financial markets, the FHFA has been working with the Treasury, the Fed, the SEC, and the Federal banking agencies to monitor market conditions and coordinate regulatory activities. We have been assisting the Treasury Department as it develops ideas for the TARP. I also serve as a Director on the Financial Stability Oversight Board.

Foreclosure mitigation is an important objective under the TARP program. The objective applies to all Federal agencies that hold troubled assets, including FHFA as conservator of Fannie Mae and Freddie Mac. In support of the TARP, and as a Federal property manager, FHFA will work to ensure the successes of these foreclosure minimization programs.

In conclusion, FHFA and the housing GSEs have a critical role in returning the mortgage market to stability and preventing foreclosures. It will take time but I believe the many steps that have been taken will provide a much more solid foundation for creating a stable future for the mortgage markets and, most importantly, American homeowners, renters, workers, and investors.

I look forward to working with the Committee and all of Congress in achieving this goal.

Thank you.

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

Ms. Duke, welcome to the Committee.

STATEMENT OF ELIZABETH A. DUKE, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Ms. DUKE. Thank you.

Chairman Dodd, Senator Shelby, and other members of the Committee, I appreciate this opportunity to discuss recent actions taken to stabilize financial markets and foreclosure prevention efforts. My oral remarks today all focus primarily on actions taken by the Federal Reserve. My colleagues are all focusing on other important initiatives at their agencies.

Financial markets have been strained for more than a year, as house prices declined, economic activity slowed and investors pulled back from risk taking. These strains intensified in recent weeks. Lending to banks and other financial institutions beyond a few days virtually shut down. Withdrawals from money market mutual funds and prospects that net asset values would fall further severely disrupted commercial paper and other short-term funding markets. Longer term credit became much more costly as credit spreads for bonds jumped and interest rates rose.

These problems and increasing concerns about the economy caused equity prices to swing sharply and decline notably. Policymakers here and in other countries have taken a series of extraordinary actions in recent weeks to restore market functioning and improve investor confidence.

The Federal Reserve has continued to address ongoing problems in interbank funding markets by expanding its existing lending facilities and recently increased the quantity of term funds at auctions to banks and accommodated greater demand for funds from banks and primary dealers.

We also increased our currency swap lines with foreign central banks. To alleviate pressure on money market mutual funds and commercial paper issuers we implemented several important temporary facilities, including one to provide financing to banks to purchase high quality asset-backed commercial paper for money funds, and another to provide a backstop to commercial paper markets by purchasing highly rated commercial paper directly from businesses at a term of 3 months.

On Tuesday of this week we announced another program in which we will provide senior secured financing to conduits that purchase certain highly rated commercial paper and certificates of deposit from money market mutual funds.

The financial rescue package recently enacted by Congress, the Emergency Economic Stabilization Act (EESA), provides critically important new tools to address financial market problems. EESA authorized the Troubled Asset Relief Program (TARP), which allows Treasury to buy troubled assets, to provide guarantees, and to inject capital to strengthen the balance sheets of financial institutions. As provided in the Act, the Federal Reserve Board and its staff are consulting with Treasury regarding the TARP and Chairman Bernanke serves as Chairman of the Oversight Board for TARP.

Last week the first use of TARP funds was announced. The Treasury announced a voluntary capital purchase program and nine of the Nation's largest financial institutions agreed to participate. A second complementary use of TARP funds will be used to purchase mortgage assets in order to remove uncertainty from lenders' balance sheets and to restore confidence in their viability.

Another objective is to improve the modification efforts of services on these loans to prevent more avoidable foreclosures.

The Federal Reserve System is also working to develop solutions to rising foreclosures. For example, the Federal Reserve has worked with other agencies to put in place the standards and procedures for the new Hope for Homeowners program, and I serve on that Oversight Board. These loans can help borrowers who might otherwise face foreclosure because the new loan payments are affordable and the homeowner gets some equity in their homes. Lenders and servicers are analyzing their borrowers for good candidates for the H4H program. The FHA and its authorized lenders are poised to process applications.

We do appreciate the additional flexibility provided in the program by Congress in EESA, in particular allowing up front payments to junior lien holders that agree to release their claims.

In addition, the Federal Reserve System is strategically utilizing its presence around the country through its regional Federal Reserve Banks and their branches to address foreclosures. We have employed economic research and analysis to target scarce resources to the communities most in need of assistance.

The Federal Reserve System has sponsored or cosponsored more than 80 events related to foreclosures since last summer, reaching more than 6,000 lenders, counselors, community development specialists, and policymakers. For example, we sponsored five "Recovery, Renewal, Rebuilding" forums this year in which key experts discuss the challenges related to REO inventories and vacant properties and explored solutions.

We also cosponsored an event at Gillette Stadium in August that brought together more than 2,100 borrowers seeking help with servicers and housing counselors.

In conclusion, the Federal Reserve has taken a range of actions to stabilize financial markets and to help borrowers and communities. Taken together, these measures should help rebuild confidence in the financial system, increase the liquidity of financial markets, and improve the ability of financial institutions to raise capital from private sources.

Efforts to stem avoidable foreclosures, I believe, will also help homeowners and communities. These steps are important to help stabilize our financial institutions and the housing market and will facilitate a return to more normal functioning and extension of credit.

Thank you.

Chairman DODD. Thank you, Ms. Duke.

We have been joined on the Committee by Senator Bob Casey of Pennsylvania as well. Bob, we thank you for being here this morning.

I will begin the questioning here. I want to have the clock on for 5 minutes, so we will try to be brief in our questions here so everyone gets a chance to participate, knowing full well we have got a couple of people who are going to have some other demands.

Let me begin. I want to pick up—Bob Menendez, I thought—whether anyone wants to agree with his conclusions or not, I think the fact that he has framed it well in terms of getting action, getting things moving. We have had a lot of strong rhetoric, a lot of urging. As my colleague from New Jersey will recall on this Committee, this is the 76th hearing, by the way, we have had, a third of which have been on this subject matter alone in the last 20 months, but sitting here urging people to meet, having meetings, in fact, in this room with stakeholders, urging them to do workouts when it came to mortgage foreclosure issues. And as he points out, we have not seen as much as we would like.

I appreciate the testimony that there still is some movement, and others may disagree. But I have felt for the last 20 months, since this effort began, that the foreclosure issue is still very much at the heart of all of this, that we have got to get to the bottom of this. Until you find that bottom, while credit is beginning to move, it is still going to be timid, to put it mildly. And so this is really an essential element, in my view, of this effort.

So I want to focus a little bit on that. It is not the only issue, obviously, and there are other questions we have to get to. But I want to start with this one, if I can. And let me begin with you, Ms. Bair, if I can.

You note in your testimony that EESA grants authorization to Secretary Paulson to use loan guarantees and credit enhancements to facilitate loan modifications. In fact, this is not just—this is Section 109 of EESA. We cannot always say this. I am familiar with it because we wrote it, you and I did. As the author of the language specifically, I know exactly what I intended with that language.

One of the concerns we had at the time in writing the bill on September 20th, 24 hours after receiving the bill on September 19th, was to make sure that, in addition to the accountability questions, dealing with the golden parachutes, dealing with taxpayer protections, was the foreclosure issue. What could we write in this bill that would give the authority to get more than just rhetorical response to the foreclosure issue?

And so Section 109 was written to give that kind of power and authority, broad authority, which is what we intended with this bill. One of the things we all felt strongly about was to make sure we gave the needed regulatory agencies the broad authority and the resources they needed in order to respond, without Congress trying to write them for them. That certainly is beyond our capacity as an institution of 535 members to start dictating specifically. But wrote the language specifically for broad authority here.

And so I feel very strongly about that language because I know how important you felt it was and I felt it was to include it as part of the bill.

So I wonder if you might, first of all, since you have been talking about this over the last couple of days, just answer some very quick questions on this. One, could you describe briefly, if you can, how the program might work? Do you think the FDIC has the capacity to get such a program up and running quickly? And would the FDIC be willing to take on this task?

And then, Mr. Kashkari, I want to come back to you. I spoke with the Secretary of the Treasury this morning, as you may know, about this very matter, and, again, understanding there are some details to be worked on, but I certainly was left with the impression that Treasury likes this idea, would like to get it going. And I am going to make some comments about Section 102 in a minute because I know there is some pushback on that section of the bill, which I am also very familiar with. But the idea that Section 102 relates to Section 109 of the bill is baloney, in my view. But, nonetheless, would you please respond to my questions?

Ms. BAIR. Well, we are having very good discussions with Treasury, and I think Treasury is doing their due diligence, and we are sharing some ideas. And they are looking at some other things as well, and we want to respect that process and adhere to that process because, at the end of the day this would be a Treasury program, an Administration program. It would not be an FDIC program, though we are certainly willing to serve as contractor, under another provision of the bill. And, consistent with discussions we had earlier during the consideration of this legislation, yes, we think credit enhancements certainly should be looked at as a policy option because you can leverage them. With whole loan purchases, you have got to buy the whole loan. With some type of credit enhancement program, you can perhaps leverage your resources to reach a broader array—reaching a larger number of loans by providing incentives for modifications.

We think, in looking at credit enhancements, one area to look at in particular is uncertainty regarding the redefault rate, and that gets a little bit into the weeds of the loan modification process. But, based on our experience at IndyMac, we are finding a lot of investor pushback, and some of the economic analysis that servicers do to justify loan modification is complicated by uncertainty about redefaults. So once they modify the loan, what happens if the borrower still defaults on payments subsequently? And then they have to try to liquidate, and the losses are greater. So I think that is one area where greater certainty could be provided, which would make the economic decision to modify a lot more powerful, if not irresistible. So that is one area.

And I think this kind of authority should be coupled with a systematic infrastructure to do this. I think another impediment to private servicers doing these loan modifications is—they are just doing it ad hoc. They are doing it borrower by borrower. There is no industry-wide framework. I think with the IndyMac protocols we have helped that along, and the Countrywide-Bank of America agreement with the State Attorneys General is a protocol very similar to ours. So I think we have a workable model.

Also, I think another reason to look at credit enhancements is because a lot of these loans are in securitization trusts. Under the REMIC rules, I am not sure you can buy the whole loan out. So for portfolio lenders, perhaps whole loan sales or purchases would be more of an option. For loans in securitization trusts, however, you can refinance them out, which is the FHA program, but this approach has got some limitations. You have to try to provide incentives to get these loans modified while they stay in the trusts. It is very difficult to buy them out.

So, those are the general areas we are looking at. Again, I think we are having very good discussions with Treasury. Treasury and the Administration want to be careful with this, but I know Secretary Paulson is very committed. And I do not want to speak for him. Neel can. But I know from my discussions with him, he is concerned about this as much as anybody. He wants to leverage resources to the extent he can to prevent unnecessary foreclosures. I think the entire Administration feels that way. So there is a policy process underway. I think it will happen quickly, and hopefully we will be able to make some public announcements in the not too distant future.

Chairman DODD. You have the resources to do this, and FDIC is willing to do this.

Ms. BAIR. Yes, we would be happy to serve as contractor, absolutely.

Chairman DODD. Now, let me just—because I wanted to make that record. In talking about—I want to talk about 109 and 102. You can glaze over the eyes of people, but just to make it clear what we are talking about. Section 109 of the bill was to use loan guarantees and other credit enhancements to facilitate loan modifications. It is very separate and apart, in my view, from Section 102. The 102 provision was intended to serve as a potential alternative to the old idea of purchasing toxic assets. The provisions of this section were not meant to apply to the authority provided in 109. As the author of the loan modification provisions, I want to make it clear that this was not the intent of the law, nor do we read it as the letter of the law. So in terms of at least for legislative history, for those of us engaged in the crafting of it, those two sections were very separate. One came much later. Section 102 came afterwards, 109, in the order of how these were brought up. So I raise that with you.

Now, Mr. Kashkari, let me—and, again, I do not believe in revealing details of conversations I have had with the Secretary, but, nonetheless, we talked about this, this morning at some length. And as I understand it—and you have heard Ms. Bair say this as well—it is the intent of the Treasury to get this program up and working. There are things you need to work through. I am not suggesting that is done yet. But is that the position of the Treasury Department?

Mr. KASHKARI. Chairman, we are passionate about doing everything we can to avoid preventable foreclosures and encouraging loan modifications. We are, I would call us at this stage, in a policy process, understanding the proposal, understanding the details. As you know, this Committee played a real leadership role in the Hope for Homeowners program. We need to understand how this new proposal would interact, for example, with existing programs that are in place to make sure we have a thoughtful, comprehensive solution.

So we are in a policy process. We are moving very quickly, and we are looking very hard at it at this point.

Chairman DODD. We are still getting around 10,000 foreclosures a day, so every day we wait, another 10,000 families end up in tough shape. So I appreciate wanting to do it carefully, but there is a sense of urgency that I think needs to be demonstrated here in order to get this really moving.

I am not asking you not to be lacking prudence in all of this, but I hope there is a deep appreciation of what is happening far removed from this city alone, across this country, and we need to get moving on this to get to the heart of all of this.

Mr. KASHKARI. Absolutely, Chairman. We share your sense of urgency.

Chairman DODD. Now let me jump quickly to the issue of the—the banks issue. On October 20th, Monday, the Secretary said that the infusion of capital through preferred stock—talking about the equity investment here—"to increase the confidence of our banks"—I am quoting him now—"so that they will deploy not hoard their capital, and we expect them to do so."

Many have assumed that this new capital would be used to make more loans which are necessary to enable business to operate. However, recently the press has reported that several banks receiving the taxpayers' money intend to use it to buy other banks. The Washington Post reported, and I quote, "JPMorgan Chase, BB&T, and Zions Bancorporation have all said in recent days that they are considering using some of their Federal money to buy other banks. About 10 financial institutions belonging to the Financial Services Roundtable, which represents 100 of the Nation's largest financial services firms, are also considering making acquisitions with the money."

Now, I don't want to rule out acquisition as a step, and I think the word "hoarding" is the word that I sort of glomp onto. I appreciate the Secretary's comments because I can just tell you there will be a vehement response up here if that is what is perceived with these dollars is hoarding this money, providing that kind of cushion. So I appreciate the comments, but I think Senator Menendez said it well.

What can you tell us, what guarantees, what assurances, what commitments are Treasury going to extract from these lending institutions that they are not going to do this other than rhetorically begging them not to do it? I think we need more than just begging at this point.

Mr. KASHKARI. Chairman, we share your view. It is a very important point. We want our financial institutions lending in our communities. It is essential. And so if you look at some of the details—terms around the preferred stock purchase agreement, there are specific contractual provisions on how they can and cannot use the capital.

As an example, we are preventing increases in dividends because we do not think it is appropriate to take Government capital, the taxpayers' money, and then increase dividends. That does not increase capital in the financial system, so that is prohibited.

Second, share repurchases are also prohibited. We do not want to put Government capital in and then boost the stock price by buying back a bunch of shares. That is contractually prohibited.

In addition, we have got other language in there focusing on commitments around increasing lending, working hard to help homeowners. Some of them are contractual provisions. Others are more guidance in nature. But we share your view 100 percent. We want these institutions in our communities lending.

Chairman DODD. Are we going to insist upon it, not want it?

Mr. KASHKARI. Well, we are insisting upon it through all of our actions, through all of our—every dialog we have with these institutions. If you take the example of mergers and acquisitions that people have raised in the past week or so, we should look very carefully at that, because if we have a small bank, a failing bank in a community, that bank is not in a position to write loans for its small businesses, its homeowners. If a larger bank, a stronger bank, is able to acquire that and capital is put into that combined entity, that community is now better served. And so we have to be very careful about not discouraging prudent acquisitions because that can actually help us get through this troubled time that we are in right now.

Chairman DODD. I agree. They said that. I am not ruling out acquisitions. The hoarding notion is the one that really is distracting.

Senator Shelby.

Senator SHELBY. Thank you.

Secretary Kashkari, why did Treasury not attach a requirement to increase lending as a price for receiving the Government money? In other words, we are talking about lending to keep our economy going, are we not?

Mr. KASHKARI. We are, Senator. Again, we completely agree with the spirit of that, and we want our banks to lend. But we also did not want to be in a position of micromanaging our banks. We wanted to create a program where thousands of institutions across our country would volunteer to participate, and if we came in with very specific guidance on "you must do this, you must do that," we were afraid that we would discourage firms, discourage healthy institutions from participating. And it is the healthy institutions that we want to take the capital because they are going to be in the best position to lend.

Senator SHELBY. One of the big rationales from Treasury in injecting this money into these nine large banks was to make them perhaps more solvent and have more capital to lend. Is that central to the whole scheme here?

Mr. KASHKARI. It is central, Senator.

Senator SHELBY. So if it is central to the whole scheme, why aren't you insisting on in a macro sense that they not hoard the money, as Senator Dodd said?

Mr. KASHKARI. I would return, Senator, to the provisions I talked about, about prohibiting share repurchases and increasing dividends. If you put a bunch of capital in a bank and they cannot return the capital through a share repurchase or dividend——

Senator SHELBY. We understand.

Mr. KASHKARI [continuing]. The return on capital reduces. There are strong economic incentives for them to take that capital and put it to good use. Their own shareholders will demand it; otherwise, their own returns are going to come down. So we feel that the provisions we put into the agreements provide the economic incentives for them to lend.

Senator SHELBY. Another question. It is my understanding under the capital program nine banks will receive a total of $125 billion. Is that correct?

Mr. KASHKARI. That is correct.

Senator SHELBY. The remainder of the $250 billion that Treasury intends to spend on capital purchases is to be allocated among the thousands of other banks.

Mr. KASHKARI. That is correct.

Senator SHELBY. It has been suggested that some of the banks receiving funds under the program of the $125 billion do not need it and did not want it. Was requiring participation by the nine banks simply a symbolic gesture intended to mask the financial weaknesses of some of the banks? In other words, why would you want to push money on people that did not need it? In fact, if they did need it, that is what the program was about.

Mr. KASHKARI. Well, Senator, if you will allow me to say a couple points, first of all, the terms for the first nine are identical for the terms for number 10, number 100, and number 1,000. There is a range of capital that a firm can take down, 1 percent of risk-weighted assets up to 3 percent of risk-weighted assets.

Senator SHELBY. OK.

Mr. KASHKARI. So the 125 seems like a lot for nine institutions, but those nine institutions have 50 percent of the deposits in the country. So it is the same proportion for the first nine and number 4,000. There is no preference, first of all.

Second, again, this is a program, we want healthy institutions to use the capital. And we encourage the institutions to participate so that there would be no stigma. The healthy institutions who were in a strong position today can become even stronger and make even more loans. That is better for our system as a whole, Senator.

Senator SHELBY. But the Comptroller of the Currency, FDIC, the Federal Reserve—we have Governor Duke here—these are all regulators of the banking system. When one bank acquires another one, you have to get approval from the regulator. So you still have that whip in there to deal with any acquisition of any bank, either kind of suggested, forced, or voluntary, do you not? All of you. Is that fair, Chairman?

Allowing firms to fail, Mr. Secretary, over the past year, Treasury, the Fed, and FDIC have devised a broad array of programs to help prevent the failure of various financial institutions, including banks, money market funds, broker-dealers, and insurance companies. To what extent have these programs propped up insolvent firms and prolonged the current economic crisis by delaying their inevitable failure? Because some firms are going to fail whatever you do to them. How long can we—the Government, the taxpayer—continue to prop up so many institutions? And at what point does it become more cost-effective to allow firms to fail? Chairman Bair, you have to do that from time to time, and you have. First, you.

Ms. BAIR. Well, we do, and it is always a difficult decision, and the primary federal regulator actually is one that makes the decision. We have back-up authority to close banks, but we almost always defer to the primary regulator. The primary regulator makes the decision.

I think banks are a little different than other sectors of the financial services system. I think it needs to be repeated, reiterated that banks overall are very well capitalized. Yes, we have some banks with some challenges, but the vast majority are well capitalized. This is not a solvency crisis along the lines of what we saw during the S&L days. We are dealing with liquidity issues right now, and liquidity issues are harder. Sometimes the liquidity issue is the market signaling a longer-term capital solvency problem. But as the confidence problem has grown and grown, irrational fear has overtaken us somewhat. So we see institutions that otherwise are viable being threatened with closure because they cannot meet their obligations.

So that is the balancing act we are trying to strike here. With the additional liquidity guarantees and the additional capital infusion, we are trying to keep banks, that are otherwise viable, healthy and lending and to prevent unnecessary closures because of liquidity drains for institutions that otherwise have plenty of capital.

Senator SHELBY. But there are still going to be plenty of failures out there——

Ms. BAIR. There will be.

Senator SHELBY [continuing]. Whatever you do. Correct?

Ms. BAIR. And we agree with you, Senator. When it is there and it is clear, we want them closed early, because if we wait it will increase our resolution costs. We absolutely agree with that.

Senator SHELBY. Secretary Kashkari, as the Treasury moves assets from institutions by way of the TARP program, the participating institutions will have already taken out insurance on those assets in the form of credit default swaps. Will Treasury allow firms to retain the credit default swaps that they have used to hedge the securities that they sell to the Government?

Mr. KASHKARI. Senator, at this point we do not have a firm policy on what to do with any hedges associated with the assets. I think that those are complex issues that we are working through with the regulators. Once we identify exactly which assets we are going to buy and the purchasing mechanism, those are important details that we are going to work through.

Senator SHELBY. But the firms that sell their assets to the Government under the plan you are talking about, TARP, they would stand to profit if those assets default under the credit default swaps, would they not?

Mr. KASHKARI. That is true in the credit default swap market broadly. Many participants are writing insurance contracts on assets they may or may not own. So I think that that is a very important issue that we are sensitive to. I think it is an issue that we all need to wrestle with more broadly.

Senator SHELBY. Last question. What specific factors will the Treasury consider when determining whether it will make an equity purchase in a bank? What types of banks do you expect to be the best candidates for equity purchases? Those with solid balance sheets? Those with a high percentage of trouble assets? And will insolvent banks be prohibited from participating in your program?

Mr. KASHKARI. Senator, we have spent a lot of time working with the four banking regulators for them to come up with a standardized process that they are going to be reviewing applications and then making a recommendation to the Treasury Department. The regulators in many cases have their professionals in these institutions and have been working with them for years. So the regulators are best positioned to judge the viability of an institution and how healthy it is. Ultimately, it will be the Treasury Department's determination, but we are going to rely very heavily on the judgment of the regulators.

Senator SHELBY. Thank you.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Johnson.

Senator JOHNSON. Ms. Bair, thank you for coming by my office to discuss deposit insurance issues yesterday. Throughout the next year, Congress will have to make some decisions on permanent changes regarding deposit insurance coverage. Should the new $250,000 level be made permanent? And will banks be able to afford the higher premiums?

Ms. BAIR. That is a very good question. Congress sets our deposit insurance limits, and the base limit has been temporarily increased by Congress to $250,000 through the end of 2009.

I think that we will need to gauge the situation at that point. I am concerned if we still are working through our challenges that we would not want to create a cliff effect where there would be a massive exodus of money because of the drop down. So I think that is an issue that is going to have to be handled very carefully. If Congress would like to take it back down perhaps it should be done in a phased approach. But certainly I think if you keep the higher limit it needs to be built into the premium structure, and we can do that over a period of time to ease the premium impact. While we are industry-funded, we do have wide latitude to borrow from Treasury for short-term liquidity needs if we need it. We have not had to do that, and I hope we will not have to do that. But I think to maintain the principle of industry funding, it should be built into the premium structure if Congress decides to make the $250,000 permanent.

Senator JOHNSON. Continuing on, we have seen over a million loans reworked by HOPE NOW, and efforts are underway for the Hope for Homeowners program. But there are some concerns that these programs are not making a large enough difference for those facing foreclosure. How would you change what the Government and institutions are currently doing to make modifications more meaningful?

Ms. BAIR. I think we have been having excellent discussions with Treasury and our fellow bank regulators and the housing authorities about this. I think there are lots of authorities to explore. One which Chairman Dodd mentioned earlier, using credit guarantees or credit enhancements, may be an additional tool we should use. But we are behind the curve. There has been some progress, but it has not been enough. We need to act, and we need to act quickly and dramatically to have wide-scale systematic modifications with standard industry metric applied across the board. And if economic incentives need to be provided to help make the economics of those modifications work, especially for these loans that are in securitization trusts, then I think that is what we need to do.

It can be done. I think we are showing at IndyMac it can be done. I am very grateful that the Bank of America settlement also uses a protocol similar to ours. The trick is to provide the appropriate incentives, the carrots and the sticks, if you will, to make sure it is done on a more industry-wide basis.

Senator JOHNSON. This is a question for all the panel. Beginning to restructure the financial services regulatory structure is a complicated undertaking. What do each of you believe is the starting point for restructuring? What is the No. 1 structural regulatory deficiency in your opinion that needs to be corrected by Congress? Ms. Bair?

Ms. BAIR. At the top of my list would be regulatory arbitrage, which I think has taken a number of forms. There is uneven regulation. And it is true with mortgage lending standards. We did not have across-the-board mortgage lending standards, and we ended up seeing negative competition, with non-banks being very aggressive with their loan originations and that created competitive pressure on the banks to start doing the same.

I think another area is capital standards. We have had relatively strong capital standards for insured depository institutions, less so with other parts of the financial services sector. Where you are seeing the most profound distress at the institutional level is with the institutions that are most leveraged. So, again, ending that uneven regulatory treatment and having some consistency across the board and leverage constrained is another area that I hope Congress will be looking at next year. We need to have more even regulation applying to a wide range of institutions, and we also need to have resolution mechanisms—which we have for banks, but currently not for these other institutions. This is why Treasury and the New York Federal Reserve Bank had to develop a process for the Lehman Brothers and AIGs of the world, because the process for it right now just does not exist.

Senator JOHNSON. Mr. Kashkari, can you add anything to that?

Mr. KASHKARI. I agree with Chairman Bair and would add two things. One is, in March, the Treasury Department published a comprehensive proposal on how to restructure the regulatory system. It is a long-term approach.

I would also add to what she said and comment on mortgage origination standards, not just in the banks but mortgage brokers, which right now it is not done on the national level and there is not consistency. And I think bringing some type of national Federal oversight and consistent would be helpful.

Senator JOHNSON. Mr. Montgomery?

Mr. MONTGOMERY. Yes, sir. While not a banking regulator, I can say going forward that reform of the Real Estate Settlement Procedures Act—RESPA, as it is known—which, after a 6-year effort, we are on the verge of getting that out in the next 2 to 3 weeks, I think that will bring more closely into the light of day what consumers pay at the closing table, what are the terms of their loans, what are the settlement costs, things of that nature. And we think that will definitely help the process going forward.

Senator JOHNSON. Mr. Lockhart?

Mr. LOCKHART. I certainly support the Treasury blueprint and, actually, Congress in July, when they passed the law combining OFHEO with the Federal Housing Finance Board and also taking the HUD mission, it was a major step forward in the housing area of pulling the regulators together and having a much more comprehensive approach.

One thing that was left off in that legislation, as it moved through, was we were going to be put on as a member or a participant with the financial regulators and their FFIEC activity. I believe that that should be added at some point.

Senator JOHNSON. Ms. Duke?

Ms. DUKE. I think I would echo the need to draw regulation more widely, to look at probably the business models as they will develop, because I don't think the business model that we used in the past of originate to distribute will continue; but to make sure that all participants in the financial transaction chain are regulated in the same manner. Also, I think supervision and enforcement in addition to regulation are key pieces of it. And I would echo the need to have some resolution protocols for institutions that fall outside of the insured depositories. I think it is an important point that we have a mechanism for insured depositories, but we did not have anything for those that were outside of it. And the bankruptcy court did not seem to be the right place to try to deal with some of those issues.

Senator JOHNSON. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Sheila Bair, I just could not resist that idea of that across-the-board regulation, and for those of us who were involved in 1994 with the crafting of the HOEPA legislation, that legislation required all lenders—State-chartered, federally chartered institutions—to apply standards against deceptive and fraudulent practices. Not a single regulation was ever promulgated under that law for 15 years. And more than any other single thing I can think of, had that regulation been promulgated and someone enforcing them on lenders across the board, I think we would be in a very different place today.

Senator Crapo.

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

Mr. Kashkari, I want to direct my first question to you, and I want to follow up on the line of questioning that our Chairman and our Ranking Member went into with regard to the $250 billion of liquidity that has been provided to the banks. Their focus there was to make sure that those dollars were not hoarded and that the actual result would be the lending that we would like to see happening. And I understand that, and I appreciate your answers with regard to that part of the program.

The question I have goes to the toxic asset purchase issue. It seems to me that the plan to utilize these resources that Congress has provided for the purchase of toxic assets has the opposite impact. In other words, it creates an incentive for investors to stay on the sidelines for a while and watch what the Government is going to do and then maybe step in at some later date and either buy or finance purchases from the Government. And I just wonder what your thoughts are on that aspect of the proposal.

Mr. KASHKARI. Senator, thank you for the question. The question you ask is fundamental to the design of the program. The program is intended not only to buy troubled assets, but in doing so to provide price transparency to the market, because our view is that there is a lot of money on the sidelines who are interested in investing in our institutions and in these assets themselves. And our hope is that by the Federal Government taking the first step through a very open, transparent process, that will encourage private capital to come in. That is the exact intention of the program. So we agree with the spirit that you raise.

Senator CRAPO. But isn't the fact that the Federal Government is going to step in in such a major way going to create just the opposite result, namely that the private capital will sit back, stay on the sidelines, and watch for a while to see what will develop?

Mr. KASHKARI. I think it is a very good question, and I think there is some merit to that point up until we get started. And that is why we are moving as fast as we can. But once we get started— and we are going to get started slowly, methodically, let people and let the markets see what we are doing. We expect them to understand it very quickly and then start to come in.

Senator CRAPO. All right. Thank you.

Chairman Bair, I also am concerned that the direction we are heading with this, particularly with the numbers of guarantees that we are now seeing put into place, has essentially driven us far down the road toward a situation in which financial institutions are basically becoming disconnected from the risk of lending. Could you address that?

Ms. BAIR. I agree with you. These guarantees make me uncomfortable. We had a compressed timeframe to make a decision. We evaluated the pros and cons, the risks and the benefits. But at the end of the day, especially given what was going on in Europe, we did not think we had an alternative. We needed to move ahead.

I am aware of the additional moral hazard, obviously, with expanded guarantees. We have in place a heightened supervisory process on the use of these, and very tight controls over weaker institutions using these, if they use them at all. So we can compensate through the supervisory process for some of the additional moral hazard. The other key is to make sure they are temporary. And, believe me, I am determined that these will be temporary. And we are charging a premium, I would hasten to add. This is not just something we are providing. We are charging a premium for it.

Senator CRAPO. Your point on the temporary nature I think is very important. In fact, one of my questions was going to be, How do you take the guarantee away?

Ms. BAIR. Well, we are. We are out there now saying that it is going away June 30th. And I understand there might be some pressure to continue it. I do not think anybody should assume it is going to be continued. It is not. My every expectation is that it will go away.

There are things, if you needed to have some type of phased process as opposed to a clipped process, I think you can do that by reducing the cap, ratcheting up the premiums, so there are ways to ease out if we want to have a slower process. But I am resolved to end these expanded guarantees because of the additional moral hazard that they create for us.

Senator CRAPO. Thank you.

And, Mr. Kashkari, back to you. With regard, again, to the toxic asset purchase—and I am focusing now on the underlying mortgages and the question I have is: How will the servicing of the loans be handled? Will it be handled by the current servicing managers? Or are we going to create a new system or a new—I was going to say "bureaucracy"—a new set of managers and re-create the system that we have now?

Mr. KASHKARI. At this point, Senator, our intention is, where possible, to keep the servicing with the existing servicer, but send to them very specific instructions, a plan on how we want them to conduct the servicing consistent with our objectives.

Senator CRAPO. All right. Thank you. And another question I have is I appreciate the fact that Treasury has submitted a request for ideas on how we can establish the insurance program that was involved in the legislation that we had. And as you know, the liquidity crisis is not limited to the residential mortgage arena. It is expanding into a number of other areas, and the one I am thinking of right now is the commercial mortgage arena.

Has Treasury considered using the insurance program to provide a Government guarantee or an insurance for the safest part of or for some part of the commercial mortgage market?

Mr. KASHKARI. Senator, that is a very good point. We have heard a lot of the same perspectives that you raise, both from the banking regulators and from individual institutions. If you look out in the regional bank market, in particular, they have a lot of mortgages, whole loans, commercial mortgages on their balance sheets. So we think that the insurance program may well be applicable there, and these are just the very ideas that we are soliciting right now.

Our initial focus is on residential, but we are very aware of and focused as a second step on commercial

Senator CRAPO. All right. Thank you very much. And one last question I wanted to ask is you had talked a moment ago about credit default swaps and the fact that there are a number of those in which one of the swapping parties does not have an ownership interest in the underlying asset. That has been an issue that we have discussed in hearings in the Agriculture Committee on derivatives. And the question I have is: Is there no purpose for those types of swaps? I understand one of the arguments that is being made is that even though the swapping parties may not have an ownership interest, they may have a very strong financial interest in the outcome of—or in the strength of the company that is engaged in the underlying transaction, or some other type of reason for wanting to be sure that that transaction is insured.

Mr. KASHKARI. Senator, I will say, first of all, I am not an expert in the credit default swap market, so let me just set expectations. But I think you are right. I think that there are many reasons why financial institutions or financial counterparties may want to hedge certain risks that they may or may not own directly the underlying asset. So I think that is right, and I think that we need to have the experts take a hard look at that.

Senator CRAPO. All right. Thank you very much.

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

Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman.

My first question is for Mr. Kashkari. I would just like to follow up on my opening statement. I know Senator Dodd talked a little bit about this, to ensure that the capital that TARP provides to banks is effective in achieving the joint goals—stability in the financial markets, but also the unfreezing of the credit markets to deal with Main Street. So I have asked you for a while, and Senators Reed and Menendez joined me in this. What about the idea of setting some guidelines? If you have public guidelines out there—now, I realize you cannot do one size fits all, nor do I think you can mandate these things. But the idea of guidelines to help importune banks which are sensitive institutions to public—given that they are a regulated industry to public pressure would make sense. Can you please tell us if you intend or Treasury intends to put out such guidelines on, first of all, a general, a ballpark figure of how much of this capital should be lent out? You know, obviously, it would accelerate—there is a multiplier effect because for every dollar of capital you can, obviously, more than a dollar or two of lending.

Mr. KASHKARI. Well, Senator, as you and I have discussed, we share the spirit of your question completely and want these institutions to lend and provide credit to our communities. In fact, it is not published yet, but when the final purchase agreement is put out there between the Treasury and the individual institutions, there is specific language in the purchase agreement about lending and about taking aggressive steps on foreclosure mitigation. It is not a legally binding contract.

Senator SCHUMER. Right.

Mr. KASHKARI. Neither would guidelines be. But it does considerably more——

Senator SCHUMER. Is it more than just a general exhortation?

Mr. KASHKARI. Well, forgive me, I am not an attorney so I cannot tell you——

Senator SCHUMER. I am not asking you as an attorney. I am just saying if it says we encourage the banks to lend the money, it is not going to be much. If we say, you know, for every dollar of capital they get, we would expect there would be two or three or four—you know, something like that, we would expect, not mandate.

Mr. KASHKARI. Again, we do expect, but we are hesitant to put a specific dollar figure because these financial institutions—again, as you know, Senator, we are talking about very large financial institutions and very small. One size fits all is——

Senator SCHUMER. What are you going to do for banks that do not increase their lending at all that take this capital?

Mr. KASHKARI. Sure. As I mentioned previously, Senator, I think that the provisions on preventing dividend increases and stopping share buybacks provides very strong incentive for these institutions to want to lend again.

Senator SCHUMER. But we have had a couple of leading executives talk about they think that the banks—and they were talking not about their own specific institution alone—are going to just sort of hoard the money for a while, and they thought was in their best interest, and that worries me.

Mr. KASHKARI. It worries us, too. We want these institutions to lend, absolutely, but also recognize the situation we are all in right now is the situation of unprecedented lack of confidence in the system.

Senator SCHUMER. Understood

Mr. KASHKARI. And so the immediate reactions may be more reserved. I think as things—as the markets begin to sort themselves out, I would expect to see these institutions lending.

Senator SCHUMER. I would urge you to consider putting out these guidelines. And then there is one that may be easier. What about guidelines inveighing against new investments in these exotic financial instruments that brought so many of the institutions down to begin with? That is an easier one for you to write.

Mr. KASHKARI. It is a very good point, and we certainly do not want institutions taking undue risks. But, candidly, Senator, I think that my banking regulator colleagues are probably in the best position to help guide their regulated entities in the actions and steps that they should be taking.

Senator SCHUMER. Well, that is about all institutions. I am talking specifically about institutions that are benefiting from the capital injection.

Mr. KASHKARI. Yes, and, again, I think our perspective has been we want as many institutions as possible to participate and not wanting to be overly prescriptive in keeping away the healthy——

Senator SCHUMER. I know. But as I said, I think you are leaning too far in giving them dessert and not enough in making them eat their vegetables. So I hope you will consider that.

For Ms. Bair—you know, as I mentioned in my opening statement, I have tremendous respect for you. Here is something that befuddles me. We have for a year been sort of chasing our tail in terms of relieving the foreclosure problem with all these kinds of voluntary programs. And they just do not work, by and large. If the institution has the whole mortgage, they work. But for the majority of mortgages and the majority of subprime and all these that are chopped up in 40 pieces, you have the problem of one of the tranche holders—probably the riskiest piece—saying, "I am not going to participate." And we have tried and tried—Secretary Paulson, I salute Senator Dodd and Chairman Frank for their efforts. But everyone will agree none of them are really going to work. And yet we still come back to this exhortation process, and then 3 or 4 months later, we are disappointed that it has not worked.

Isn't it really true—and help me understand this—that the only way we are going to make major, major progress in limiting foreclosures and getting refinancings is changing the bankruptcy law, which is the only constitutional way to require that 40th tranche holder to come to the table and say, "Hey, under bankruptcy, I will get zero, so I will negotiate for 5 cents on the dollar or 10 cents on the dollar," or whatever. I am befuddled by the fact that that fact, which seemed so obvious to me, is not governing our actions on this. It seems almost—you know, I forgot who said, but it is hope over reality if you do it the other way in any kind of voluntary way.

Could you please address that for me?

Ms. BAIR. Well, I would agree, I think some of the voluntary efforts have helped, but they have clearly not helped enough. We are falling badly behind.

Senator SCHUMER. As you said.

Ms. BAIR. And more needs to be done. I would agree with that. I think there are authorities in EESA that can be used with a carrot as well as a stick approach to get this done on a more broad-scale basis.

We have not taken a position on the Bankruptcy Code change.

I do think, though, that whether that is or is not a good tool to put into the arsenal, hopefully we would also have a process that, prior to a borrower having to threaten bankruptcy or go into bankruptcy, we could get that loan modified.

Senator SCHUMER. Do you have any hope for—I am sorry. My time is up. Just a last question. Do you have any hope for a voluntary model? I do not.

Ms. BAIR. No. No, there needs to be a package of carrot and stick incentives. I agree with that.

Senator SCHUMER. Thank you, Mr. Chairman.

Chairman DODD. And let me say to my colleague from New York, I mentioned this before, but we may end up in a lame-duck session, and there may be various proposals. I think we have come to the point once again where I think legislatively we have to try this again as part of some other ideas. And so I am putting together a package of ideas that I will ask my colleagues to take a look at, obviously all of us here in November, as part of—whether it is a stimulus package or whatever else, but some steps we might take instead of waiting until after January to get back to maybe deal with some of these issues. And that is one of them.

Senator Hagel.

Senator HAGEL. Thank you, Mr. Chairman.

Secretary Kashkari, in your statement you noted that Treasury announced recently a streamlined, systematic process for all banks wishing to assess the $250 billion infusion program. And you further noted that qualified and interested publicly held financial institutions will use a single application form. You talked a little bit about that. You will factor in the recommendations of the regulators, and you will publish the required legal documents so private banks can participate as well as the same economic terms as the public—on the same economic terms as public banks. And you talk about allocating sufficient capital, which you believe $250 billion is enough, so that all qualifying banks can participate.

My question is, then: What is the criteria that you are going to use? Because as I understand it, it will get down to a final judgment, essentially an arbitrary judgment. You are factoring in qualifications to start with. You are factoring in input from the regulators. But, in essence, it will be yours or Paulson's or someone at Treasury's decision who gets the money and who does not. So here are a couple of the points that I would hope that you could address for me.

Do all the qualifying banks that apply, will they get into the program? If they qualify, will they get in? Is bank consolidation a factor when you start deciding who gets the money? For example, bank consolidation could be used as a lever, it could be used as a threat to force consolidation. Will you take those first two issues and give us what you can on this? Thank you.

Mr. KASHKARI. Yes, Senator, thank you for the question. The regulators are going to be the first screen for institutions, so, for example, a bank may send an application to the FDIC as an example, and the FDIC may review that application and determine that this bank is not a good candidate for a capital purchase program and may send that back to the institution, and Treasury will never see that application.

For the applications that we see with the recommendations of the regulators, in most cases I would imagine, we are going to take the guidance of the regulators because they are the ones who know these institutions very well.

There could be other factors that are also considered. So, for example, if an institution had a private capital raising at the same time that they were also seeking public capital, that would also weigh into our analysis as we determine is this a good use of taxpayer resources.

At the end of the day, this is a program that is meant for healthy institutions. We want them to lend. And so working very closely with our colleagues in the regulatory agencies, we think that that is the right approach.

To the point of consolidation, I do not think we have any specific program focus on consolidation. Again, I think it will be a case-by-case analysis with our regulatory colleagues. The example I gave I think is a good one. If you had a small failing institution that was being acquired by a much healthier, stronger institution, the idea of putting Government/taxpayer dollars into that combined entity, we think that is a good use of taxpayer dollars because that community is well served now by that combined stronger institution.

Senator HAGEL. Could you envision a scenario, with the regulator or without the regular, where you would offline in private conversations—because I suspect there will be some private conversations on these things. I have been told, as a matter of fact, that there have been by banks inquiring, checking in, how do we apply, on what basis are you going to make these determinations. Could you envision a situation where you say to a bank if you would be willing to seriously look at consolidation on whatever terms with whichever institutions, then we might well look favorably on your participation in the program?

Mr. KASHKARI. I would imagine that those types of conversations may happen between the regulators and the entities, but I would defer to my regulatory colleagues more so than——

Senator HAGEL. Chairman Bair, can you help us on this?

Ms. BAIR. Well, as Neel alluded to earlier, I think you need to distinguish between an acquisition that stabilizes a bank having some challenges versus using the additional capital to build your empire, as opposed to making loans. The former I think is something we want to encourage, and I think there may be some institutions where, on a stand-alone basis, it may not be a good investment for the Treasury, but on an acquisition basis, it might be very good. So I think that kind of healthy acquisition activity is something that should be encouraged. And, again, to the extent it would prevent failures or the risk of failure for institutions later on, that can help protect the deposit insurance fund.

Senator HAGEL. When do you think that this program will actually be in place so that you will start to make some decisions?

Mr. KASHKARI. It is in place now.

Senator HAGEL. Aside from the nine big banks.

Mr. KASHKARI. On Monday, the regulators posted application forms on their websites.

Senator HAGEL. So the banks, the institutions are now filling out the application, three pages, is that right?

Mr. KASHKARI. It is two or three pages.

Senator HAGEL. Filling out applications, working through their regulators. They are now coming into your office.

Mr. KASHKARI. And then the regulators have already begun submitting recommendations to us today on institutions that we are going to evaluate and make decisions.

Senator HAGEL. Have you made any discussions beyond the nine big banks?

Mr. KASHKARI. I do not believe at this point we have made any.

Senator HAGEL. I have not seen any. Have you made any—when would you make the next group of decisions?

Mr. KASHKARI. We are in the process within Treasury of formalizing our review process and procedures and finalizing those and begin processing those applications immediately. But I will also comment, the announcement that I talked about within 48 hours is when the contracts are finally signed. An initial approval to an institution will not trigger the official announcement. It is only when we get further down the process and we are actually signing contracts with the institutions. That is what will trigger the formal announcement within 48 hours.

Senator HAGEL. When would you think that the first additional banks beyond the first nine might be announced? A week? Two weeks?

Mr. KASHKARI. Well, announcement, again, forgive me, announcements of the actual transaction——

Senator HAGEL. Well, just get me to where we need to be, and that is, money on the street. When will they get their money?

Mr. KASHKARI. Our goal is to have the $250 billion out the door by the end of the year.

Senator HAGEL. But give me a better answer than that. You tell me the process is already underway. You are accepting applications. When, then, can you tell this Committee that we will have some money in the hands of this next series of banks? A week? Two? You will make decisions. Contracts, whatever the process is. Not your intent, your hope.

Mr. KASHKARI. Understood.

Senator HAGEL. But where are we?

Mr. KASHKARI. My expectation is a few weeks because it will take time for the banks themselves to do their work, work with their attorneys, meet with their boards as necessary, before they are in a position to sign the final contracts with Treasury. So we are going to give them initial indications very quickly so they can do all the legal work they need to do on their end before we can fund these transactions.

Senator HAGEL. But you are looking at a few weeks at best before the final deal is made. Then I assume that that means the bank gets the money?

Mr. KASHKARI. Correct.

Senator HAGEL. Over the next few weeks.

Mr. KASHKARI. I think it will be a few weeks before the next batch are actually funded.

Senator HAGEL. Thank you.

Chairman DODD. Thank you for that, Senator. I appreciate it.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman, and thank you all for your service, and I hope you all understand the questions and the line—we all have a common goal here, and maybe some of us are trying to spur you to look at some things that either you are looking at but maybe not with the intensity that many of us think you should, in fact, look at it. And so I hope you are taking them in that spirit.

Mr. Kashkari, you said in your statement you expect that all participating banks—expect all participating banks to continue to strengthen their efforts to help struggling homeowners avoid preventable foreclosures. We expect that, too, but that has not happened. And we have servicers who seem to be incentivized in a different direction. My office has been dealing with a whole host of people in foreclosure, and the servicers—you know, we have one case in which one servicer said, “Absolutely not, can’t do anything to help you,” and then we called back and got a different entity within that servicing entity, and they offered a deal that actually was something that could save the home. We have other that seem to be incentivized to go to foreclosure.

So, you know, I have a real problem in saying that we expect as we are infusing large amounts of capital. What would be wrong with, for example, Treasury promulgating guidelines on loan modifications for institutions that are participating in the capital purchase program, you know, similar to what the FDIC’s existing loan modification program is?

Mr. KASHKARI. Well, Senator, we share your concern and your focus on this issue. I personally have spent the past 14 months working with servicers and with counselors to try to reach homeowners and encourage loan modifications, and we have made a lot of progress. The industry is now at a pace of around 200,000 workouts a month, which is a huge increase from where they were when we started. But we agree with you, it is not enough. We need to do more.

So I think that the actions that we have taken and we continue to take working with these companies and with servicers, we continue—we just need to press them and push them to do everything that they can.

The hardest part about a loan modification is not the calculation. A first-year finance student could do the calculus of which is better. It is getting to the homeowner. It is getting them to pick up the phone and call. And we have worked very hard.

For example, if you will indulge me for a moment, if there is any homeowner out there that is concerned about losing their home, the worst thing they can do is do nothing. They should pick up the phone. We have got a hotline, a national hotline, 888–995–HOPE. They should call.

Chairman DODD. Mr. Secretary, could I interrupt you 1 second? Why can't the lender make that call, too? They know they have got a customer, a borrower in trouble. They know that. Why don't they pick up the phone and call that borrower and try and track them down. Why doesn't it work that way as well?

Mr. KASHKARI. Well, they absolutely are, and we are pushing them to do that. In fact, over the summer—I believe it was in June——

Chairman DODD. Sorry, Bob. I didn't mean to——

Mr. KASHKARI [continuing]. We worked with the servicers and the counselors together in HOPE NOW to create guidelines and standards for loss mitigation for the industry that said exactly that, Chairman. They need to be sending letters in advance of rate resets. They need to be making these phone calls in advance of borrowers going in delinquency. A lot of times what you will find is there is a real challenge we have. The bank is doing their duty to their investors by making calls saying, "You are behind in your payments. You are behind in your payments." That is the collection——

Senator MENENDEZ. But what about—Mr. Secretary, I hate to have all my time eaten up by this, but let me just ask you this: What about the bank that I told you about? And this is—we have a lot of people coming to seek help. I tell you, my office is inundated. We have had five foreclosure clinics that I have conducted myself in the State of New Jersey. We have got a lot of people seeking help, so maybe there are some who are hiding or afraid and in the bunker. But we have got a lot of people seeking help. And so we have got Reverend Soaries in New Jersey who does a very good job through a community development financial institution, and he is trying to help constituencies to be able to keep their homes. He goes and offers the bank $160,000 out of $175,000. They say no. He goes to the foreclosure with a full certified check, and then the bank bids up. Tell me how that is in keeping with the spirit that we are trying to work out these mortgages. It is not. And so I do not quite understand what is wrong with issuing guidelines by Treasury, particularly for those participating in these programs, that does similar to the FDIC.

And, second, you know, about hoarding the money, I am concerned about it. I know that you say that the inability to buy back shares or to issue dividends is enough an incentive. But, you know, they are going to pay—what?—5 percent dividend in the shares that we have purchased from them—I mean that we have lent to them. So I am not quite sure that that is the incentive to ultimately not sit on their money as they build their overall standing. I think you need to have some set of very clear guidelines. They are not mandatory. But it is the expectation. You know, I cannot judge an employee if I do not tell them what the standards are. And I cannot tell the banks whether or not they have fairly used the collective money of the people of the United States in achieving the goal that we all want for them and to create liquidity in the marketplace, particularly for Main Street, if I do not give them a set of standards of what I am looking for to accomplish. I do not quite understand what the reticence of that is.

Mr. KASHKARI. Senator, we share your perspective, and we want these banks to lend, and I do not think we have reticence to it. I think we will look at this with our regulatory colleagues. Ultimately, the regulatory——

Senator MENENDEZ. Why not set a standard, then? Why not set a set of standards by which people could judge by?

Mr. KASHKARI. Again, I think a set of standards could be a very useful tool. We need to be careful not to be too prescriptive. Again, we are trying to strike the right balance, not just getting the big banks to participate, but getting the 1,000th bank, the 3,000th bank in our communities to participate. And setting a one-size-fits-all standard may not be the right approach, but we need to look at it.

Senator MENENDEZ. All right. One last question. It goes to both you and Governor Duke. You know, we gave AIG $85 billion and then—lent it, I should say, not gave it. And then we further agreed to extend an additional $38 billion in credit. Now, our Nation's public transit agencies are potentially liable in payments in the hundreds of millions of dollars to banks due to the downgrading of AIG through LILO and SILO leverages leases.

Does the Treasury and the Fed think it appropriate for these banks to be in a position to make a windfall at the expense of these public agencies which ultimately would have a huge consequence—a huge consequence—to the ridership and to the States that ultimately operate these public agencies? Without action by the Treasury's banks, you know, to intervene, they stand to gain all of the benefits the IRS has declared to be inappropriate and, you know, it seems to me that we have a very huge and pending challenge here. And I hope that both the Federal Reserve and the Treasury Department are going to look at this, or else we are going to see a very huge consequence to hundreds of public transit agencies across the country, and that would be devastating at a time in which we are seeking to move more people into the opportunities that exist today in the marketplace, that we are trying to do something about our energy questions, and at a time in which State entities would ultimately be faced with even greater amounts of moneys that have to come up front. I think it is wrong, and certainly the banks that we are lending to here should not take advantage at the same time that we are propping up AIG.

Mr. KASHKARI. Senator, this is an issue that came to my attention very recently, and my colleagues and I at the Treasury are going to look at it. I would be happy to get back to you on it.

Senator MENENDEZ. I appreciate it. If you would get back to me, I would be very interested.

Mr. KASHKARI. Absolutely.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator, very much.

Senator Corker? And let me just say for the record, too, I want to thank Bob Corker. During those 13 days, there were a number of people—obviously, everyone was involved, but some more adamantly and directly than others, and Bob Corker was one of them. I just say, we would not have gotten to that final result without your help and support, so I appreciate it personally and I want to say publicly how much I appreciate your involvement.

Senator CORKER. Thank you, Mr. Chairman. I very much enjoyed it and want to work with other Members of this Committee all the way through this process. I know the implementation is equally important to the legislation, and then coming back in January to regulate appropriately. We have a 20th century regulatory system and I think we understand that and we will be focused on the 21st. I look forward to being hopefully equally constructive, and I thank you.

I do want to maintain the focus on the fact that certainly housing prices have shown problems in our financial industry. I think the exuberance, if you will, that we had in the housing industry for so many years, you know, most people could probably see that at some point, this had to fall. I mean, it was crazy, what was happening, especially in some of the States like California and others where people were paying three and four times just over a few years what they were paying before.

We knew there was going to be a decline, and I hope we will maintain our focus on the fact that, really, this whole issue around foreclosures today has to do with the way financial markets work now. It is no longer the case of people going into their local financial institution and having a loan with their local banker that they see at the Rotary Club or other places and maintaining that relationship, and if they get behind, they have the opportunity to talk with them about that. That just doesn't exist now, and so that is one of the frustrations, I know.

The other huge issue, obviously, are these exotic derivatives and other kinds of things that exist that no one knew existed, and candidly, we wouldn't be having this hearing today, I don't think, if it weren't for that. So that is really, when we are talking about the root of the problem, it is sort of the chicken and egg, I guess, but I hope that that is where we will maintain our focus over the next year or so.

Now, having said that, this foreclosure issue, I listened to Senator Schumer's comments, and candidly, in fairness, I do think most of what we are doing is hope. I mean, the way the disconnect exists right now between the borrower and the lender is so confusing that the average citizen who gets up every day having to work and raise kids, I mean, it is hope, and I understand that, and I think at some point we will be looking at this in a different way than we are right now.

I appreciate so much your efforts, Ms. Bair. In the conversations we have had, I think you have addressed the FDIC insurance issues appropriately all the way through. I did hear you mention stabilizing. I think foreclosure is a problem and I think we need to figure out a way to deal with that. Stabilizing, I don't know. That bothers me some. I think, unfortunately, there is a ways for that to fall now. We still have not hit bottom and I think anything we do that is stabilizing in ways that don't make sense really just caused the market to be sluggish for a long, long time.

And I am wondering if just very briefly you might respond to that. Maybe you were just talking about foreclosures. Stabilizing—the word “stabilizing” bothers me some because I think we move into a prolonged time of sort of fictitious prices that don’t allow us to hit bottom as quickly as we should, and I wonder if you might expand on that.

Ms. BAIR. Yes. The markets need to correct. We do need to find the bottom. And markets will eventually find the bottom. What I am concerned about is that we are going to overshoot because we are in this self-reinforcing cycle now where economic decisions to modify loans are not being made. It may be in everyone’s economic self-interest to modify that loan, but it is still going into foreclosure because of skewed economic incentives, in large part stemming from the different interests in the securitization trust. So loans that economically should not be going into foreclosure are, which is creating more downward pressure on home prices, which is creating more distress in the housing market, which is creating more need for foreclosures——

Senator CORKER. So it is really more on the foreclosure point——

Ms. BAIR. It is absolutely.

Senator CORKER. OK.

Ms. BAIR. That is exactly right.

Senator CORKER. And I think we have had a lot of discussions. I know even Chairman Dodd alluded to some of the meetings we had. There are some politically—there have been in the past some politically unacceptable ways of dealing with that for both sides to come together, but I think at present, we all understand even prescriptive things are not going to solve this until we get to a point where the lender has some ability to quickly deal with this issue, and I don’t want to expand on that right now. We might do that some more privately.

Ms. Duke, we are going to be dealing with a lot of unintended consequences. I mean, at the end of the day, any time there is government intervention, there are unintended consequences, and I think that is going to be one of the biggest issues we deal with during implementation and even beyond.

I know you have already been asked one question about that from Senator Menendez, but we are having some issues where, let us face it, manufacturing is a very important part of our country’s employment. We have had stress on manufacturing for years now. We have actually had a little bit of a breakthrough over the last 6 or 8 months just because the value of the dollar is changing some now.

But at the end of the day, you all are doing some good things and you are taking A1/P1 paper here, I think, beginning very shortly. You have just set up a facility to do that. What that means is that manufacturers that have A2/P2 paper are getting nailed, and all of a sudden, they have got like a 500 basis point problem that they are dealing with. I have talked to Chairman Bernanke about that.

I wonder if you could just bring us up to date as to what might be happening, because we have one manufacturer that has A1/P1 and all of a sudden they are good because you are taking them. We have A2/P2, and all of a sudden they are at a 500 basis point disadvantage and basically getting ready to lay people off. And I am sure you have some way of solving that very soon. I am looking forward to hearing what that is.

Ms. DUKE. Senator, I wish I could tell you I had a way to solve it immediately. The objective behind the commercial paper programs and the A1/P1 are to get the markets for commercial paper moving again. The objective is that once they start moving, then that will move the other parts of the market, as well. But we are monitoring all parts of the financial markets and looking for ways to unclog the pipes, if you will, on all parts of the market. We are aware of A2/P2. We are aware of a number of different markets where they are having difficulty.

The other thing I would say, unfortunately, for many years, risk was not priced, and so I think for all borrowers and all issuers, even when financial flows return to normal, pricing is going to be higher than it was a couple of years ago, but we are working——

Senator CORKER. For both A1/P1 and A2/P2?

Ms. DUKE. For all borrowers. And as I said, we are watching them. We are operating within our own restrictions in terms of credit risk that we can take. We are addressing that in terms of collateral that we take at our discount window borrowings in every way that we can.

Senator CORKER. We think you have the ability to take the A2/P2. I hope that very soon you will figure out a way to deal with that appropriately, and I very much understand what you are saying about the risk and I think it is very good that you send that signal out now, that at the end of the day, risk wasn't being priced and borrowing costs probably are going to have greater spreads in them than they have had in the past.

Just briefly with Mr. Montgomery, I know we are running out of time and Ms. Bair has a board meeting. Mr. Montgomery, I think it is really great that we are increasing through FHA the amount of lending that is occurring. I hope that that is not occurring because banks are dumping their worst loans on the FHA and that we are going to have another hearing down the road dealing with that. I don't know if you would take 15, maybe 10 seconds to respond to that, but I just want to throw that flag out there and thank you for your actions but hoping that you are not taking us down the road of other problems down the road.

Mr. MONTGOMERY. Well, that is one of ten things that wake us all up in the middle of the night. The reason why FHA didn't take part in the boom, there are a lot of them. One is we did not lower our underwriting criteria. We had this crazy notion that people should verify their income. They should produce tax returns. They needed to have at least 2 years with their current employer. And we have not lowered those standards. And our ratios, our front-end ratios, our back-end ratios exist for a reason. I think because of that, I think you will see FHA continue to perform admirably over here on the long term.

If I could just interject one thing here real quick, sir, on the servicing, FHA, and I referenced this number before, the last 3 years, we have saved 300,000 FHA borrowers from foreclosure, 300,000. That is a number you have not read anywhere. You don't see that, and it is because our loss mitigation program, which Congress put into place 10 years ago, is working, and the main reason it works is because we require it. Lenders and servicers know this. The borrowers know this. The investors know this. They are required to do loss mitigation. If they don't do that, they face treble damages from FHA and I think that is one of the keys to why this has been successful. You have not read about those borrowers going to foreclosure because they have not been.

Senator CORKER. Thank you, and if I could just—we have all traveled a long ways to be here and we thank you for having this hearing.

Mr. Kashkari, I have to tell you that the concern about the—first of all, thank you for what you are doing and I appreciate the conversations that we have had. I do think the concern about the loans is somewhat unfounded. I mean, at the end of the day, people are paying 5 percent for this money. I know it raises at some point to 9 percent. At some point, the banks have to make a profit. I mean, they can't just hoard cash. I mean, it is pretty self-evident, is it not, that the way that money is going to be made is lending that money, and while there may be an initial hoarding, at some point, this money has to go out. Otherwise, these enterprises are not making money. I mean, that is just sort of self-evident.

I wonder if you could just take maybe 10 seconds to address that issue. It concerns me. Obviously, I supported this measure and was involved in it. One of the things in the back of my mind was, once the camel nose goes under the tent and you get a bunch of Senators and a bunch of House members involved in the business of banking, all of a sudden, we are telling the banks what to do, which, let us face it, part of our problem with Fannie and Freddie, and I don't want to go into that now, we will deal with it after the election, but was that very thing, OK. And so I am very concerned about us making prescriptive arrangements with these banks. I don't think you are going to get many participants in that regard, but we are going to destroy our banking system if we do that.

I appreciate the balance you are trying to create, but is it not self-evident that with paying for these through dividends—it is basically a loan, let us face it, that they can show as equity—they have got to make loans to make money and be in business. Is that a yes or no answer?

Mr. KASHKARI. Yes. I think the economic incentives are strong and clear.

Senator CORKER. OK. So I understand it is nice to raise these concerns. Let me just, speaking of sort of the camel nose under the tent, and none of us know what is going to happen into the future. We don't know who the next Treasury Secretary is. Hopefully, it will be someone who understands what derivatives are and mortgage-backed securities and all of that.

But the allocation process today as you see it going forward, you are talking about $250 billion for senior preferred. Do you have any sense now—I know we talked 10 days or so, maybe a week or so ago about this—do you have any greater sense of the allocation of this $700 billion today? And the second part of the question, since I am way over time, how much of it do you think may be actually spent by January 20 or so?

Mr. KASHKARI. Senator, obviously, we have already allocated $250 billion. We have sent a notification to Congress for another $100 billion to take us to $350 billion. The allocation has not been determined between more equity or mortgage-backed securities or whole loans at this point. We are trying to design the tools and we will use them and adjust them as we go forward. And there has been no determination made on when any notification would be sent to Congress on the final $350 billion. We would work with the committee at the appropriate time to look at that.

Chairman DODD. Thank you, Senator.

Senator CORKER. Thank you. I think if I were in your case, I would probably be vague on that, too. I would, offline, like to get a better sense of what you think that may actually be. I will not repeat it publicly if you tell me that.

Mr. Chairman, thank you for this hearing and thank you for letting me play a role in the shaping of this.

Chairman DODD. Not at all, and let me just say to my colleague from Tennessee, we raise these issues about—the word "hoarding" was used by the Secretary of the Treasury. That wasn't my word, it was his word, and I didn't raise it to be nice. There have been articles about it. And I don't disagree with the acquisition notion. I don't want to prohibit that. But there is a concern, not to just sit on it—obviously, that is not going to happen—but how those dollars are being used. There are a number of ways you can use the dollars, and obviously lending is critical and that is what we are looking for here. But that is not the exclusive use of the money. We want to make sure we channel that to the extent we can encourage that is part of the goal in mind.

Let me turn to Senator Casey.

Senator CASEY. Mr. Chairman, thank you for calling this hearing in the midst of both an election and a financial crisis for the country. I want to thank our witnesses for your testimony and your work, your public service.

There are a lot of ways to describe the challenge we have with regard to foreclosures. The numbers keep coming in. We saw today in one story that foreclosure filings for the third quarter are up 71 percent. In Pennsylvania, the third quarter foreclosure filings were up 73 percent from the 2007 third quarter to 2008. Maybe the most difficult number for Pennsylvanians to look at with regard to this is Pennsylvania filings rose 18 percent from second quarter to third quarter of this year, whereas the national number was a lot lower than that, 3.5 percent.

I was struck by a number of parts of the testimony. Chairman Bair, this probably describes this better than numbers, your statements about the impact of foreclosures, and these are descriptions that others have used and said in different ways, but I thought it was important to highlight them, and I am quoting from page eight. "Foreclosure is often a very lengthy, costly, and destructive process that puts downward pressure on the price of nearby homes." Later on page eight, you say, "Foreclosures may result in vacant homes that may invite crime and create an appearance of market distress, diminishing the market value of other nearby properties." Well said.

I guess in light of that problem that we have, which is a foundational problem for why we are all here, I wanted to ask Assistant Secretary Kashkari about Section 109 that our Chairman pointed to earlier. Section 109(a) of the Emergency Economic Stabilization Act has a "shall" and a "may." The shall part says the Secretary shall implement a plan that seeks to maximize assistance for homeowners and use the authority to encourage the servicers of the underlying mortgages to take advantage of Hope for Homeowners, the program we have to modify mortgages. Section 109(a) also says the Secretary may use loan guarantees and credit enhancements to facilitate modifications.

I am struck by the contrast between especially the mandatory language, the "shall implement a plan" language of 109, versus your testimony where—and I am being critical here, but I don't want to be casual about this—your testimony is about four-and-a-half pages. You cover what you have a responsibility to implement, principally the Troubled Asset Relief Program, and I realize that is a difficult challenge for anyone and any group of people.

But the homeowner preservation section is one small paragraph. You talk about maximizing opportunities to help as many homeowners as possible. You talk about appointing an interim Chief of Home Ownership Preservation. That is good. We appreciate that you did that. And looking for other opportunities to help homeowners. I am summarizing a brief paragraph.

But I am struck by the contrast between that seeming, at least in the testimony, the verbiage of the testimony, the seeming deemphasis or lack of detail on home ownership preservation versus the mandatory language of 109. I want to just get your reaction to my assessment of that.

Mr. KASHKARI. Thank you, Senator. As I have said previously, we are very, very focused on this issue of avoiding preventable foreclosures. The testimony was written in a manner to give an update to the Congress, to this committee, and to the people on our progress, and different paths identified seven work streams, have made further progress, and others, there is a lot of work being done but we haven't made major announcements yet. So most of the testimony is focused on the capital program because we have already announced that program and are executing it.

We have a team of people working interagency on the home ownership preservation piece led by Donna Gambrell, and when their work product is complete, we are going to come out in just as much detail as we did on the capital program.

Senator CASEY. Let me ask you this, a couple of very specific questions. The statute says that you shall implement a plan. Tell me when you think that plan will be completed and what progress you are making toward that, when the plan will be completed and when will it be implemented.

Mr. KASHKARI. The plan is under development now with Donna and our team working with HUD, with the FDIC and others to look at these different alternatives. The first implementation of that plan is going to be put into place when we have bought mortgages and mortgage-backed securities as instructions that we are going to be sending to the servicers. So that is going to be the vehicle for implementing that plan.

Senator CASEY. And when would that be?

Mr. KASHKARI. As soon—we are running—working around the clock to get these programs up and running. I think it is weeks, it is not days, but it is also not several months. So we are working very hard to get that up and running.

Senator CASEY. So you are talking about weeks in terms of implementing the plan contemplated by Section 109(a)?

Mr. KASHKARI. I think it is weeks in terms of when we are going to have mortgages and mortgage-backed securities, and then we will be submitting detailed instructions to the servicers of those loans on the aggressive loss mitigation techniques we want them to take.

Senator CASEY. I want to get back to you in a second. I also want to ask Chairman Bair, with regard to the "may" section, may use loan guarantees, I am assuming that the language that is in 109—on page 11 of your testimony, you speak to, in the last paragraph under the foreclosure section, loan guarantees could be used as an incentive for servicers to modify loans. The government could establish standards for loan modifications. You go on from there.

I am assuming you are saying, A, that there is authority under Section 109(a) to do this, and B, that you would recommend it, is that right?

Ms. BAIR. Yes, our lawyers think there is authority to do it, and yes, we definitely think it is a policy option. We are in discussions with Treasury. There is a policy process underway. But yes, we think there are a number of advantages in combination with other tools, especially for loans that are in securitization trusts, to use a guarantee as leverage to get the loans modified. It is also advantageous to implement systemwide protocols to streamline this process and get it going on a much broader scale.

Senator CASEY. And I think people around the country are happy that you are discussing this. Tell me—either of you can answer, or both—tell me, what is the time line for the completion at least of discussions which may lead to the implementation of a loan guarantee strategy?

Ms. BAIR. Well, I understand—quickly. I think there are meetings and discussions actively going on right now and——

Senator CASEY. When you say "quickly," do you mean weeks?

Ms. BAIR. The Treasury Department is the implementor of the TARP program, so we are sharing ideas with them about this particular aspect. It is an Administration process and we want to be respectful of that, but I really think that Neel and Secretary Paulson are very committed to this and moving in a very timely way.

Senator CASEY. Mr. Assistant Secretary, is that an accurate characterization of the Treasury Department's position at this point, that you are in agreement with what Chairman Bair has proposed on page 11 of her testimony with regard to loan guarantees?

Mr. KASHKARI. We are looking at it very closely and working with our colleagues around the administration to understand the plan, understand how it would be implemented, what effect we think it would have, and how it would interact with the other programs. And so it is something we are very seriously considering.

Senator CASEY. When will we know the results of your serious consideration?

Mr. KASHKARI. It is hard to give a specific date, Senator. We are working on it, as the Chairman said, Chairman Bair said, in real time right now, and as soon as decisions are made and we are in a position to make any announcements, we will do so.

Senator CASEY. So are we talking weeks in terms of this determination you have to make?

Mr. KASHKARI. Again, Senator, I am not trying to be evasive. It is hard to predict the policy process. I don't know if it is days or if it is weeks. It is something we are very focused on right now.

Senator CASEY. Well, I would urge you and I would urge the administration to move with dispatch, because one thing, as Senator Dodd has said and others, is that there is a sense of a lack of urgency. I realize this stuff takes—this work, I should say, takes a lot of close examination and it is not easy to develop new programs. But when you juxtapose the foreclosure filing reality, the impact that is having on neighborhoods, the jobless rate numbers, which keep spiking up—we are headed to maybe a million job losses this year. In Pennsylvania, we have got 67 counties, almost half of them have unemployment rates above 6 percent. About 15 of them have unemployment rates above seven as of the last monthly county-by-county number.

And then you also have a lot of taxpayers looking to Washington and they don't—and I am just saying this as an opinion of mine, but I think it is shared by a number of people—they don't have a lot of confidence in the current President to be able to deal with this. We have two candidates for President, neither of which has the authority to deal with this. They look to the Congress and they are not sure they can identify one person there.

So what Treasury does and what every institution represented at this table does is critically important in any context, but especially in the context of the juxtaposition of big problems in people's lives and a vacuum or a lack of leadership that is focused on a singular person or a single institution. So your actions and your decisions and your sense of urgency is critically important to inspiring—I know you have got to worry about market confidence, but I think also taxpayer confidence has worn pretty thin.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Casey.

Let me underscore the point that Senator Casey has made, and Bob, I think maybe before you walked in, this was the very first issue I raised, as well, in a conversation between Sheila Bair and Neel Kashkari, and I talked to the Secretary of the Treasury this morning about this, as well. And again, we don't need to go back and forth on asking you specific questions and trying to get it, but I think you leave here—I hope you leave here—I left the conversation this morning, as I heard, without getting into the details of it, that the Secretary of the Treasury is determined to get this program up and running. Now, that is what I was left with. Again, I know there are things to work out, but I want you to go back, Mr. Assistant Secretary, and convey the reactions here about our determination to get this up. It is very important.

And I didn't raise this earlier, but when you ran down your list of priorities, one through ten or 11 or whatever it was, No. 5 was foreclosure mitigation. I wrote it down here on my notepad. None of us want to sit here and go back and flyspeck, and this may seem trivial, but to people out there with that 10,000 a day losing their homes, it is not trivial at all. And the idea that that is No. 5 on our list—I understand you have got a lot of things to do. It would help a lot to have a heightened sense of urgency about this issue, and there is a plan. We wrote it into the law specifically.

We worked hard to write 109 into the law. That was not just throw-away language. It was very specifically written. And I know where 102 comes from and I know what that was intended to do. I was involved in every dotted "I" and crossed "t" in that bill, as you know, and as Sheila Bair knows. And so when people come back to me and say, well, 102 impacts on 109, no, it doesn't. I know the history of that. That is a ruse to delay the import of Section 102, in my view.

So I would really hope that having heard this, you will go forward.

I have one question before we let both of you go, and then I have got a couple of questions for our remaining panelists. It was raised by Senator Corker—I will give you a chance to respond to my last point, Secretary, if you want to, as well—and that is this idea, the auction process and the taking equity position, and again, I am not going to ask you to give me an exact percentage, but I was sort of left with the impression as of the beginning of last week when there was a shift and it was the source of the major headlines in the country that we were moving toward the capital infusion idea and moving further away from the auction idea, not abandoning it at all.

And, in fact, I know in my conversations with the Treasury Department, I think there was a deep appreciation that when we wrote the legislation, the EESA legislation, we wrote a lot of flexibility and broad authority. The original proposal which you sent up to us that Saturday on the 19th of September only allowed the auction process, the authority for that. And we responded by saying, that is not the only idea. There are others. We have other ideas. We ought to give you broader authority. That is where that language came from.

I was left with the impression that there has been a major shift at least away from the auction process toward the equity side of this. Am I wrong in reading that, without apportioning a percentage to how the 350 gets used?

Mr. KASHKARI. Mr. Chairman, we, first of all, agreed with you and worked very hard with you to design that flexibility, and I think that as the Secretary has said, we moved toward the capital program first because markets deteriorated much more quickly than we had expected, and putting in capital was a faster way—buying equity was a faster way to put capital in the system.

Nonetheless, we think that there are multiple complementary tools to get at this fundamental capital problem and purchasing assets, whether it be through an auction mechanism or it is buying whole loans, is another important complementary tool, especially to attract private capital to come in and help capitalize our system.

So, again, as you said, we are not going to put percentages on each, but we are pushing very hard on all fronts so that we have all the tools available as we need and deem appropriate.

Chairman DODD. I think the reason was raised—and, again, you have spent your adulthood working on these issues. But the old idea, in the auction process you are getting a dollar one for in, you buy an asset for one dollar, you get a dollar value out of it—or hopefully you do; whereas in the equity side you put that dollar in, you may leverage $10 or $100 off that. And so it seems like a more attractive idea if the goal is here to excite the capital markets to begin moving. And as between the two—and I understand the value of having the option of dealing with the auction process. But in terms of the overall goal to provide that kind of—that shock, the electro-shock to the system, to get that circulatory process working, the auction—excuse me, the equity position seems to be more designed to do that than the auction process.

Mr. KASHKARI. Well, there is no question, Senator. A dollar of equity goes a lot further than a dollar of asset purchases.

Chairman DODD. Right.

Mr. KASHKARI. That is why we started there. But we think that they all have a complementary role to play.

Chairman DODD. Yes, I agree with that as well. You both have been very, very—the last one I wanted to make to you on this, and it goes back to the question of Senator Menendez. I just want to read you something. This is from a lawyer in Staten Island. I should probably have let Senator Schumer read this because it is from his constituent. But we worked with this family regarding the mitigation problems, and this is just a quote. He said, "One of the biggest hurdles"—this is a lawyer representing some people on foreclosure. "One of the biggest hurdles we encounter is the lenders" inability to respond to our requests in a timely manner. The other problem is the lenders assign new negotiators and loan mitigation specialists several times over the course of the negotiations, thereby starting the review process all over again. Our office has a staff working on these files 7 days a week, and it may still take us months to get any sort of response from lenders. It is virtually impossible for homeowners to deal with these negotiations on their own. The lenders are creating such a time constraint that by the time they issue the approval, the buyer has walked away from the deal. The system is designed to fail."

Now, again, this is one we worked on, and they spend their law firm doing this. Again, I just want you to take that kind of back with you, because I presume it is not an isolated case of what is going on, the practicalities of this. And that is why I think it is so important that that lender—you mentioned earlier—I did not mean to jump in a sense, but obviously the borrower should step up. I agree with you. But also that lender needs to understand that that borrower in that situation of a highly distressed mortgage probably has 20 other problems going on. They may be in the process of losing their job. They have got all sorts of other things occurring. It is not sort of a stovepipe; I have got just a foreclosure problem. I will almost guarantee you that family has a lot of other issues they are grappling with.

And so the idea that they are going to kind of pick up that phone casually as if somehow it is as if they need a new set of tires on their care I think is different. And I think the borrower—or the lender, rather, has to understand that. If we are really going to get at this, it seems to me there has to be a deeper appreciation of what is going on with that family that is about to lose their home. So I would hope you would just take that back and work on that.

Let me ask, Tim, do you have any questions for either Sheila or—or, Bob, do you have any quick questions for either one before the——

Senator JOHNSON. For the entire panel, do you think our economy needs another economic stimulus? Yes or no. Sheila.

Ms. BAIR. Well, that is a little bit outside my bailiwick. I think I will defer on that. It is really not a type of issue that the FDIC really weighs in. I think you probably have much greater expertise than I in making——

Senator JOHNSON. The President and the Fed Chairman have, as you know, said yes to the concept. Neel.

Mr. KASHKARI. Respectfully, Senator, I also am not an expert on that. I am spending 100 percent of my time on implementing the TARP, so I would defer to some of my colleagues.

Senator JOHNSON. Brian.

Mr. MONTGOMERY. I assume we are going down the line here. A little out of my world. I can assure you we have our own economic stimulus that we are doing through FHA. You heard some of the numbers I referenced earlier.

Thank you, sir.

Mr. LOCKHART. What we need to me from the mortgage markets in particular is to get the capital markets working again, and that is the bank liquidity being put in. We need to be able to bring down mortgage rates. We need to be able to borrow longer term for some of these financial institutions. The key thing to me is to stimulate the financial institutions so they can start lending again.

Ms. DUKE. And given that it is my turn to defer, I will defer to the Chairman of the Federal Reserve, who on Monday did express support.

Senator JOHNSON. Mr. Lockhart, what guidance have you given Fannie Mae and Freddie Mac regarding loan restructuring? And what efforts are being made by Freddie and Fannie to restructure loans?

Mr. LOCKHART. We have been extensively talking with——

Chairman DODD. Could I just interrupt just for 1 second? I promised Sheila Bair I would get her out an hour ago, and it is an hour, and I apologize to you. Also, Neel, we have held you up now. It is 2½ hours, and we are grateful for your being here. Let me underscore the points that were made by Bob Menendez. Our questions are not—if there seems to be an edge on them, it is only because that is what our constituents and the country are feeling. And so it is not pointed at anyone except a sense of urgency that people are feeling about all of this. But we are very grateful to all of you for the work you are doing and grateful to have you here this morning.

Do you mind, Tim, if they——

Senator JOHNSON. Yes.

Chairman DODD. I promised them they could go. So thank you both very much.

Mr. KASHKARI. Thank you, Chairman.

Chairman DODD. Go ahead, Tim. I am sorry.

Senator JOHNSON. Mr. Lockhart, that was the last question I had.

Mr. LOCKHART. Do you want me to continue answering the question, Mr. Chairman?

Fannie and Freddie have loan servicers working on their loans. They hold over $30 million loans in this country, so they have probably have the majority of the loans in this country. The good news is that their book of business is significantly better than the average book of business. Their delinquencies are less. But just because of the amount of loans that they have, there is a tremendous amount of activity going on in loan modifications and foreclosure prevention.

We are continuing to work with them. Fannie Mae just announced a program earlier this week called "Second Look," where the idea is to contact the people that are about ready to be foreclosed and give them one more chance to work it out.

A key thing here is really to get to the people, and it may be more than a phone call. You may have to actually go to the door of the house to find these people. It really is critical to contact the people and work with them. They are going to continue to do that, and they will be cranking that effort up significantly.

Senator JOHNSON. Thank you.

Chairman DODD. Thank you very much.

Let me ask just a couple of quick questions. Mr. Montgomery, I want to compliment you again as well. Keeping those underwriting standards may have been a painful process. Everyone was probably saying, "Why aren't we doing more to get more of this business?" But we are all very grateful you stuck to the principles on that. And you are rightly proud as well to have been able to launch the Hope for Homeowners plan in such a short time. That is really rather amazing going from July to October 1, and I want to commend you for it. And I hope it is just more than hope as well, but we have plan here that could really make a difference with some people.

In the end, of course, the goal is to help homeowners. Please just update us on what you are doing to maximize the use of this program. What steps have you taken to sign up lenders? What steps have you taken to ensure borrowers know about the program? And what impediments do you see in the use of this program?

And let me just add anecdotally, again, going back to people we are hearing from, when they make that call, the first advice is "Call your lender." Now, I appreciate that, but too often what happens then is you get into that calling your lender and you end up along the lines that lawyer in Staten Island talked about, representing a number of people facing foreclosure. So would you please respond to those?

Mr. MONTGOMERY. Absolutely. We are proceeding on a hundred different fronts as far as outreach, between our call center, between direct mail, homebuyer events across the country, working with our lenders. You know, certainly I suppose we could always use more funds for it, but luckily the H4H program did give us some funds to do education and outreach, and I can assure you we are using those funds.

As to the impediments, we hosted a roundtable on Monday with lenders, and they told us some of the impediments they are hearing about. I would say probably the one at the top would be the cost of it. The 3-percent up-front premium, the 1.5-percent annual premium, just to put that 1.5-percent annual premium in perspective, on a $180,000 loan that is about $225 a month. And by the time—the other concern they had is explaining the shared equity and explaining the shared appreciation. This is something a lot of them do not have experience in doing. They are concerned with consumers, and this is to my earlier point about the training. They take it very seriously. They want to get the training correct. But imagine sitting down with a consumer and trying to explain the shared equity, that they would owe 50 percent of that, and also explaining the shared appreciation that in year 7 and year 20 and year 25, you will still owe Uncle Sam at least 50 percent of the appreciation on that loan.

That is not to say it cannot be workable. That is not to say that we do not want to continue to work with you on some fixes, because we do. But I am just letting you know from their perspective, this is what lenders are telling us.

Chairman DODD. I appreciate that, and that is not easy and so we thank you. We want you to keep us—we will be working with you as well, and if you have these kinds of concerns, we ought to stay in close touch, the Committee staff and others, with you.

Let me, if I can, Ms. Duke, let me ask you, we talked about all the other Federal entities that own a significant number of mortgages that are receiving resources and backing. In the financial rescue legislation that Congress passed, we require each of your agencies to actually work to modify mortgages here. Governor Duke, the Fed owns a significant number of these mortgages, many of which are subprime and delinquent as a result of the $30 billion of the assets that the Fed acquired from Bear Stearns back in March. And yet I notice that you do not mention those mortgages in your testimony.

What specific steps has the Fed undertaken to conduct mortgage workouts of those loans that the Fed acquired as a result of the Bear Stearns issue? And how many of the loan modifications or workouts have been done?

Ms. DUKE. Mr. Chairman, I am going to have to confess I do not know about the assets that are in that $30 billion portfolio. It is my understanding that they are pledged as collateral and that they would be actually mortgage-backed security assets. If I could respond to you in writing?

Chairman DODD. I appreciate that, but I was a little disappointed that we did not get something on that. This is, again, one of these—that was the first step back in March, and that $30 billion is out there. And, again, a lot of it is hope, and in the long term, there will be a payback on that. But in the meantime, it seems to me these loan modifications are critically important as well.

Last, I want to ask you about the oversight of AIG. Senator Martinez of this Committee and Senator Feinstein were the authors of a provision in the legislation dealing with the licensing of brokers as part of the bill. Last week, the Wall Street Journal reported, and I quote, “Even after receiving an emergency loan that gave the Government an 80-percent ownership stake, AIG is spending money to lobby States to soften new controls on the mortgage industry. AIG is currently working to ease some provisions in the new Federal law establishing strict oversight of mortgage originators.”

Now, I presume they are referring to the provision here dealing with the licensing requirements in the bill that was passed in July, the Housing and Economic Recovery Act, signed into law in late July.

So the question I have for you is this: Has the Federal Reserve taken any action to suspend AIG’s lobbying activities and other activities of the company, such as the spa trip, which was detailed in the press? And I want to ask the other panelists as well, what has been done to ensure that entities receiving Federal assistance and are continuing to lobby against—and I should have asked this, of course, of Mr. Kashkari, but I will ask him in writing—against the important protections for borrowers? And did we put any lobbying restrictions in all of these activities?

This is the kind of thing that just sends the American public through the ceiling, the idea that they are using their tax money all of a sudden to turn around and undermine a provision in the law specifically designed to try and plug up a gaping hole that allowed an awful lot of these bad lending practices to go forward. And the idea that any part of taxpayer money is being used to undermine the very provisions which did not exist that contributed significantly to this problem is, to put it mildly, infuriating.

Ms. DUKE. I absolutely understand that concern, and we have had conversations with management of AIG. We do not manage AIG day to day. We have had those conversations, and I believe yesterday or the day before, management of AIG has come out with a series of steps that they have taken to curb that sort of spending, to set up a special governance committee, and to limit their lobbying activities to monitoring of legislation rather than active——

Chairman DODD. Well, I appreciate what AIG—but what is the Fed doing? I need to know what you are doing. Are we insisting upon this? We do not have to have the stories come out, but it seems to me that rather than reading about this, why isn’t there some demand occuring even before that happens?

Ms. DUKE. I understand that frustration. The loan to AIG came up very quickly. It is not something that we were accustomed to doing. We have had people inside AIG primarily monitoring the financial flows and the valuation of assets. In the last couple of weeks, we have actually stepped up our conversations with management, which is new management, as you know, and they are very much concerned about this as well, and take——

Chairman DODD. Well, staff reminds me that the second loan was made after the spa story. It would seem to me that that story might have been enough to provoke the Fed to take some action, that second tranche was at least going to be conditioned better than it was. Well, I wish you would carry this back.

Ms. DUKE. I will. I will

Chairman DODD. Because this is really important, again.

Ms. DUKE. Yes, sir.

Chairman DODD. We are trying to build public confidence in the direction we are trying to head, and it doesn't help—let me put it to you very bluntly here. The confidence of the American public that we are on the right track with all of us this is going to be critical. And if they hear their money is being used for these kinds of things, we lose that confidence, and that makes this all the more difficult to move forward on.

Well, again, I thank you for—the GSE loan modifications you sort of addressed with Senator Johnson's question, Mr. Lockhart. Did you want to add anything to that at all? What steps has FHFA taken to require enterprises to do these loan modifications?

Mr. LOCKHART. It has been an ongoing activity. We are now putting out a quarterly report, which will move to a monthly report. This will put a lot of transparency around that. Everybody will be able to tell what is going on in their modifications.

Up to now, it has not been as rigorous as we would have hoped. Now that they are in conservatorship, these activities will increase significantly. As I said in my testimony, they are working with the FDIC IndyMac program so that they are looking at that technique. They are actually running an experiment where they are doing some on their program and some on the FDIC program to see which are more successful.

They have a whole series of different loan modification activities going on. It is critical to prevent those foreclosures. The new CEOs have made it a very high priority. As I said, Fannie Mae has this new Second Look program that before they move to foreclosure, they are opening up those files again, trying to contact the people in the houses, and seeing if there is anything they can do to prevent foreclosures.

We will be working very closely with them. We are a Federal property manager under the legislation. We are going to be appointing people within the organization to have that specific duty to work in the conservatorship.

Chairman DODD. I should have asked the others this question, too, but I will ask it of you and submit it in writing to the others. Are you lacking any authority that you would otherwise need from us here? Are there existing statutory or regulatory provisions you have that would make it possible for you to demand more accountability in this area?

Mr. LOCKHART. In that we are the conservator now over Fannie and Freddie, we have the authority, yes, sir.

Chairman DODD. Well, we are going to have you back up here in a few weeks. This is not the last time we are going to see each other on these matters. So when you come back up again, at least as one Member of the Committee, I want to hear more about what we are expecting and more of what is happening.

Mr. LOCKHART. I will be more than happy to.

Chairman DODD. I appreciate that.

Senator Corker.

Senator CORKER. Mr. Chairman, thank you. I appreciate the opportunity to ask a few additional questions.

Ms. Duke, on the AIG issue, I know there has been a lot of consternation about the fact that AIG is paying—look, by the way, I agree with all the concerns that have been raised about their behavior and think it is reprehensible based on where they are. But then on the flip side of that, as far as moving them away from Government, I know there has been a lot of speculation about actually this is a pretty usurious arrangement in some ways and that they might be better off, if you will, either in bankruptcy or seeking other ways out of this.

Any sense of where we are? They are a public company. You are a public entity. I am sure you can talk about those pretty freely with us. Where are we as it relates to an exit strategy and moving them away from where they are today?

Ms. DUKE. AIG has a plan and had from the very beginning a plan to sell assets to repay the loans from the Federal Reserve——

Senator CORKER. And let me just ask you, I mean, I understand about selling assets so, in essence, you end up with sort of nothing left. There is a growing concern there. I would love any editorial comments as to whether that is even the best result or whether seeking equity in other ways at this point, now that people can ascertain what the real risk is and have had time to do that, I would love editorial comments as to whether their plan is even the right plan.

Ms. DUKE. Let me try to answer your question without getting into any non-public information about the company. We have been working with them ever since the loan was made. First of all, the reason the loan was made originally was a concern about systemic risk and risk to the financial markets. And we did not at that time fully know or understand exactly where all of those risks might be and what the magnitude of them might be. And so we are spending a lot of time trying to understand exactly what the risk is. If we are going to hold up the tent, if you will, we want to find out exactly what the risk is that we are protecting against. And then what steps it will take to get us to the other side. How quickly are those risks unwinding? And also what steps will it take to bring this to a conclusion to have AIG take the steps that it needs to take to repay the——

Senator CORKER. And is the best step for them to sell off all the parts? Or is the best step for them, now that people have a better sense of what the real risk is, a different type of equity injection?

Ms. DUKE. I think our best effort is to make sure that the overall outcome to the public is the best outcome to the financial markets generally, not necessarily for the single institution.

Senator CORKER. And I understand that, and that is why we are all up here. So I guess what you are saying is your are semi-agnostic in that regard, and if selling assets pays the $85 billion back plus the additional injection you just made, or the other, either way, that we get away from the immediate taxpayer risk, but then on top of that, maybe even more importantly, or equally important—I should not say "more"—is the system risk.

Ms. DUKE. The systemic risk is the key to it, and while we are certainly mindful of having our loan repaid, it is not just a pure credit decision. This is also one of trying to monitor the——

Senator CORKER. And since you can't give publicly some of the discussions that you are having, is there a sense that there is something working right now that will move them away from your institution and into a different scenario that does alleviate that systemic risk?

Ms. DUKE. The sense is that there are an awful lot of people working toward that end, and the company is so large and there are so many subsidiary companies, and the markets in which they operate are so complex that I think it is going to take quite a bit of working through to that conclusion.

Senator CORKER. Thank you.

Mr. Lockhart, I just could not resist with you being here. How much time is left in your term?

Mr. LOCKHART. The law passed in July made me the Director of FHFA until another Director was nominated and approved by the Senate.

Senator CORKER. It could be long, could be short.

Mr. LOCKHART. It could be long, could be short.

Senator CORKER. It is my goal that—or it is my hope that you will work yourself out of a job pretty quickly. I know the biggest part of your portfolio is Fannie and Freddie; the others sort of lesser, if you will.

Is there any need for—I have a strong prejudice in this regard, but is there any need for Federal involvement in Fannie and Freddie? My sense is absolutely not. I know we have had some conversations in our office about that, and I am just wondering what your answer to that might be. And if not, if the markets can deal—I mean, housing finance is not particularly complex. It really is not. Any sense as to how soon we might be out of the business, if you will, of having these Government-sponsored entities and you maybe being on the beach someplace?

Mr. LOCKHART. That would be nice. Certainly, there needs to be Federal involvement from the standpoint of there needs to be supervision.

Senator CORKER. No doubt supervision. I am glad you finally have the ability to supervise and have powers to do that.

Mr. LOCKHART. Right, and we obviously did not, before the law was passed, have strong enough powers. Going forward, it is going to be up to Congress to make a decision about what the future of these companies should be.

Senator CORKER. Of course, but is there any need for that—I know Congress likes to play in these things, and that is what has created the problem.

Mr. LOCKHART. There is a need for a secondary mortgage market player in this country. There is a very significant need. Hopefully, it could be provided by the private sector. The private label security market failed in doing that, in fact. I am hopeful it will be recreated over time.

Senator CORKER. And also the GSEs failed in that, too, right? So both the public and private sector failed, if you will——

Mr. LOCKHART. The GSEs continued to provide liquidity in the secondary mortgage market.

Senator CORKER. Because of us.

Mr. LOCKHART. They failed because they had an inadequate capital structure and an inadequate regulatory structure. The law that set up our old agency was not strong enough. Their structure, no doubt, Senator, needs to be rethought going forward. Whether it should be a GSE structure or a purely private sector structure, I believe is a very important issue that should be addressed.

Senator CORKER. Senator Dodd, Mr. Chairman, if you need to go to lunch or something, we need to close this out. Please let me know. Or I will chair the meeting for a while if you wish. [Laughter.]

Senator CORKER. I would never do that.

Chairman DODD. We are in a pro forma session. You may decide to do something here. I have got to keep an eye on you.

Senator CORKER. Is there any need for the Federal Government whatsoever to be involved in the secondary market? It is a simple, easy—I mean, it makes our exotic derivatives look like, you know, elementary stuff. Is there any reason whatsoever for the Federal Government to be involved in the secondary market?

Mr. LOCKHART. First, they are through FHA. My colleague to my right——

Senator CORKER. Through the GSEs. Through the GSEs. Is there any reason whatsoever for the Federal Government to be involved in—other than we like to be, some of us like to be.

Mr. LOCKHART. The mortgage structure in this country is built around a 30-year mortgage. There needs to be some mechanism to bring a 30-year mortgage to the marketplace. That can again be through a GSE structure. It could be through a private sector structure. The secondary mortgage market is extremely important to get these mortgages off balance sheets of the banks so that they can relend money going forward and liquify themselves. There needs to be a mechanism to bring them off the banks' balance sheets and spread them out to investors around the world. Again, that can be done through a private sector mechanism or a government mechanism.

Senator CORKER. From what you are saying in your supervisory role, almost as a bystanding for some time because you did not really have the authority you needed; now you have it. And——

Mr. LOCKHART. We took some authority we did not have, actually, and we kept their capital requirements much higher than the law said. We kept their portfolios shrunk.

Senator CORKER. Since, in fact, there are ways for the private sector to deal with 30-year mortgages, and since, in fact, there is a way for there to be a secondary market totally through the private sector, is there any real sense that the borrower has benefited really that much from the slightly lower rate, if you will, the GSEs get because of this implied backing—and as it has turned out, real backing—that the Federal Government has given? Has there been really enough of a benefit there for us to be mucking it all up by being involved in the way we are?

Mr. LOCKHART. There have been studies and there is back and forth in those studies, as most academic studies are. There is debate. I really haven't seen the definitive answer on the question.

Senator CORKER. Well, if you, the regulator and the supervisor and now the conservator—that is a pretty stunning comment to make, and I hope the world is listening to you at this moment. I understand there are some other interesting hearings happening, but that is a pretty stunning comment.

Mr. LOCKHART. What they do do, and this is the important thing, is that they provide liquidity to the mortgage market. Without them, our mortgage market would be in total chaos.

Senator CORKER. But they monopolize, and obviously if they were not in the business, somebody would be filling that vacuum. But the question I asked——

Mr. LOCKHART. In this market, I am not so sure.

Senator CORKER. Well, maybe not in this market——

Chairman DODD. Who fills the vacuum? Where would it be today without this right now? You just said it. I would like to repeat that. What would happen if this did not—what condition would we be in today in the absence of that?

Mr. LOCKHART. They are providing 80 percent of——

Chairman DODD. And in the absence of that, what would this be like?

Mr. LOCKHART. In the absence of that, we would have an extremely, extremely serious problem providing liquidity. We would just have to buildup a much, much bigger TARP.

Chairman DODD. So while theoretically talking about some alternative is a great idea, but, nonetheless, the suggestion somehow that we would be better off today without it I think needs to be emphasized.

Mr. LOCKHART. They do hold over $5 trillion worth of mortgages in this country. There would have to be some other mechanism. At this point, it is not there.

Senator CORKER. If I could, since the Chairman jumped in on my questioning—and I appreciate that. The fact is, though, that there is nothing to—there is no reason to believe that other private entities that were in the middle of this right now that were not, on the other hand, dealing with all these other issues we are talking about would not continue to be doing the same thing. There is no reason not to believe that. But I think the most stunning comment that has been made, if I understand it correctly, is the supervisor, the Director now of this new organization, does not—he cannot really tell whether there is any benefit whatsoever to the borrower. That is pretty stunning to me, and that the purpose of this was to allow these two GSEs to borrow money less expensively in order to make homeownership more affordable. And I guess—and this is, I am sure, an ongoing dialog we will have in the ensuing years.

What worries me is that by having these organizations, we probably did encourage, because we were sponsoring them, if you will, we encouraged them to do things that were not good. And at the same time, we had that ability—excuse me, Congress had that ability, but really the borrower was not necessarily benefiting from lower rates. OK? We will talk about this at another time, but I thank you for——

Chairman DODD. Well, in fairness to Mr. Lockhart, as I understood you to say, you were talking about the academics.

Mr. LOCKHART. Right.

Chairman DODD. There was division back and forth. And I think what you were saying and suggesting is that there has been a debate about that particular question.

Mr. LOCKHART. That is what I was saying.

Chairman DODD. That is the way I thought you answered the question.

Mr. LOCKHART. Right.

Chairman DODD. Is there any other——

Senator CORKER. Well, he himself has not been able to discern as to whether the borrowers had benefited in any way. That to me is a pretty strong——

Chairman DODD. That is called a diplomatic answer to your question.

Senator CORKER. Well, I do not think it is diplomatic. We have had meetings in our office. I think it is a realistic answer. But I would love for him to answer for himself since we are doing a good job of answering for him.

Mr. LOCKHART. I think the Chairman is right that there are some dueling academic studies on the issue and, frankly, I have not spent a lot of time on that issue. I have been really full out trying to regulate them and trying at this point to rehabilitate them.

I believe it is critical at this point that we need to fix them up. We need to get them out of conservatorship. It is a very critical, important issue that you raise, Senator, what the future of these two companies should be. I feel that will be a debate in Congress. We will certainly provide all the information we can to help that debate.

Senator CORKER. Well, I think—and I can tell by the body language of the Chairman out of the corner of my eye it is time for this meeting to end. But let me just say we have worked together on numbers of things very constructively. I know that on this issue in particular we probably have a philosophical difference——

Chairman DODD. Not necessarily

Senator CORKER. But I do hope that as you are working through this and there is transition occurring, I do hope there is a vision in the very, very near future that these two organizations have nothing whatsoever to do with Government. And I hope that is at least one of the plans that we are working on. I know a lot of people like to attribute everything that is happening to this. That is obviously unfair. But the fact is that this is—as we move ahead, we have the camel's nose under the tent here already, and obviously, the camel occupies the tent now because of where we are. We have the camel's nose under the tent occurring right now with the—I guess we are calling it "the rescue plan" now. I hope that we will not edge into areas that we are not supposed to be edging into there, and I look forward to your leadership as hopefully we move these organizations off, cause them to be lofted on their own into the future and we figure out other ways for the private sector to deal with the secondary market. And I hope that finds you retired very soon.

Thank you for your service.

Mr. LOCKHART. Thank you.

Chairman DODD. Well, thank you. Let me just end on that note. As you point out, Mr. Lockhart, a lot of our problems was the private secondary market here that contributed significantly to bad lending practices. Clearly, we need to change this notion. But as I understand it, the only country in the world that has provided a 30-year fixed-rate mortgage was the United States. I do not know of any example around the world. And to attribute all of the problems, in fact, as you point out, in the absence of the liquidity provided today by this, we would be in a very, very difficult, far more difficult situation than we are in.

Now, clearly, we are going to change. We are going forward. What replaces this? That will be a debate. There are various ideas on how to do it. But one of the things I take exception to is the notion somehow that it has been a bad idea to take relatively poor people and make it possible for them to get into homeownership. We have greatly benefited as a country, what it has meant to a family, a neighborhood, what it has meant to our economy. And as long as you have got good, strong, underwriting standards that demand accountability by that borrower in the process, it has worked. And I hope we do not retreat from that. It has been a great wealth creator for many millions of people in this country over the years, and providing the means by which we do it.

Now, there are a variety of means by which you can do it, but one of my fears will be, as we see here, the assumption somehow because there is a Government-sponsored enterprise of one kind, whether it is a utility idea, as Secretary Paulson has suggested, or others, clearly the present model does not work. And that has to change without any question whatsoever. And there is a legitimate debate about whether or not—which side you replace it with. But I just want to point out that we would not be in the mess we are in today were it not for the fact that there was an improper or lack of regulation in that private secondary market as well. So I want to be careful before people jump to that option without some serious considerations as well as the way we are headed.

This has been a very worthwhile hearing, and we thank you. We are going to come back again and again, obviously, on this, and some of the issues involving foreclosure we want to continue to raise with you as well. But I am very grateful to all of you, and I appreciate the work that you are doing.

The Committee will stand adjourned.

[Whereupon, at 1:10 p.m., the hearing was adjourned.]

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

EMBARGOED UNTIL DELIVERY

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

TURMOIL IN THE U.S. CREDIT MARKETS:
EXAMINING RECENT REGULATORY RESPONSES

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

U.S. SENATE

October 23, 2008

Room 538, Dirksen Senate Office Building

Chairman Dodd, Senator Shelby, and Members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding recent efforts to stabilize the nation's financial markets and reduce foreclosures. The events of the past several weeks are unprecedented.

Conditions in the financial markets in recent weeks have shaken the confidence of people around the world in their financial systems. Losses in the stock markets have reduced the valuations of publicly-traded companies and have imposed losses on individual investors. Credit markets have not been functioning properly, threatening grave harm to the economy.

The loss of confidence created by the cumulative impact of these events has required the government to take extraordinary steps to bolster public confidence in our financial institutions and the American economy.

Achieving this goal requires a sustained and coordinated effort by government authorities. Congress is to be commended for passing the Emergency Economic Stabilization Act of 2008 (EESA), which provides authority for the purchase of troubled assets and direct investments in financial institutions, a mechanism for reducing home foreclosures, and a temporary increase in deposit insurance coverage. Working with our colleagues at the Treasury Department and our fellow bank regulators, the FDIC is prepared to do whatever it takes to preserve confidence in the financial system.

Despite what we hear about the credit crisis and the problems facing banks, the bulk of the U.S. banking industry is healthy and remains well-capitalized. What we do have, however, is a liquidity problem. This problem is largely caused by uncertainty about the value of mortgage assets, which is making banks reluctant to lend to each other or lend to consumers and businesses.

In my testimony, I will detail recent actions by the FDIC to restore confidence in financial institutions. I also will discuss the FDIC's continuing efforts to address the root cause of the current economic crisis – the problems caused by the failure to effectively deal with unaffordable loans and unnecessary foreclosures.

Recent Actions to Restore Confidence

The FDIC has been a participant in several actions by Congress, the Treasury Department and the federal regulators in recent weeks designed to restore confidence in insured financial institutions. These have included temporarily increasing deposit insurance coverage and providing guarantees to new, senior unsecured debt issued by banks, thrifts or holding companies. These measures will help banks fund their operations.

Increased Deposit Insurance

With the enactment of the EESA, deposit insurance coverage for all deposit accounts was temporarily increased to $250,000, the same amount of coverage previously provided for self-directed retirement accounts. Temporarily raising the deposit insurance limits should bolster public confidence and provide additional liquidity to FDIC-insured institutions.

The FDIC implemented the coverage increase immediately upon enactment of EESA. The FDIC website and deposit insurance calculators were updated promptly to reflect the increase in coverage and ensure that depositors understand the change. The two bank failures since the change in the coverage level were resolved by healthier banks acquiring all of the failed institutions' deposits. These two failures did not require individual deposit insurance determinations, although the FDIC was fully prepared to implement the $250,000 coverage limit.

It is important to note that the increase in coverage to $250,000 is temporary and only extends through December 31, 2009. The FDIC will work closely with Congress in the coming year to ensure that consumers are fully informed of changes to the deposit insurance coverage level and understand the impact on their accounts.

Temporary Liquidity Guarantee Program

Last week, the FDIC Board of Directors approved a new Temporary Liquidity Guarantee Program (TLGP) to unlock inter-bank credit markets and restore rationality to credit spreads. This voluntary program is designed to free up funding for banks to make loans to creditworthy businesses and consumers.

The program has two key features. The first feature is a guarantee for new, senior unsecured debt issued by banks or thrifts and bank holding companies and most thrift holding companies, which will help institutions fund their operations. Eligible entities include: 1) FDIC-insured depository institutions, 2) U.S. bank holding companies, 3) U.S. financial holding companies, and 4) U.S. savings and loan holding companies that engage only in activities that are permissible for financial holding companies under section 4(k) of the Bank Holding Company Act.

The guarantee applies to all newly-issued senior unsecured debt issued by participating entities on or after October 14, 2008 through and including June 30, 2009, including fed funds purchased, other interbank funding, promissory notes, and commercial paper. In general, issuers will be limited in the amount of guaranteed debt they raise, which may not exceed 125 percent of senior unsecured debt that was outstanding as of September 30, 2008 and scheduled to mature before June 30, 2009. For eligible debt issued on or before June 30, 2009, coverage is only provided until June 30, 2012, even if the liability will not have matured.

Eligible entities will automatically participate in the FDIC's TLGP unless they opt out by November 12. Participating institutions will be subject to supervisory oversight, including to prevent rapid growth or excessive risk-taking. The FDIC, in consultation with the entity's primary Federal regulator, will determine continued eligibility and parameters for use.

Both term and overnight funding of banks have come under extreme pressure in recent weeks, with the interest rate for short-term funding ballooning to several hundred basis points over the rate for comparable U.S. Treasury bills. The new temporary FDIC guarantee will allow banks and their holding companies to roll maturing senior debt into new issues fully backed by the FDIC.

The second feature of the new program provides insurance coverage for all deposits in non-interest bearing transaction accounts at institutions unless they choose to opt out. These accounts are mainly payment processing accounts such as payroll accounts used by businesses. Frequently, such accounts exceed the current maximum insurance limit of $250,000. Many smaller, healthy banks have expressed concerns about deposit outflows based on market conditions.

This temporary guarantee will expire December 31, 2009, consistent with the temporary statutory increase in deposit coverage. This aspect of the program allows bank customers to conduct normal business knowing that their cash accounts are safe and sound. This guarantee should help stabilize these accounts, and help the FDIC avoid having to close otherwise viable banks because of large deposit withdrawals.

It is important to note that the TLGP does not rely on taxpayer funding or the Deposit Insurance Fund. Instead, both aspects of the program will be paid for by direct user fees. Coverage for both parts of the program is automatic for the first 30 days, without charge. After that, the FDIC will begin assessing premiums or user fees for the coverage unless an institution opts out of one or both elements of the program. Prior to the end of this period, eligible entities must inform the FDIC whether they will opt out of the guarantee program. If an entity does not opt out of the program within the 30 days, it must participate in the program. If an institution opts out, the guarantees are good only for the first 30 days.

Premiums will be structured as follows. All newly issued senior unsecured debt will be assessed an annualized fee equal to 75 basis points multiplied by the amount of debt issued under the program. This assessment will generally be at the time of issuance or shortly thereafter. For non-interest-bearing transaction deposit accounts, a 10 basis point surcharge would be applied to non-interest-bearing transaction deposit accounts not otherwise covered by the existing deposit insurance limit of $250,000 and implementing rules or other guarantee. This surcharge will be added to the participating bank's existing risk-based deposit insurance premium paid on those deposits.

The TLGP parallels actions by European and Asian nations. If the FDIC had not acted, guarantees for bank debt and increases in deposit insurance by foreign governments would have created a competitive disadvantage for U.S. banks. Along with Treasury's actions to inject more capital into the banking system, the combined coordinated measures to free up credit markets, should give banks the self-assurance to resume normal lending.

Since these measures were implemented at the beginning of last week, we have seen steady progress in reducing risk premiums in money and credit markets. Yields on short-term Treasury instruments, which had approached zero in mid-September, have now risen back in line with longer-maturity instruments. Quotes for Libor, the London Interbank Offer Rate, also have declined in relation to Treasury yields -- indicating a slow thaw in the interbank lending market. Interest rates on short-term commercial paper have fallen back to their lowest levels since mid-September, indicating that liquidity is also starting to return to that market. While it is clearly too early to declare the end of the crisis in our financial markets, as a result of the coordinated response of the Fed, the Treasury, the FDIC and our counterparts overseas, we are making steady progress in returning money and credit markets to a more normal state.

The FDIC's action in establishing the TLGP is unprecedented and necessitated by the crisis in our credit markets, which has been fed by rising risk aversion in financial markets and serious concerns about the effects this will have on the real economy. The FDIC's action is authorized under the systemic risk exception of the FDIC Improvement

Act of 1991. In accordance with the statute, the Secretary of the Treasury invoked the systemic risk exception after consultation with the President and upon the recommendation of the Boards of the FDIC and the Federal Reserve. The systemic risk exception gives the FDIC flexibility to provide such guarantees which are designed to avoid serious adverse effects on economic conditions or financial stability.

Efforts to Reduce Unnecessary Foreclosures

Minimizing foreclosures is important to the broader effort to stabilize global financial markets and the U.S. economy. Foreclosure is often a very lengthy, costly and destructive process that puts downward pressure on the price of nearby homes. While some level of home price decline is necessary to restore U.S. housing markets to equilibrium, unnecessary foreclosures perpetuate the cycle of financial distress and risk aversion, thus raising the possibility that home prices could overcorrect on the downside.

The continuing trend of unnecessary foreclosures imposes costs not only on borrowers and lenders, but also on entire communities. Foreclosures may result in vacant homes that may invite crime and create an appearance of market distress, diminishing the market value of other nearby properties. In addition, the direct costs of foreclosure include legal fees, brokers' fees, property management fees, and other holding costs that are avoided in workout scenarios. These costs can total between 20 and 40 percent of the market value of the property.[1] The FDIC has strongly encouraged loan holders and

[1] Capone, Jr., C. A., *Providing Alternatives to Mortgage Foreclosure: A Report to Congress*, Washington, D.C.: United States Department of Housing and Urban Development, 1996.

servicers to adopt systematic approaches to loan modifications that result in affordable loans that are sustainable over the long term.

Over the past year and a half, the FDIC has worked with mortgage lenders, the securitization industry, servicers, consumer groups, other regulators and Congress to identify and correct barriers to solving current market problems while establishing controls to guard against their reappearance in the future.

As we all know from events over recent months, no single solution or "silver bullet" can address the adverse effects of the deficiencies that have contributed to the current market turmoil. Rather, a number of approaches emphasizing different solutions for the different segments of the market are required.

HOPE for Homeowners Act

The FDIC has been playing a role in the implementation of the HOPE for Homeowners Act. As a member of the Board of Directors of the HOPE for Homeowners Program (Oversight Board), which oversees implementation of the Act, the FDIC has joined the Departments of Housing and Urban Development (HUD) and Treasury and the Federal Reserve in establishing requirements and standards for the Program that are not otherwise specified in the legislation, and prescribing necessary regulations and guidance to implement those requirements and standards.

By working cooperatively together to address the many issues necessary to achieve implementation, the Oversight Board was able to meet the October 1, 2008 statutory deadline for implementation. The final rules, as well as other guidance documents and disclosures, were posted on the Program's website on October 1. The final rules were published in the Federal Register on October 6. They will soon be updated to reflect amendments to the HOPE for Homeowners Act made by EESA. Outreach efforts to servicers, investors, housing counselors and borrowers are underway.

The statutory approach for the Program made effective use of existing governmental and market structures. By modeling the proposal on existing FHA programs, the time and expense of implementing the Act have been significantly reduced. The Program incorporates many of the principles the FDIC considers necessary to be effective. It converts current problematic mortgages into loans that should be sustainable over the long-term and subsequently convertible into securities. It also requires that lenders and investors accept significant discounts and prevents borrowers from being unjustly enriched if home prices appreciate.

Emergency Economic Stabilization Act

The EESA, recently passed by Congress, includes a number of provisions to encourage loan modifications. In particular, EESA addresses the issue of foreclosure mitigation and provides authority that could hold significant promise for future loan modifications. The statute grants authority to the Secretary of the Treasury to use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures.

Loan guarantees could be used as an incentive for servicers to modify loans. Specifically, the government could establish standards for loan modifications and provide guarantees for loans meeting those standards. By doing so, unaffordable loans could be converted into loans that are sustainable over the long term. The FDIC is working closely and creatively with Treasury to realize the potential benefits of this authority.

IndyMac Federal Bank Loan Modifications

As the Committee knows, the former IndyMac Bank, F.S.B., Pasadena, California, was closed July 11. The FDIC is conservator for a new institution, IndyMac Federal Bank, F.S.B. (IndyMac Federal), to which the accounts and assets of the former IndyMac Bank, F.S.B. were transferred. As a result of this arrangement, the FDIC has inherited responsibility for servicing a pool of approximately 712,000 mortgage loans, including more than 60,000 mortgage loans that are more than 60 days past due, in bankruptcy, in foreclosure, and otherwise not currently paying. As conservator, the FDIC has the responsibility to maximize the value of the loans owned or serviced by IndyMac Federal. Like any other servicer, IndyMac Federal must comply with its contractual duties in servicing loans owned by investors. Consistent with these duties, we hope to convert as many of these distressed loans as possible into performing loans that are affordable and sustainable over the long term. We are now actively evaluating distressed mortgages for refinancing through FHA programs, including FHA Secure and HOPE for Homeowners, and are sending letters proposing refinancing through FHA to more than 2,000 borrowers this week.

As we have done in some past failures, the FDIC as conservator for IndyMac Federal initially suspended most foreclosure actions for loans owned by IndyMac Federal in order to evaluate the portfolio and identify the best ways to maximize the value of the institution. While not all mortgages can be successfully modified, and foreclosures will be necessary in some cases, I have long advocated streamlined loan modifications. In the case of IndyMac Federal, the FDIC has begun a program of loan modifications for delinquent and at-risk borrowers. The FDIC as conservator for IndyMac Federal is systematically identifying loans in the portfolio that are currently delinquent or in default, or where borrowers are unable to make their payments due to interest rate resets or other reasons. Where it will improve the value of the loan, IndyMac Federal is offering loan modifications to eligible borrowers.

Specifically, on August 20, the FDIC announced a loan modification program to systematically modify troubled residential loans for borrowers with mortgages owned or serviced by IndyMac Federal. Of the more than 60,000 mortgages serviced by IndyMac Federal that are more than 60 days past due, in bankruptcy, in foreclosure, and otherwise not currently paying, approximately 40,000 are potentially eligible for our loan modification program. Initially, the program was applied only to mortgages either owned by IndyMac Federal or serviced under IndyMac Federal's pre-existing securitization agreements, which provided sufficient flexibility. However, with their agreement, we are now applying the program to many delinquent loans owned by Freddie Mac, Fannie Mae, and other investors. We are working with the owners of the remaining mortgages to gain approval to apply the new modification program to those loans as well. Let me emphasize that securitization agreements typically provide servicers with sufficient flexibility to apply the IndyMac Federal loan modification approach. In fact, the agreements at IndyMac Federal were more restrictive than those that apply to many other securitizations.

By achieving mortgage payments for borrowers that will be both affordable and sustainable, these distressed mortgages will be rehabilitated into performing loans and avoid unnecessary and costly foreclosures. We expect that by taking this approach, future defaults will be reduced, the value of the mortgages will improve, and servicing costs will be cut. The streamlined modification program will achieve the greatest recovery possible on loans in default or danger of default, in keeping with our statutory mandate to minimize impact on the insurance fund and improve the return to uninsured depositors and creditors of the failed institution. At the same time, we can help many troubled borrowers remain in their homes. Under the program, modifications are only being offered where doing so will result in an improved value for IndyMac Federal or for investors in securitized or whole loans, and where consistent with relevant servicing agreements.

Applying workout procedures for troubled loans in a failed bank scenario is something the FDIC has been doing since the 1980s. Our experience has been that performing loans yield greater returns than non-performing loans. In recent years, we have seen troubled loan portfolios yield about 32 percent of book value compared to our sales of performing loans, which have yielded over 87 percent.

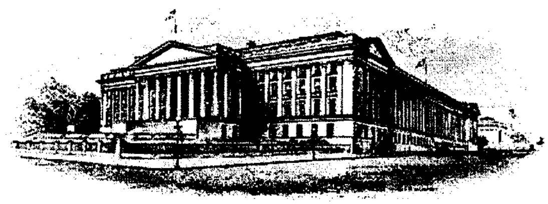
Through this week, IndyMac Federal has mailed more than 15,000 loan modification proposals to borrowers, and has called many thousands more in continuing efforts to help avoid unnecessary foreclosures. While it is still early in our implementation of the program, over 3,500 borrowers have accepted the offers and many more are being processed. We are still working to verify incomes, but thousands of borrowers are already making their modified payments. I am pleased to report that these efforts have prevented many foreclosures that would have been costly to the FDIC and to investors. This has been done while providing long-term sustainable mortgage payments to borrowers who were seriously delinquent. On average, the modifications have cut each borrower's monthly payment by more than $380.

Our hope is that the program we announced at IndyMac Federal will serve as a catalyst to promote more loan modifications for troubled borrowers across the country.

Conclusion

In recent weeks, the FDIC has engaged in unprecedented actions to maintain confidence and stability in the banking system. Although some of these steps have been quite broad, we believe that they were necessary to avoid consequences that could have resulted in sustained and significant harm to the economy. The FDIC remains committed to achieving what has been our core mission for the past 75 years – protecting depositors and maintaining public confidence in the financial system.

I will be pleased to answer any questions the Committee might have.



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10 a.m. (EDT), October 23, 2008
CONTACT Jennifer Zuccarelli, (202) 622-8657

INTERIM ASSISTANT SECRETARY FOR FINANCIAL STABILITY NEEL KASHKARI TESTIMONY BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

WASHINGTON - Chairman Dodd, Senator Shelby, members of the committee, good morning and thank you for the opportunity to appear before you today. I would like to provide an update on the Treasury Department's progress implementing our authorities under the Emergency Economic Stabilization Act of 2008.

Every American depends on the flow of money through our financial system. They depend on it for car loans, home loans, student loans and household needs. Employers rely on credit to pay their employees. In recent months, our credit markets froze up and lending became extremely impaired.

The President asked Congress to move rapidly last month to grant the Treasury Department extraordinary authority to address this unprecedented situation. Congress, led by this Committee and others, recognized the threat frozen credit markets posed to Americans and to our economy as a whole.

The Treasury has moved quickly since enactment of the bill to implement programs that will provide stability to the markets and help enable our financial institutions to support consumers and businesses across the country. We are focused on applying the authorities you provided in ways that are highly effective and protect the taxpayer to the maximum extent possible.

Secretary Paulson is implementing the Department's new authorities with one simple goal - to restore capital flows to the consumers and businesses that form the core of our economy. To achieve this goal, Treasury is pursuing steps that are intended to help financial institutions remove illiquid assets from their balance sheets and to attract both private and public capital. Our programs are being designed to help financial institutions of all sizes so they can grow stronger and provide crucial funding to our economy.

Since the announcement of our capital purchase program, we have seen numerous signs of improvement in our markets and in the confidence in our financial institutions. While there have been recent positive developments, the markets remain fragile.

Implementation

I'd like to spend a few minutes outlining the steps we have taken to implement the EESA. In the three weeks since Congress passed the new law, we have accomplished a great deal on many fronts. We are moving quickly - but methodically - and I am confident we are building the foundation for a strong, decisive and effective program.

As I have previously described, we have seven policy teams driving forward. They are making rapid progress:

1) Mortgage-backed securities purchase program: This team has made tremendous progress. We have announced that the Bank of New York-Mellon has been selected to serve as our master custodian. A Treasury team has been working with the Bank of New York to design the auction, identify which mortgage-backed securities to purchase and determine how best to reach thousands of potential bidders, quickly and effectively. This team is completing its review of more than 100 securities asset manager solicitations and expects to hire asset managers in the coming days.

2) Whole loan purchase program: This team is working with bank regulators to identify which types of loans to purchase first, how to value them, and which purchase mechanism will best meet our policy objectives. They also have made tremendous progress in reviewing over 100 whole loan asset manager proposals and expect to hire asset managers very soon.

3) Insurance program: We are establishing a program to insure troubled assets. On Friday, October 10 we submitted a request for comment to the Federal Register seeking the best ideas on structuring options for the insurance program. That request posted on Thursday, October 16 and responses are due by Tuesday, October 28. We already have received responses and expect to receive many more before the comment period closes. We will begin designing and establishing the program immediately.

4) Equity purchase program: On Tuesday, October 14, Treasury announced a voluntary Capital Purchase Program to encourage U.S. financial institutions to build capital to increase the flow of financing to U.S. businesses and consumers and to support the U.S. economy. Throughout the process of developing this comprehensive and effective program, we worked very closely with the four banking regulatory agencies.

Under the program, Treasury will purchase up to $250 billion of senior preferred shares on standardized terms. The program is available to qualifying U.S. controlled banks, savings associations, and certain bank and savings and loan holding companies engaged solely or predominantly in financial activities permitted under the relevant law.

The minimum subscription amount available to a participating institution is 1 percent of risk-weighted assets. The maximum subscription amount is the lesser of $25 billion or 3 percent of risk-weighted assets. Treasury intends to fund the senior preferred shares purchased under the program by the end of this year.

As Secretary Paulson noted on Monday, this is an investment. The government will not only own shares that we expect will result in a reasonable return, but also will receive warrants for common shares in participating institutions. And we expect all participating banks to continue to strengthen their efforts to help struggling homeowners avoid preventable foreclosures.

On Monday, October 20, Treasury announced a streamlined, systematic process for all banks wishing to access this program. We worked with the four banking regulatory agencies to finalize the application process. Qualified and interested publicly-held financial institutions will use a single application form to submit to their primary regulator – the Federal Reserve, the FDIC, the OCC or the OTS. These regulators have posted this common application form on their websites. We are working hard to finalize and publish the required legal documents so private banks can participate as well on the same economic terms as public banks.

The terms for this program are the same for all institutions that apply before the capital purchase program deadline of November 14, 2008. We have allocated sufficient capital, $250 billion, so that all qualifying banks can participate. Therefore, it is important to note that Treasury will not implement this program on a first-come-first-served basis.

I would like to walk you through the application process, which we made very simple so that all banks can apply. To apply for the capital program, banks should review the program information on the Treasury website and consult with their primary federal regulator. They can go to the regional office of their primary federal regulator anywhere in the country, be it California, Kansas or Texas. After this consultation, the institution should submit an application to that same regulator. Treasury worked with the regulators to establish an evaluation process; this means that all regulators will use a standardized process to review all applications to ensure consistency.

Once a regulator has reviewed an application, it will send the application and its recommendation to the Office of Financial Stability at the Treasury Department. Treasury will give considerable weight to the regulators' recommendations and decide whether or not to make the capital purchase. All completed transactions will be publicly announced within 48 hours of execution, as per the requirements of the law. We will not, however, announce any applications that are withdrawn or denied.

5) Homeownership preservation: We have begun working with the Department of Housing and Urban Development and HOPE NOW to maximize the opportunities to help as many homeowners as possible, while also protecting taxpayers. We have hired Donna Gambrell, Director of the Community Development Financial Institutions Fund and former Deputy Director of Consumer Protection and Community Affairs of the FDIC, to oversee this effort and to serve as interim Chief of Homeownership Preservation. When we purchase mortgages and mortgage-backed securities, we will look for every opportunity possible to help homeowners.

6) Executive compensation: Companies participating in Treasury's programs must adopt the Treasury Department's standards for executive compensation and corporate governance, for the period during which we hold equity issued under this program. These standards generally apply to the chief executive officer, chief financial officer, plus the next three most highly compensated executive officers. We do not believe senior officers should be rewarded for failure. Treasury issued executive compensation guidelines on Tuesday, October 14, for three TARP programs:

A. Troubled Asset Auction Program- As prescribed by the Act, any financial institution that sells more than $300 million of troubled assets to the Treasury via an auction would be prohibited from entering into new executive employment contracts that include golden parachutes for the term of the program. Treasury released Treasury Notice 2008-TAAP regarding this restriction. Furthermore, under the Act, (1) the financial institution may not deduct for tax purposes executive compensation in excess of $500,000 for each senior executive, (2) the financial institution may not deduct certain golden parachute payments to its senior executives and (3) a 20-percent excise tax will be imposed on the senior executive for these golden parachute payments. Treasury released I.R.S. Notice 2008-94 regarding these new tax rules.

B. Capital Purchase Program- Any financial institution participating in the Capital Purchase Program will be subject to more stringent executive compensation rules for the period during which Treasury holds equity issued under this program. The financial institution must meet certain standards, including: (1) ensuring that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution;

(2) required clawback of any bonus or incentive compensation paid to a senior executive based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate; (3) prohibition on the financial institution from making any golden parachute payment to a senior executive based on the Internal Revenue Code provision; and (4) agreement not to deduct for tax purposes executive compensation in excess of $500,000 for each senior executive.

C. Programs for Systemically Significant Failing Institutions- The Treasury Department may have to provide direct assistance to certain failing firms on terms negotiated on a case-by-case basis. Treasury issued guidance for the executive compensation standards that will apply to the firms participating in such programs and their senior executives (Treasury Notice 2008-PSSFI). These standards are similar in all respects to the Capital Purchase Programs executive compensation standards described above, with one significant difference. In situations where Treasury provides assistance under the systemically significant failing institutions programs, golden parachutes will be defined more strictly to prohibit any payments at all to departing senior executives.

7) Compliance: Treasury is committed to transparency and oversight in all aspects of the program and has taken several important steps to meet the letter and spirit of our important compliance requirements.

A. Government Accountability Office: We have been meeting regularly with the Government Accountability Office to monitor the program. In addition, GAO is establishing an office at Treasury.

B. Financial Stability Oversight Board: The Financial Stability Oversight Board was established and the group selected the Chairman of the Federal Reserve Board to chair the group. While the law requires the Oversight Board to meet once a month, the Board had its second board meeting only six days later, on Monday, October 13 to review the Capital Purchase Program. The Board met again on Wednesday, October 22 to review progress of the TARP work-streams, as well as to appoint staff to the Board, including William Treacy as Executive Director, Kieran J. Fallon as General Counsel, and Jason A. Gonzalez as Secretary.

C. Special Inspector General: The Administration is working to identify and interview potential candidates to serve as Special Inspector General for potential nomination and confirmation in November. In the interim, Treasury's Inspector General has been monitoring our progress.

Recruitment

Recruiting the right people is essential to the success of this program and we continue to move quickly. It will obviously take time to bring on board permanent members of the team that will manage this program over the long term and provide stability during the transition. While the permanent team is being identified for tomorrow, we are tapping the very best, seasoned, financial veterans from across the government to help launch the program today. We have been successful in recruiting outstanding interim leaders for key positions in the Office of Financial Stability and the team continues to grow daily.

Procurement

Now, let me turn to procurement.

Our approach to procurement is based on the following strategy. First, in order to protect the taxpayers, we will seek the very best in private sector expertise to help execute this program. Second, to the extent possible, opportunities to compete for contracts and provide services should be available to small businesses, veteran-owned businesses, and minority and women-owned businesses. Third, we are taking appropriate steps to mitigate and manage conflicts of interest.

We have established formal procurement processes, to ensure that selections are fair and in the best interest of the taxpayers. In many cases, we have established expert review panels, comprised of Treasury employees, employees of other federal agencies and expert consultants who review submissions and make recommendations regarding the quality of the proposals. The review committees make recommendations for a final decision to a senior career officer in the Treasury.

As announced, Treasury has retained: The Bank of New York Mellon as our lead custodian; EnnisKnupp as our investment adviser; Simpson, Thacher and Bartlett as our legal adviser for the equity program; Pricewaterhouse Coopers and Ernst & Young for internal control and accounting services. In the coming weeks we expect to issue additional procurement requests.

Taking aggressive steps to manage conflicts of interest is essential because firms with the relevant financial expertise may also hold assets that become eligible for sale into the TARP or represent other clients who hold troubled assets. Firms competing to provide services must disclose their potential conflicts of interest and recommend specific steps to manage those conflicts. Treasury's review team evaluates firms' conflicts and their plans and ability to impose procedures to manage them. Treasury will only hire firms when we are confident in our and their ability to successfully mitigate any conflicts. Furthermore, the Office of Financial Stability has a Chief Compliance Officer who will be responsible for making certain that firms comply with agreed upon mitigation procedures.

Secretary Paulson and I believe that it is essential that the TARP be structured in a manner that encourages participation of small businesses, veteran-owned businesses, and minority and women-owned businesses. We asked vendors to demonstrate their ability and commitment to working with small, veteran, minority and women-owned businesses as sub-contractors. And we are evaluating their submissions in part on their capability to do this. In addition, we announced on Friday, October 17 subsequent guidelines for solicitations with specific opportunities for these businesses.

As you can see, we have accomplished a great deal in a short time. But our work is only beginning. A program as large and complex as this would normally take months - or even years - to establish. We don't have months or years. Hence, we are moving to implement the TARP as quickly as possible while working to ensure high quality execution.

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WRITTEN STATEMENT OF BRIAN D. MONTGOMERY

ASSISTANT SECRETARY FOR HOUSING, FEDERAL HOUSING COMMISSIONER

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

"TURMOIL IN THE U.S. CREDIT MARKETS: EXAMINING RECENT REGULATORY RESPONSES"

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

October 23, 2008

Thank you for the invitation to come before you today to discuss what the Department of Housing and Urban Development is doing, and plans to do, at this time to support our nation's homeowners and communities. As all Americans have come to learn in recent months, the housing market is central to our economy, and economic confidence is critical to the availability of credit.

As the nation's lead housing agency, the Department is uniquely qualified to offer valuable insight into many of today's current market conditions. HUD takes its homeownership mission very seriously and remains focused on sustaining responsible homeownership. HUD continues its support of the broader efforts by Congress and the Administration through the Housing and Economic Recovery Act (HERA) and the Emergency Economic Stabilization Act (EESA) to help restore confidence in the housing and financial sectors of our economy.

HUD's Federal Housing Administration (FHA) has been at the forefront of many of the Agency's efforts during these daunting economic times. Just in the last two years, FHA has seen its market share grow from 2 percent to 17 percent and its loan volume is running at three to four times last year's level. FHA guaranteed more than $181 billion in mortgage loans in FY 2008. In the midst of all this, FHA has been a leader in contacting FHA-insured homeowners in trouble to work out solutions. In 2008, FHA servicers completed more than 100,000 loss mitigation actions. Of these actions, 96,500 are currently retaining homeownership. This represents an 11.5 percent increase in home ownership retention over 2007. Overall, the expected retention rate for these borrowers is 87 percent.

In fact, loss mitigation efforts by HUD have helped about 300,000 families keep their homes over the last three years. Over a year ago, HUD noted an alarming number of American homeowners heading toward foreclosure and took action. Specifically, on August 31, 2007, acting through the FHA, HUD launched *FHASecure*. This initiative offers certain homeowners with adjustable rate mortgages, current or delinquent, the ability to refinance into a FHA-insured mortgage.

I am pleased to report that, since *FHASecure* was launched, FHA has helped nearly 400,000 families, many of whom were facing the loss of their homes, refinance into a safe, more affordable FHA-insured mortgage. We believe a total of about 500,000 families will refinance into more affordable FHA mortgages by the end of the calendar year.

HUD also worked diligently through its approved housing counseling agencies to provide loss mitigation, mortgage delinquency, and default counseling services to assist homeowners facing foreclosure. HOPE NOW has also streamlined the loan review process to speed up loan modifications and refinancings, and established best practices to deal with difficult situations like second liens. At the moment, 27 of the nation's largest mortgage companies are participating, companies that service about 90 percent of all subprime loans. With the help of HOPE NOW, nearly 2.3 million loans have been reworked since July 2007. An industry-wide problem requires an industry-wide solution.

With the enactment of the Housing and Economic Recovery Act, Congress provided HUD with additional tools to strengthen the housing market. These critical changes have proven beneficial to American families. In addition to FHA Modernization, two new programs were placed under HUD's leadership to help distressed homeowners as well as state and local governments confronting high foreclosure rates and abandoned properties within their jurisdictions.

First, the HOPE for Homeowners (H4H) program was created to help those at risk of default and foreclosure refinance into more affordable and sustainable loans. Working closely with an Oversight Board comprised of the Treasury Department, Federal Reserve Board, Federal Deposit Insurance Corporation, and HUD, H4H is being administered by HUD's Federal Housing Administration. I speak for all four agencies when I tell you that we are proud to have launched this program on October 1, 2008, just 60 days after the bill being signed into law and the first date allowable under the legislation. We expect the first loan guarantees by the first of the year. This program presents an additional financing option to families facing some of the most difficult mortgage debt situations.

Second, HUD launched the Neighborhood Stabilization Program on September 29, 2008. This program provides emergency assistance to state and local governments, in the form of Community Development Block Grant (CDBG) funds, to acquire and redevelop foreclosed properties that might otherwise be abandoned and become blight within their communities. State and certain local communities can also use these funds to purchase abandoned homes and to rehabilitate, resell, or redevelop those homes in order to stabilize neighborhoods and stem the decline in home values.

On October 3, 2008, Congress and the President took another significant step, by enacting the Emergency Economic Stabilization Act. The passage of this economic assistance package was essential. Credit must begin to flow again to businesses and American families. When credit is frozen, American families can't access the capital they need to pay for education, buy homes, or pay for emergencies. Businesses can't get the capital they need to invest in ways that grow our economy, thereby creating jobs and expanding opportunity for all Americans.

The President recognizes that government action is essential to get credit flowing again to businesses and American consumers. Of course, stabilizing the system and restoring confidence to the markets is not going to happen overnight but I remain confident that our thriving economy will return because of the optimistic and entrepreneurial spirit of the American people and our workers.

The central feature of the EESA is the establishment of the Troubled Assets Relief Program (TARP). Through this program, the Secretary of the Treasury is authorized to purchase, and make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as determined by the Secretary within the parameters of the Act. HUD serves on the Financial Stability Oversight Board (FSOB) for TARP, which is already being used to re-capitalize financial institutions and restore liquidity to credit markets. In fact, the FSOB met on Wednesday of this week to begin framing up the practical means by which oversight will be conducted.

Conclusion

I appreciate having this opportunity to update you on the various efforts being undertaken at HUD to ensure that the bedrock of America's economy, the housing market, remains strong and vibrant.

# # #

Federal Housing Finance Agency
1700 G Street, N.W., Washington, D.C. 20552
Phone: 202-414-3800
Fax: 202-414-3823

Statement of James B. Lockhart, III, Director, Federal Housing Finance Agency

Before the Senate Committee on Banking, Housing, and Urban Affairs

On "Turmoil in the U.S. Credit Markets: Examining Recent Regulatory Responses"

October 23, 2008

Chairman Dodd, Ranking Member Shelby and members of the Committee, thank you for the opportunity to testify on the Federal Housing Finance Agency's (FHFA) responses to the turmoil in the U.S. credit markets. I will begin by discussing the activities of the FHFA, as the regulator of Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBanks), including how we are addressing the foreclosure crisis, and then turn to my role as Board member to the Troubled Asset Relief Program (TARP) pursuant to the Emergency Economic Stabilization Act.

There is no doubt that the mortgage market pendulum swung extremely widely towards easy credit, poor underwriting, risky mortgages and even fraud. The market had to correct, but what I want to discuss with you today is how to prevent the pendulum from swinging too far in the other direction of too tight credit standards.

Fannie Mae, Freddie Mac and the 12 Federal Home Loan banks have played a critical role in dampening that pendulum swing. In mid-2006, when you approved my nomination, their market share of all new mortgage origination was less than 40%. The private label Mortgage Backed Securities ("MBS") created by Wall Street were beginning to dominate. By the third quarter of 2007, the excessiveness of these PLS were apparent to everyone and the housing GSEs support to the market became critical. They supported 92% of all mortgages originated in that quarter and continue to remain above 80%.

Update on FHFA Activities/Fannie Mae and Freddie Mac Conservatorships

While we will mark the formal transfer of all personnel to FHFA on Monday, October 27th, the work of the new agency is well underway and there is much going on. I will report on a few key matters here, particularly those that will have an impact on stabilizing the U.S. markets.

On Saturday, September 6, 2008, FHFA placed Fannie Mae and Freddie Mac into conservatorships. This was not undertaken lightly. Despite considerable recent progress on the part of the Enterprises to rectify past problems, market conditions, compounded by a weak regulatory capital structure, overwhelmed those improvements. The result was that the Enterprises were unable to fulfill their mission of providing liquidity, stability, and affordability to the housing market. It was evident that regulatory action was needed.

Intense supervisory reviews in July and August led to the conclusion that the companies each presented critical safety and soundness concerns. We were convinced that we needed to act immediately before the conditions of the Enterprises worsened, and the markets for the Enterprises' securities became too unstable to permit normal business activity and threatened the financial health of other institutions. We consulted with Federal Reserve Chairman Bernanke and Treasury Department Secretary Paulson. Both concurred with FHFA that conservatorship needed to be undertaken.

The conservatorship was only possible because of the Housing Economic and Recovery Act of 2008 ("HERA") provision authorizing the Treasury Department to finance the GSEs. The three critical facilities put in place are:

1. A secured credit facility for Fannie Mae, Freddie Mac and the Federal Home Loan Banks. This facility has not been used.

2. A Treasury funded facility to buy Fannie Mae and Freddie Mac MBS. Treasury is actively buying MBS as are the two Enterprises. These purchases are designed to help reduce MBS spreads and mortgage rates.

3. The most important facilities are the $100 billion each Senior Preferred Agreements, which ensure that the Enterprises have a positive net worth. This facility is well over three times the statutory minimum capital requirements and lasts until all liabilities are repaid or it is exhausted. Effectively, it is a government guarantee of their debt and MBS. Under this facility, they can grow their portfolios by about $100 billion each, which will further support the market.

Conservatorship is intended to stabilize a troubled institution with the aim of maintaining normal business operations and restoring its safety and soundness. In this case, the goal is to help restore confidence in Fannie Mae and Freddie Mac, enhance their ability to fulfill their mission, and mitigate systemic risk. FHFA will act as conservator of the Enterprises until they are stabilized. The conservatorship and the access to credit from the U.S. Treasury provide an effective guarantee to existing and future debt holders of Fannie Mae and Freddie Ma as there is an explicit commitment by the U.S. Treasury to provide up to $100 billion in senior preferred stock for each Enterprise. FHFA appointed two new Chief Executive Officers and two new non-executive Chairmen, whom I worked with very closely over the last 7 weeks to help stabilize the mortgage market.

Since Monday, September 8, FHFA examiners, lawyers, and other experts have been onsite continuously at Enterprise headquarters and locations of other key operations to ensure a smooth transition. Their role has been to reassure Enterprise employees about the continued business operations objective of the conservatorships, support the needs of the new leadership at the Enterprises, and facilitate resolution of questions and issues as they arise. I am pleased to report that we are finished with this transition period.

Federal Home Loan Bank Oversight

The counter-cyclical capital structure of the FHLBanks has allowed them to play a critical role in supporting financial institutions and mortgages lending over the last year. Their secured advances just reached one trillion dollars, up 58 percent from the $640 billion at June 30, 2007.

FHFA has been very busy carrying out mandates of HERA, for supervising the FHLBanks. We published a regulation implementing amendments to the Federal Home Loan Bank Act concerning the composition and election of boards of directors of the FHLBanks. The FHLBanks have begun elections to establish boards in line with regulation by January 2009.

As an early synergy of HERA combining OFHEO and FHFB, I approved the Federal Home Loan Bank of Chicago's "MPF Xtra" initiative. Under this agreement the Chicago FHLBank gathers conforming, fixed-rate mortgages from participating financial institutions, and then immediately sells them to Fannie Mae for securitization. This partnership provides an opportunity for smaller members to sell conforming mortgages to Fannie Mae at a competitive price and retain the mortgage servicing.

FHFA staff worked with the FHLBanks, the Treasury Department, and the Federal Reserve Bank of New York (FRBNY) to create the GSE Credit Facility using the authorities in HERA to promote financial market stability and liquidity. Establishment of the GSE Credit Facility enhances the safety and soundness of the FHLBanks by reducing the potential for illiquidity in the debt market. Although we do not expect the FHLBanks to use the facility, its existence provides assurance that they will be able to meet debt obligations in full as they come due, thereby mitigating rollover risk for investors in the FHLBanks' consolidated obligations. FHFA has also developed guidance for the FHLBanks to increase their daily liquidity positions. The liquidity and market risk areas have been critical in recent weeks, both for the Enterprises and the FHLBanks. We have seen here the benefits of collaboration in supervision that FHFA affords. Market risk experts from both supervision teams have been meeting and sharing market updates daily, which has enhanced our ability to monitor and to help the GSEs respond to the volatile market conditions. The mortgage market rally after the conservatorship has dissipated with the continuing turmoil in the market. Spreads have widened for the GSEs and many other issuers of securities. As confidence returns and investors understand the strength of the Treasury agreements, we would expect these spreads to narrow. Lower mortgage rates combined with falling house prices should help bring affordability back to the markets.

Another example of early collaboration among the supervision teams has been in accounting policy, where the accounting teams have worked together in moving towards a unified approach to assessing other than temporary impairments of market securities held by all the GSEs.

Affordable Housing, Mission and Loan Modifications

The new legislation, added the responsibility for the Enterprises' affordable housing goals and mission enforcement to the responsibilities of the safety and soundness regulator. The Federal Housing Finance Board already had responsibility for both areas of supervision for the FHLBanks. While FHFA has had these responsibilities over the Enterprises for only a short time, they ranked among our most immediate concerns in making the determination to place the Enterprises into conservatorship. A key reason for moving quickly to conservatorship was that the companies' abilities to serve their mission had been impaired. Ceasing new business activity and shedding assets was not acceptable.

As the companies operate in conservatorship, I have already instructed each new CEO to examine their underwriting standards and pricing, and they have begun to do so. Earlier this month, for example, Fannie Mae and Freddie Mac cancelled a planned doubling of an adverse market delivery fee, an action that should lower costs to potential borrowers. I expect any future changes to reflect both safe and sound business strategy and attentiveness to the Enterprise's mission.

Fannie Mae and Freddie Mac are critical to the secondary market for multifamily loans, and multifamily lending is critical to the affordable housing mission of the Enterprises. I am determined to ensure that in conservatorship both Enterprises remain dedicated to and actively involved in multifamily lending. Last month, I released a statement to all market participants that the Enterprises will continue to be a source of underwriting and financing for multifamily loans.

Enforcement of the affordable housing goals established for the Enterprises by the Congress, once HUD's responsibility, is now up to FHFA. While ensuring liquidity in the mortgage marketplace has necessarily been a primary focus in recent weeks and months, ensuring that low and moderate income persons and underserved areas have ready access to affordable mortgage loans remains a critical responsibility of the Enterprises. In the near-term, the Enterprises are charged with meeting the very ambitious goals set by HUD back in 2004, a year in which the mortgage market looked far, far different than it does today. In 2007, they missed two subgoals. Based on our discussions with the Enterprises, the miss may be larger in 2008, but we can expect that roughly half of the units financed this year will qualify for the low and moderate income housing goal, more than a third of those financed will qualify for the underserved area goal and more than one out of five units will qualify for the special affordable goal. With the Enterprises now in conservatorship, even if some or all of the goals set for this year by HUD are found to be unattainable, I will expect each Enterprise to develop and implement ambitious plans to support the borrowers and markets targeted by the goals. They know this and are acting accordingly.

The most critical components of stabilizing the mortgage market are assisting borrowers at risk of losing their homes and reducing foreclosures. Keeping people in their homes is critical, not only for their families and their neighborhoods, but also for the overall housing market. A more systematic approach to loan modification is essential. Well before the conservatorship actions, we had asked the Enterprises to accelerate their loan modifications with features that included a principal write-down or forbearance. As IndyMac Federal Bank services mortgages for both Enterprises, we have encouraged them and they have agreed to join the FDIC's loan modification program. I expect the ongoing work on loan modifications being done there, and with other seller servicers, to continue to be a high priority for the Enterprises, both as a matter of good business and as a matter of supporting the Enterprises' mission.

Through August 2008 of this year, the Enterprises completed a total of 130,971 loss mitigation actions which included 36,847 loan modifications. Year-to-date, modifications have averaged 4,606 per month versus 2,884 per month in 2007 -- an increase of 60 percent. For all loss mitigation actions completed, 92 percent resulted in borrowers being able to keep their homes.

The two new CEOs are committed to increase loan modification and foreclosure prevention activities. Both Enterprises are focused on addressing challenges to completing more workouts. Those challenges include successfully contacting the borrower, responding to the high volume of workout requests and offering modification terms that create an affordable payment. The Enterprises have expanded resources internally and have added onsite personnel to assist in servicers' shops. Contracting with "on the ground" solicitors to go door-to-door to deliver borrower assistance materials and to speak with borrowers is making a difference. Both Enterprises have lowered the minimum interest rate and extended the maximum term for a loan modification. Fannie Mae has expanded workouts by providing bridge loans to delinquent borrowers in temporary difficulty (the HomeSaver Advance program), and targeting borrowers with as few as one missed payment. Both Enterprises are compensating foreclosure attorneys not only for completing the foreclosure, but for assisting borrowers with a workout. Finally, the Enterprises have delegated more authority to servicers to decision loss mitigation requests. As I stated, we need to have the Enterprises remain active in the markets and these actions that they have taken are aimed at keeping the market liquid and avoiding an over-tightening of credit.

This year, FHFA started collecting and publicly reporting on loss mitigation activities, which have been disclosed in our first and second quarter *Mortgage Metrics Reports.* Starting November 1, we will supplement these quarterly reports with monthly updates on loss mitigation activity. The quarterly report includes a loss mitigation performance metric that measures the number of loans worked out by the number of loans for which foreclosure was likely. Year-to-date, the results were 49 percent. While FHFA commends the Enterprises for their efforts, it is evident more can be done.

Loan servicers are a critical component to the loan modification process. The Enterprises have recently agreed to pay the servicers more for their loan modifications, and incentives have increased from an average of $450 to $750. In addition, they are working with servicers to develop and pilot new approaches for loan modifications. As these pilots are successful, they will be expanded.

Finally, I am pleased to report that on October 17th FHFA published a regulation in the *Federal Register* to implement Section 1218 of HERA, which provides temporary authority for the FHLBanks to use a portion of the subsidy money in the Affordable Housing Program to refinance mortgages for families at or below 80 percent of area median income. This regulation supports the refinance program in HERA's Hope for Homeowners program by permitting funding of additional principal write-downs or payment of closing costs. The use of such funds will ensure that a full range of federal assistance is available to homeowners quickly. We've discussed this initiative with the Federal Housing Administration, which is very supportive of the prospect of added support on this initiative.

Support of Treasury and Other Regulators

The Enterprises and the FHLBanks share the critical mission of providing stability, liquidity, and affordability to the housing market. During this difficult time in our financial markets, FHFA has been working with the Treasury Department, the Federal Reserve Board, the Federal Reserve Bank of New York, the Securities and Exchange Commission, and the federal banking agencies to monitor market conditions and coordinate regulatory activities. In particular, we have been assisting the Treasury Department as it develops ideas for its TARP. I serve as a director on the TARP Oversight Board. FHFA's role in TARP is discussed more fully below.

In coordination with Treasury Secretary Paulson's efforts to add liquidity to mortgage markets, in September we directed the Enterprises to provide additional funding to mortgage markets through the increased purchase of mortgage backed securities. As the Enterprises increase their portfolios, and provide direct support to the mortgage market though ongoing securitization activities, our safety and soundness supervision of those activities, support for the conservatorships and oversight of the FHLBanks continues apace.

FHFA's Role in TARP

Let me now turn to a discussion of the TARP and FHFA's role. On October 3, 2008, the President signed the Emergency Economic Stabilization Act ("EESA"). The new law provides authority and facilities for the government to restore liquidity and stability to the financial system. In particular, the EESA authorizes the Treasury establish a TARP, to purchase troubled assets from financial institutions, as well as a Troubled Assets Insurance Financing Fund, or TAIFF, to guarantee troubled assets. Congress has authorized the purchase or guarantee of up to

$700 billion of troubled assets (any guarantee premiums accumulated in the TAIFF offset the $700 billion).

The FHFA has a significant role to play under the EESA. As I said, I am one of five members of a Financial Stability Oversight Board established to ensure the implementation of EESA is consistent with the purposes of the act, in the economic interest of the U.S., and consistent with protecting the taxpayers. The Oversight Board is specifically charged with reviewing the TARP and TAIFF programs, including the financial agents appointed to implement them, the classes of troubled assets to be purchased, and the structure of vehicles used to purchase them, as well as their effect on promoting financial market stability, preserving home ownership, and protecting the taxpayers. The Board makes recommendations to the Secretary of the Treasury, reports any suspected illegalities to the new Special Inspector for the TARP or the U.S. Attorney General, and may appoint a credit review committee to evaluate assets purchased.

Foreclosure mitigation is an important objective under EESA. The objective applies to all federal agencies that hold troubled assets, including the FHFA as conservator of Fannie Mae and Freddie Mac. In this capacity, the FHFA is termed a federal property manager, as are the FDIC, with respect to mortgage assets held by bridge depository institutions, and the Federal Reserve Board, with respect to mortgage assets other than those held, owned, or controlled in connection with open market operations or as collateral for a current advance or discount. Treasury, FHFA, and the other federal property managers, must each implement a plan that maximizes assistance for homeowners to minimize foreclosures, encouraging mortgage servicers, considering net present value to the taxpayer, to use the HOPE for Homeowners program and other available loan modification programs. Loan guarantees and credit enhancements under the TAIFF insurance program may be used to facilitate loan modifications. The plans must consider troubled multifamily mortgages as well as those on single family homes. In modifications to multifamily mortgages, the plans must consider, where permissible, steps to allow renters who are current on their rent to stay in their homes, and endeavor to protect governmental rent subsidies and protections while ensuring smooth operations.

Where Treasury or the property managers own securities backed by residential loans rather than the loans themselves, and securities contracts may constrain the abilities of the servicer, they are encouraged to work to facilitate modifications of the underlying loans. Treasury is to coordinate with FHFA and other federal property managers to identify opportunities to acquire classes of troubled assets to improve the loan modification and structuring process. Treasury is specifically charged, where appropriate, to consent, while considering the effect on the taxpayer, to requests for loss mitigation measures arising under existing investment contracts.

Along with the other federal agencies, FHFA will report to Congress information on loan modifications and foreclosures. We have already been working with Fannie Mae and Freddie Mac to find new ways to prevent foreclosures, and we have begun reporting their foreclosure prevention activities publicly, as noted earlier.

In conclusion, FHFA and the 14 Housing GSEs that we supervise have a critical role in returning the mortgage markets to stability. It will take time, but I believe the many steps that have been taken including the creation of FHFA, the Fannie Mae and Freddie Mac conservatorships, the multiple actions by the Federal Reserve and TARP as well as strong actions to address the foreclosure crisis provide a solid foundation for creating that stable future for the mortgage and financial markets and most importantly, American homeowners, renters, workers and investors.

I look forward to working with this Committee and all of Congress in achieving this goal.

I would be pleased to answer any questions the Committee may have.

Clarification:
A sentence in a paragraph found on page 3 of this document was reworded for clarity on October 23, 2008, at 5:30 p.m.

For release on delivery
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October 23, 2008

Statement of

Elizabeth A. Duke

Member

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

October 23, 2008

Chairman Dodd, Senator Shelby, and other members of the Committee, I appreciate this opportunity to discuss recent actions taken to stabilize financial markets and foreclosure prevention efforts.

Financial markets have been strained for more than a year, as house prices declined, economic activity slowed, and investors pulled back from risk taking. These strains intensified in recent weeks. Lending to banks and other financial institutions beyond a few days virtually shut down. Withdrawals from money market mutual funds and prospects that net asset values would fall further severely disrupted commercial paper and other short-term funding markets. Longer-term credit also became much more costly as credit spreads for bonds jumped and interest rates rose. The problems in credit markets and increasing concerns about the state of the economy caused equity prices to swing sharply and decline notably.

Policymakers here and in other countries have taken a series of extraordinary actions in recent weeks to restore market functioning and improve investor confidence, with the aim ultimately to increase the availability of credit and the value of savings. The Federal Reserve has continued to address ongoing problems in interbank funding markets by expanding its existing lending facilities, and recently increased the quantity of term funds it auctions to banks and accommodated greater demand for funds from banks and primary dealers. We also increased our currency swap lines with foreign central banks. To alleviate pressures on money market mutual funds and commercial paper issuers, we implemented several important temporary facilities, including one to provide financing to banks to purchase high-quality asset-backed commercial paper from money funds, and another to provide a backstop to commercial paper markets by purchasing highly rated commercial paper directly from businesses at a term of three months. On Tuesday of this week, we announced another program in which we will provide senior secured financing to conduits that purchase certain highly rated commercial paper and certificates of deposit from money market mutual funds.

The financial rescue package recently enacted by Congress, the Emergency Economic Stabilization Act (EESA), provides critically important new tools to address financial market problems. EESA authorized the Troubled Asset Relief Program (TARP), which allows the Treasury to buy troubled assets, to provide guarantees, and to inject capital to strengthen the balance sheets of financial institutions. As provided in the Act, the Federal Reserve Board and its staff are consulting with the Treasury regarding the TARP. In addition, Chairman Bernanke serves as the Chairman of the oversight board for TARP that will, among other things, review the policies that are implemented and make recommendations, as appropriate, regarding the use of authorities under TARP. EESA also temporarily raised the limit on the deposit insurance coverage provided by the Federal Deposit Insurance Corporation (FDIC) from $100,000 to $250,000 per account.

Last week, the first use of TARP funds was announced. In particular, the Treasury announced a voluntary capital purchase program, and nine of the nation's largest financial institutions have agreed to participate. The program is open to financial institutions of all sizes. Under the program, the Treasury would acquire capital of financial institutions on terms that are attractive to the institutions and with features that protect the taxpayer. At the same time, the Federal Reserve Board, the FDIC, and the Secretary of the Treasury in consultation with the President, determined that there were significant risks to the stability of the financial system. With this determination, the FDIC used its authority to expand for a specified period, insurance to non-interest-bearing transactions accounts, such as payroll accounts, and a guarantee for newly issued senior unsecured debt of FDIC-insured depository institutions, including their associated holding companies.

A second, complementary, use of TARP funds will be to purchase mortgage assets, including mortgage-backed securities and whole loans. These purchases are designed to remove uncertainty from lenders' balance sheets and to restore confidence in their viability. Another objective is to improve the modification efforts of servicers on these loans to more effectively prevent avoidable foreclosures.

The Federal Reserve System is also working to develop solutions to rising foreclosures. Preventing avoidable foreclosures is good for borrowers, communities, and the economy.

A number of efforts are underway. The Federal Reserve has worked with other agencies to put in place the standards and procedures for the new Hope for Homeowners (H4H) program, and I serve on the Oversight Board. These loans can help borrowers who might otherwise face foreclosure because the new loan payments are more affordable and the homeowners get some equity in their homes. Lenders and servicers are analyzing their borrowers for good candidates for the H4H program, and the FHA and its authorized lenders are poised to process applications. We appreciate the additional flexibility provided to the program by Congress in EESA, in particular allowing up-front payments to junior lien holders that agree to release their claims.

For some time, we have called upon lenders, investors, and servicers to aggressively pursue sustainable loss mitigation activities. For example, last year the Federal Reserve and the other banking agencies issued supervisory guidance to encourage mortgage lenders and servicers to pursue prudent loan workouts. We continue to support industry-led efforts, especially those of HOPE NOW, in pursuing flexible approaches to stem the rise in foreclosures and to deal with their effects. Earlier this year, we embarked on a joint effort with NeighborWorks America on neighborhood stabilization to help communities develop strategies for addressing increases in foreclosures and vacant properties.

The Federal Reserve System is strategically utilizing its presence around the country through its regional Federal Reserve Banks and their branches to address foreclosures. Our history of working closely at the local level with communities enables us to tailor activities to the specific needs of that area. Our efforts have taken a variety of forms. We have employed economic research and analysis to target scarce resources to the communities most in need of assistance. We have provided community leaders with detailed analyses identifying neighborhoods at high risk of foreclosures. This information is helping local groups to better focus their borrower outreach and counseling efforts.

In addition, we have sponsored or supported a wide range of activities in local communities. For example, the Federal Reserve System has sponsored a series of "Recovery, Renewal, Rebuilding" forums in cities around the country in which key experts discussed the challenges related to real-estate owned inventories and vacant properties in strong and weak housing markets, and explored effective neighborhood stabilization policies. Four events were held in various parts of the country earlier this year, and the series concluded with a fifth meeting of experts this past Monday in Washington. This series is just an example of many events. All told, the Federal Reserve System has sponsored or co-sponsored more than 80 events related to foreclosures since last summer, reaching more than 6,000 attendees including lenders, counselors, community development specialists, and policymakers.

We also have supported events that bring together borrowers with counselors, lenders, and servicers. In August, the Federal Reserve Bank of Boston partnered with the HOPE NOW Alliance, NeighborWorks America, the Kraft family, and the New England Patriots Charitable

Foundation, among many others, and held an event at Gillette Stadium. More than 2,100 borrowers seeking help attended. Twenty servicers and twenty non-profit counseling agencies took part, with staff at the event and on dedicated phone lines. Although we do not yet know the outcomes for these homeowners, we are monitoring the results and other Federal Reserve Banks are considering holding similar events.

In conclusion, the Federal Reserve has taken a range of actions to stabilize financial markets and to help borrowers and communities. Taken together, these measures should help rebuild confidence in the financial system, increase the liquidity of financial markets, and improve the ability of financial institutions to raise capital from private sources. Efforts to stem avoidable foreclosure and help borrowers through H4H and more aggressive modifications, as well as to develop effective strategies for dealing with foreclosed-upon properties, I believe, will also help homeowners and communities. These steps are important to help stabilize our financial institutions and the housing market, and will facilitate a return to more-normal functioning and extension of credit.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM SHEILA C. BAIR

Q.1. Please provide the legal justification for establishing the Temporary Liquidity Guarantee Program under the systemic risk exception in the Federal Deposit Insurance Act.

A.1. The legal authority for establishing the Temporary Liquidity Guarantee Program (TLGP) is set forth in 12 U.S.C. 1823(c)(4)(G). Based on information regarding the unprecedented disruption in credit markets and the resulting effects on the ability of banks to fund themselves and the likelihood that the FDIC's compliance with the least-cost requirements of the Federal Deposit Insurance Act (12 U.S.C. 1823(c)(4)(A) and (E)) would have serious adverse effects on economic conditions or financial stability by increasing market uncertainty, the Board of Directors of the FDIC and the Board of Directors of the Federal Reserve System made written recommendations to the Secretary of the Treasury that the FDIC's creation of the TLGP program to guarantee bank depositors and senior unsecured creditors against loss under certain described circumstances would avoid or mitigate such effects. After consultation with the President, as required by the statute, the Secretary of the Treasury made the systemic risk determination that provided the FDIC with the authority to implement the TLGP.

Q.2. According to press reports, the emergency actions taken by the FDIC to guarantee unsecured senior debt issued by FDIC-insured depository institutions has had the unintended consequence of driving up the costs of borrowing for Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBs). Was this taken into account as a possible consequence as you formulated this course of action?

A.2. As noted in the press, the spread of debt issued by Government-sponsored enterprises (GSEs), including Fannie Mae, Freddie Mac and Federal Home Loan Banks (FHLBs), over Treasuries increased considerably in October and November although the overall cost of funding declined. According to Merrill Lynch data on U.S. bond yields, the spread between AAA-rated agency debt and Treasuries increased by nearly 40 basis points between September and November 2008. We believe these developments primarily reflect broad financial market uncertainty and a generally unfavorable market sentiment towards financial firms. In fact, the spread of debt guaranteed by the FDIC under the Temporary Liquidity Guarantee Program over Treasuries is larger than the spread on GSE debt.

Financial firms, including those with a AAA-rating, saw their borrowing costs increase sharply, both in absolute terms and relative to Treasury yields, during the same two months, even as the Federal Reserve continued to lower the federal funds target rate. Merrill Lynch data show that the effective yield on AAA-rated corporate debt issued by financial firms increased by 140 basis points between September and October, before declining somewhat in November. Lower-rated corporate debt experienced even more significant increases over the same period of time.

The primary purpose of the FDIC's Temporary Liquidity Guarantee Program is to provide liquidity in the inter-bank lending market and promote stability in the long-term funding market where liquidity has been lacking during much of the past year. While the FDIC's action was focused primarily on helping to restore a stable funding source for banks and thrifts, we believe that such liquidity can, in turn, help promote lending to consumers and small businesses, which would have a considerable benefit to the U.S. economy, in general, and financial firms, including mortgage lenders and GSEs. Nevertheless, partly to mitigate any potential effect of the FDIC guarantee on funding costs for GSEs, the federal banking agencies have agreed to assign a 20 percent risk weight to debt guaranteed by the FDIC (rather than the zero risk weighting that is assigned to debt guaranteed by a U.S. Government agency that is an instrumentality of the U.S. Government and whose obligations are fully and explicitly guaranteed as to the timely repayment of principal and interest by the full faith and credit of the U.S. Government).

Q.3. The FFIEC has proposed a rule that would lower the capital risk weighting that banks assign to Fannie Mae and Freddie Mac debt from 20 to 10 percent, but does not change the treatment for FHLB debt. Has any consideration been given to giving the same treatment to FHLB debt? Will FDIC-guaranteed unsecured bank debt have a comparable risk weight?

A.3. On September 6, 2008, the Treasury and Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac into conservatorship, administered by the FHFA. The next day, September 7, 2008, the Treasury announced the establishment of the Government Enterprise Credit Facility and entered into senior preferred stock purchase agreements (the Agreements) with Fannie Mae and Freddie Mac. These Agreements are intended to ensure that Fannie Mae and Freddie Mac maintain a positive net worth and effectively support investors that hold debt and mortgage-backed securities issued or guaranteed by these entities.

On October 27, 2008, the Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Office of Thrift Supervision (together, the Agencies) published in the Federal Register a Notice of Proposed Rulemaking that would permit a banking organization to reduce to 10 percent from 20 percent the risk weight assigned to claims on, and the portions of claims guaranteed by, Fannie Mae and Freddie Mac (the NPR).[1] As proposed, the NPR would permit a banking organization to hold less capital against debt issued or guaranteed by Fannie and Freddie. The preferential risk weight would be available for the duration of the Treasury's Agreements.

The NPR requested comment on the proposed regulatory capital treatment for debt issued or guaranteed by Fannie Mae and Freddie Mac and whether the Agencies should extend this capital treatment to debt issued or guaranteed by other government-sponsored entities (GSEs), such as the Federal Home Loan Banks (FHLBanks). The comment period for the NPR closed on November 26, 2008, and the Agencies received more than 200 public comments. Most of the commenters support lowering the risk weight for debt issued or guaranteed by the FHLBanks to narrow the credit spread between Fannie Mae and Freddie Mac debt and

[1] 73 Fed. Reg. 63656.

FHLBank debt. The Agencies are reviewing the comments and determining whether a 10 percent risk weight is appropriate for a banking organization's exposure to a GSE.

On November 26, 2008, the FDIC published in the Federal Register a final rule implementing the Temporary Liquidity Guarantee Program.[2] Under the Temporary Liquidity Guarantee Program, the FDIC will guarantee the payment of certain newly issued senior unsecured debt issued by banking organizations and other "eligible" entities. Consistent with the existing regulatory capital treatment for FDIC-insured deposits, the Agencies will assign a 20 percent risk weight to debt guaranteed by the FDIC.

Q.4. I commend you for aggressively pursuing loan modifications of the IndyMac loans that the FDIC now services. Please elaborate on the following three points that you make in your testimony that I want to explore further:

Q.4.a. You state that you have established a program to systematically modify troubled loans that IndyMac serviced. Please give us more details about this approach and how it differs from modifying loans on a case-by-case basis. Is there really such a thing as a systematic approach to loan modification, or do you have to touch every loan as you would on a case-by-case basis?

A.4.a. The FDIC's loan modification program at IndyMac provides a streamlined and systematic approach to implementing affordable and sustainable loan modifications. By establishing clear guidelines for loan modifications determined by an affordability metric based on mortgage debt-to-gross income, the loan modification program allows servicers to apply the model to thousands of mortgages quickly, while defining for each loan how to achieve the targeted DTI. By using a waterfall of three basic loan modification tools—interest rate reductions, term or amortization extensions, and principal deferment—it is relatively simple to run thousands of loans through a computerized analysis of the necessary combination of tools needed to achieve an affordable and sustainable payment. A standardized net present value analysis, also computerized, allows IndyMac to ensure that its modifications provide a better value to the FDIC or investors in securitized or purchased loans. All IndyMac modifications are based on verified income information from third party sources such as the Internal Revenue Service or employers.

This is very different from the loan-by-loan approach used by most servicers, which seeks to gather detailed financial information from borrowers—usually based on verbal statements—and get the highest possible monthly payment while leaving the borrower with a set amount of 'disposable income.' While this approach may appear to offer a more customized approach, it has often meant that servicers relied on stated income and stated expenses to achieve a short-term solution that continued to place the borrower in a precarious and unsustainable payment. The difficulty with this approach is demonstrated by the high redefault rates reported by some servicers.

The FDIC Loan Modification Program at IndyMac achieves an affordable payment through a three step waterfall process:

[2] 73 Fed. Reg. 72244.

- Interest Rate Reduction: Cap the interest rate at the Freddie Mac Weekly Survey Rate for the balance of the loan term and, if needed to reach the DTI target, reduce the interest rate incrementally to as low as 3 percent and re-amortize the principal balance over the remaining amortization term. The interest rate charged will not be greater than the current Freddie Mac Weekly Survey Rate at the time of modification. The reduced rate remains in effect for at least 5 years.

If the target debt-to-income ratio has not been achieved, proceed to the next step.

- Extended Amortization Term: For loans with original terms of 30 years or less, re-amortize the principal balance at the reduced interest rate (3 percent floor) over an extended amortization term of 40 years from the original first payment date.

If the target debt-to-income ratio has not been achieved, proceed to the next step.

- Partial Principal Forbearance: Defer a portion of the principal balance for amortization purposes, and amortize over a 40–year period at the reduced interest rate (3 percent floor). The remaining principal balance remains as a zero interest, zero payment portion of the loan. The repayment of the deferred principal will be due when the loan is paid in full.

Of the loan modification offers made at IndyMac thus far, 73 percent required rate reduction only, 21 percent required rate reduction and term extension, and 6 percent required rate reduction, term extension, and principal forbearance.

Q.4.b. Your testimony says that modifications are only offered where they are profitable to IndyMac or investors in securitized or whole loans. Are you finding that most modifications are profitable, and if so, please explain how you determine that they are more profitable than foreclosures?

A.4.b. Yes. While there are always some proportion of delinquent mortgages where a modification will not provide the best alternative to preserve value for the mortgage, many mortgages can be modified successfully while gaining the best value compared to foreclosure. One illustration of this fact is the net present value comparisons between the modified mortgage and foreclosure for the more than 8,500 completed modifications at IndyMac. To date, on average, the net present value of completed modifications at IndyMac has exceeded the net present value of foreclosure by $49,918 for total savings compared to foreclosure of more than $423 million.

As conservator, the FDIC has a responsibility to maximize the value of the loans owned or serviced by IndyMac Federal. Like any other servicer, IndyMac Federal must comply with its contractual duties in servicing loans owned by investors. Consistent with these duties, we have implemented a loan modification program to convert as many of these distressed loans as possible into performing loans that are affordable and sustainable over the long term. This action is based on the FDIC's experience in applying workout procedures for troubled loans in a failed bank scenario, something the FDIC has been doing since the 1980s. Our experience has been that performing loans yield greater returns than non-performing loans.

The FDIC's Loan Modification Program at IndyMac is primarily based on four principles:

(1) Affordable and sustainable modifications generally provide better value than foreclosure to lenders and investors, and to the IndyMac conservatorship and the FDIC's Deposit Insurance Fund. Modifications that exceed the net present value of foreclosure generally are consistent with servicing agreements and protect the interests of investors in securitized mortgages.

(2) Sustainable loan modifications must be affordable for the life of the loan. As a result, the Loan Modification Program is based on a first lien mortgage debt-to-gross income ratio ranging from 38 percent to 31 percent. The modifications use a combination of interest rate reductions, term extensions, and principal deferment to achieve affordable payments. The interest rate on the modified mortgages is capped at a prime conforming loan rate reported by the Freddie Mac Weekly Survey. The interest rate can be reduced to as low as 3 percent for five years in order to achieve an affordable payment followed by gradual interest rate increases of 1 percent per year until the Freddie Mac Weekly Survey rate is reached.

(3) All modifications should be based on verified income information, not stated income. This is essential to establish affordability.

(4) A streamlined and systematic modification process is essential to address the volume of delinquent mortgages in today's market. The FDIC, along with many mortgage servicers, has adopted a more streamlined process focused on modifying troubled mortgages based on a simple debt-to-income ratio since it is easy to apply and avoids costly and unnecessary foreclosures for many more borrowers.

The Program results in a positive outcome for investors and borrowers as investor loss is minimized and the borrower receives a sustainable long-term modification solution. The Program requires full income documentation in order to minimize redefault and ensure the affordability standard is uniformly implemented. The gross monthly income for all borrowers who have signed the mortgage note must be supported by either the prior year's tax returns or recent pay stubs.

Q.4.c. You state that securitization agreements typically provide servicers with sufficient flexibility to apply the modification approach you are taking for the IndyMac loans. Given this flexibility, why are so few loan modifications being made?

A.4.c. While the securitization agreements do typically provide servicers with sufficient flexibility, many servicers have been reluctant to adopt the streamlined modification protocols necessary to stem the rate of unnecessary foreclosures due to concerns about challenges from investors, a tendency to continue prior practices of focusing on loan-by-loan customized modifications, and by staffing limitations.

At IndyMac, of the more than 45,000 mortgages that were potentially eligible for modification, IndyMac has mailed modification offers to more than 32,000 borrowers. Some proportion of the remainder do not pass the NPV test and others must be addressed through more customized approaches. So far, IndyMac has completed income verification on more than 8,500 modifications and thousands more have been accepted and are being processed and verified.

As the FDIC has proven at IndyMac, streamlined modification protocols can have a major impact in increasing the rates of sustainable modifications. However, even there, challenges in contacting borrowers and in getting acceptance of the modification offers can inhibit the effectiveness of modification efforts. These are challenges that we have sought to address by working closely with HUD-approved, non-profit homeownership counseling agencies, such as those affiliated with NeighborWorks. In addition, we have sought to reach out to local community leaders and provide cooperative efforts to contact borrowers at risk of foreclosure. These efforts, which many servicers are starting to pursue, should be a focus of efforts by all servicers going forward.

In addition, servicers' concerns over challenges from investors makes adoption of a national program to provide incentives from federal funds a critical part of the strategy to achieve the scale of modifications necessary to address our housing crisis. To address conflicting economic incentives and fears of re-default risk, the FDIC has proposed that the government offer an administrative fee to servicers who systematically modify troubled loans and provide loss sharing to investors to cover losses associated with any redefaults. These financial incentives should make servicers and investors far more willing to modify loans. This proposal addresses the biggest disincentive to modify troubled mortgages—the potential for greater losses if a modified loan redefaults and foreclosure is necessary some months in the future in a declining housing market. As a result, the FDIC proposal is designed to cover a portion of the losses that could result if the modified mortgage redefaults. This will provide practical protection to servicers by allowing easier proof for the value of the modification and eliminate investors' primary objection to streamlined modifications. We have estimated the costs of this program to be about $25 billion. To protect taxpayers and assure meaningful loan modifications, the program would require that servicers truly reduce unaffordable loan payments to an affordable level and verify current income, and that borrowers make several timely payments on their modified loans before those loans would qualify for coverage. This proposal is derived from loss sharing arrangements the FDIC has long used to maximize recoveries when we sell troubled loans. We believe this or some similar program of financial incentives is necessary to achieve loan modifications on a national scale to halt the rising tide of foreclosures and the resulting economic problems.

Q.5. Each agency represented at the hearing has aggressively used the tools at their disposal in dealing with the crisis. However, sometimes the use of those tools has led to unintended consequences. For instance, when the Treasury Department guaranteed money market funds, it led to a concern on deposit insurance and bank accounts. When the FDIC guaranteed bank debt, it had an effect on GSE borrowing costs, which in turn directly affects mortgage rates.

Acknowledging that there is often a need to act quickly in these circumstances, please explain what steps and processes you have employed to inform other agencies about significant actions you undertake to ensure that there are not serious adverse unintended consequences and that your actions are working in concert with theirs.

A.5. The FDIC's Temporary Liquidity Guarantee Program was created during intensive discussions between the FDIC, the Department of the Treasury and the Federal Reserve over the Columbus Day weekend (October 11–13) and announced on October 14. Over the next several weeks, the FDIC adopted an Interim Rule, an Amended Interim Rule and a Final Rule. The FDIC's Interim Final Rule adopted on October 23 specifically requested comments on the Temporary Liquidity Guarantee Program and the FDIC received over 750 comments, including comments from other government agencies. During this process, the FDIC had frequent discussions with the Treasury, the Federal Reserve, the Office of the Comptroller of the Currency and the Office of Thrift Supervision about various aspects of the program and its potential consequences.

With regard to concerns that the actions by the FDIC to guarantee bank debt had an effect on GSE borrowing costs, as discussed above, the spread of debt issued by Government-sponsored enterprises (GSEs), including Fannie Mae, Freddie Mac, and Federal Home Loan Banks (FHLBs), over Treasuries increased considerably in October and November although the overall cost of funding declined. According to Merrill Lynch data on U.S. bond yields, the spread between AAA-rated agency debt and Treasuries increased by nearly 40 basis points between September and November 2008. We believe these developments primarily reflect broad financial market uncertainty and a generally unfavorable market sentiment towards financial firms. In fact, the spread of debt guaranteed by the FDIC under the Temporary Liquidity Guarantee Program over Treasuries is larger than the spread on GSE debt.

Financial firms, including those with a AAA-rating, saw their borrowing costs increase sharply, both in absolute terms and relative to Treasury yields, during the same two months, even as the Federal Reserve continued to lower the federal funds target rate. Merrill Lynch data show that the effective yield on AAA-rated corporate debt issued by financial firms increased by 140 basis points between September and October, before declining somewhat in November. Lower-rated corporate debt experienced even more significant increases over the same period of time. The primary purpose of the FDIC's Temporary Liquidity Guarantee Program is to provide liquidity in the inter-bank lending market and promote stability in the long-term funding market where liquidity has been lacking during much of the past year. While the FDIC's action was focused primarily on helping to restore a stable funding source for banks and thrifts, we believe that such liquidity can, in turn, help promote lending to consumers and small businesses, which would have a considerable benefit to the U.S. economy, in general, and financial firms, including mortgage lenders and GSEs. Nevertheless, partly to mitigate any potential effect of the FDIC guarantee on funding costs for GSEs, the federal banking agencies have agreed to assign a 20 percent risk weight to debt guaranteed by the FDIC (rather than the zero risk weighting that is assigned to debt guaranteed by a U.S. Government agency that is an instrumentality of the U.S. Government and whose obligations are fully and explicitly guaranteed as to the timely repayment of principal and interest by the full faith and credit of the U.S. Government).

RESPONSE TO WRITTEN QUESTIONS OF SENATOR ENZI FROM SHEILA C. BAIR

Q.1. I was happy to note in your testimony that you discussed the need to stop unnecessary foreclosures. You mentioned the FDIC's work as conservator of IndyMac and your participation in the Hope for Homeownership program as recent examples of your effort. Does the FDIC plan to develop a new program to extend loan modifications to a broader pool of mortgages than those held by IndyMac? How would such a program work and what would its impact be on mortgage investors? Where would the FDIC derive authority for such a program?

A.1. In mid-November, the FDIC announced a new proposal for loan modifications that is similar to the program we developed at IndyMac. Both target borrowers who are 60 days or more past due, and both seek to apply a consistent standard for affordable first-lien mortgage payment. The new FDIC proposal has a 31 percent debt-to-income ratio, whereas IndyMac modifications are designed to achieve a 38 percent debt-to-income ratio, but can go as low as 31 percent.

The FDIC's proposal is designed to promote wider adoption of systematic loan modifications by servicers through the use of payment incentives and loss-sharing agreements, and thus reach more troubled borrowers. Specifically, to encourage participation, funds from the Troubled Asset Relief Program (TARP) would be used to pay servicers $1,000 to cover expenses for each loan modified according to the required standards. In addition, TARP funds would be used to provide guarantees against the losses that lenders and investors could experience if a modified loan should subsequently redefault. The guarantee would be paid only if the modification met all prescribed elements of the loan modification program, if the borrower made at least 3 monthly payments under the modified loan, and if the lender or servicer met the other elements of the program.

The impact of this new proposal will be less costly than the lengthy and costly alternative of foreclosure, where direct costs can total between 20 and 40 percent of a property's market value. We expect about half of the projected 4.4 million problem loans between now and year-end 2009 can be modified. Assuming a redefault rate of 33 percent, this plan could reduce the number of foreclosures during this period by some 1.5 million at a projected program cost of $24.4 billion.

We believe that Section 109 of the EESA provides authority for this proposal. Section 109 provides that "the Secretary may use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures."

Q.2. Has the FDIC given any further consideration to the FDIC's own Home Ownership Preservation Loan program? I believe this program is a good way to avoid foreclosures and severe mortgage modifications at the same time. If this program is no longer being considered, why?

A.2. When the FDIC proposed the Home Ownership Preservation (HOP) Loan program in May 2008, we noted that congressional action would be required to authorize the Treasury Department to make HOP loans. We believe that the HOP Loan program could be an important tool for avoiding unnecessary foreclosures in combination with other tools. As the housing market and home prices have continued to decline, we have suggested the loss guarantee approach discussed above as a way of streamlining and increasing the scale of loan modifications.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM NEEL KASHKARI

Q.1. On October 20, 2008, Secretary Paulson said that Treasury's infusion of capital in financial institutions through the purchase of preferred stock is intended "to increase the confidence of our banks, so that they will deploy, not hoard, their capital. And we expect them to do so." I share that expectation. As I indicated at the hearing, I feel that Treasury should ask banks that receive these capital infusions provided by the taxpayers to make more loans to entities in the community and to not hoard the money. You said Treasury shares this view and that you "want our financial institutions lending in our communities." Within our communities, small private colleges serve important roles and many of them have borrowing relationships with banks. The credit crisis has made some creditworthy schools concerned that the banks from which they have borrowed in the past will be unwilling to lend to them on reasonable terms in the future.

Q.1.a. Does Treasury believe that banks which receive capital injections should be encouraged to continue to lend to the creditworthy customers, including small private colleges and universities, with which they have done business in the past? If so, will Treasury encourage such lending?

A.1.a. Treasury believes that the banks that received investments from the Capital Purchase Program (CPP) should continue to make credit available in their communities. By injecting new capital into healthy banks, the CPP has helped banks maintain strong balance sheets and eased the pressure on them to scale back their lending and investment activities. However, we expect banks to continue their lending in a safe and sound manner and that institutions must not repeat the poor lending practices that were a root cause of today's problems. To that effect, we firmly support the statement by bank regulators on November 12, 2008 to that effect. The statement emphasized that the extraordinary government actions taken to strengthen the banking system are not one-sided; all banks—not just those participating in CPP—have benefitted from the government's actions. Banks, in turn, have obligations to their communities to continue to make credit available to creditworthy borrowers and to work with struggling borrowers to avoid preventable foreclosures.

Q.1.b. What specific conditions or assurances has Treasury required to ensure that banks do not hoard the capital?

A.1.b. The Treasury has not imposed specific conditions on how banks can use funds obtained from the CPP. The purpose of the CPP is to stabilize financial markets and restore confidence, including by strengthening banks' balance sheets so that they can better weather the deleveraging process associated with the current economic downturn. The CPP funds were not costless to the recipient institutions: the preferred shares carry a 5 percent dividend rate and the recipients will need to put those funds to a productive use or they will lose money. The banks will have strong economic incentives to deploy the capital profitably. Banks are in the business of lending and they will provide credit to sound borrowers whenever possible. They may also use the capital to absorb losses as part of loan write-downs and restructurings. If a bank doesn't put the new capital to work earning a profit or reducing a loss, its returns for its shareholders will suffer.

However, Treasury did design important features into our investment contracts to limit what banks can do with the money: one, Treasury barred any increase in dividends for 3 years; two, Treasury restricted share repurchases. Increasing dividends or buying back shares would undermine our policy objective by taking capital out of the financial system.

In addition, Treasury has been working with the banking regulators to design a program to measure the activities of banks that have received TARP capital. We plan to use quarterly call report data to study changes in the balance sheets and intermediation activities of institutions we have invested in and compare their activities to a comparable set of institutions that have not received TARP capital investments. Because call report data are collected infrequently, we also plan to augment that analysis with a selection of data we plan to collect monthly from the largest banks we have invested in for a more frequent snapshot.

Thus, Treasury does not believe that banks will "hoard" the capital, but rather utilize this additional capital in a safe and sound manner. We expect communities of all sizes to benefit from the investments into these institutions, which now have an enhanced capacity to perform their vital functions, including lending to U.S. consumers and businesses and promoting economic growth. The increased lending that is vital to our economy will not materialize as fast as many of us would like, but it will happen much faster as a result of deploying resources from the TARP to stabilize the system and increase capital in our banks.

Q.1.c. What assurances have you received from these banks that they will employ the capital to prevent foreclosures?

A.1.c. Treasury believes that banks will employ this additional capital in a manner that best benefits their communities. Some institutions may use the funds to continue lending to community institutions (such as private universities), while other institutions may employ the funds to originate new residential mortgages or to restructure existing mortgages. In our private conversations with bankers receiving CPP funds, many institutions have stated that preventing foreclosures is a high priority for them.

Q.2. In implementing the Capital Purchase Program (CPP), what steps has the Treasury Department taken to ensure that all financial institutions that participate will receive similar accounting treatment in the determination of the value of the institution's risk weighted assets?

Q.2.a. What specific steps is the Treasury Department taking to coordinate the assessments by the various primary regulators?

A.2.a. The federal banking agencies, working in conjunction with the Treasury, developed a common application form that was used by all qualified financial institutions to apply for CPP funds. In addition, the Treasury worked closely with the bank regulators to establish a standardized evaluation process, and all regulators use the same standards to review all applications to ensure consistency.

Applications are submitted to an institution's primary federal regulator. Once a regulator has reviewed an application, it will take one of the following three actions: (1) for applications it does not recommend, it may encourage the institution to withdraw the application; (2) for applications it strongly believes should be included in the program, it directly sends the application and its recommendation to the TARP Investment Committee at the Treasury; (3) for cases that are less clear, the regulator will forward the application to a Regulatory Council, made up of senior representatives of the four banking regulators, for a joint review and recommendation.

The Treasury TARP Investment Committee reviews all recommendations from the regulators. This committee includes our top officials on financial markets, economic policy, financial institutions, and financial stability, as well as the Chief Investment Officer for the TARP, who chairs the Committee. This is a Treasury program and Treasury makes the final decision on any investments. The Investment Committee gives considerable weight to the recommendations of the banking regulators. In some cases, the Committee will send the application back to the primary regulator for additional information, or even remand it to the Regulatory Council for further review. At the end of the evaluation process, Treasury notifies all approved institutions.

Q.2.b. What lessons learned can you report from the assessment process for the first nine institutions which participated in the CPP?

A.2.b. This process has worked well. Each institution that has received CPP funds has been thoroughly scrutinized. Although the process is very labor and time intensive, the Treasury believes it is necessary to fully protect the interests of the taxpayer.

Q.3. A stated legislative purpose of EESA is that the Treasury Department use the funds' in a manner that preserves homeownership and promotes jobs and economic growth." What specific steps has the Treasury Department undertaken to ensure that the funds are being used to accomplish this objective?

A.3. The purpose of the EESA was to stabilize our financial system and to strengthen it. It was not a panacea for all our economic difficulties. The crisis in our financial system had already spilled over into our economy and hurt it. It will take a while to get lending going and to repair our financial system, which is essential to economic recovery. However, this will happen much faster as the result of TARP actions.

The most important thing Treasury can do to mitigate the housing correction and reduce the number of foreclosures is to stabilize financial markets, restoring the flow of credit and increasing access to lower-cost mortgage lending. The actions we have taken to stabilize and strengthen Fannie Mae and Freddie Mac, and through them to increase the flow of mortgage credit, together with the CPP, are powerful actions to promote mortgage lending. Treasury is working actively to stabilize housing markets and reduce preventable foreclosures, and has succeeded by undertaking the following initiatives:

- HOPE NOW: In October 2007, Treasury actively helped facilitate the creation of the HOPE NOW Alliance, a private sector coalition of mortgage market participants and non-profit housing counselors. HOPE NOW servicers represent more than 90 percent of the subprime mortgage market and 70 percent of the prime mortgage market. Since inception, HOPE NOW has kept roughly 2.9 million homeowners in their homes through modifications and repayment plans, and it is currently helping more than 200,000 borrowers per month.
- Stabilizing Fannie Mae and Freddie Mac: Treasury took aggressive actions in 2008 to stabilize and strengthen Fannie Mae and Freddie Mac, and prevent the collapse of two institutions with $5.4 trillion in debt and mortgage-backed securities held by investors and financial institutions throughout the United States and the world. The systemic importance of these two enterprises, and the systemic impact of a collapse of either, cannot be overstated. Treasury's efforts to stabilize them by effectively guaranteeing their debt has increased the flow of mortgage credit and insulated mortgage rates from the rapid increases and fluctuations in the cost of other credit.
- Hope for Homeowners: On October 1, 2008, HUD implemented Hope for Homeowners, a new FHA program, available to lenders and borrowers on a voluntary basis that insures refinanced affordable mortgage loans for distressed borrowers to support long-term sustainable homeownership.
- Streamlined Loan Modification Program: On November 11, 2008, Treasury joined with the FHFA, the GSEs, and HOPE NOW to announce a major streamlined loan modification program to move struggling homeowners into affordable mortgages. The program, implemented on December 15, creates sustainable monthly mortgage payments by targeting a benchmark ratio of housing payments to monthly gross household income (38%). Additionally, on November 20, Fannie Mae and Freddie Mac announced that they would suspend foreclosure

sales and cease evictions of owner-occupied homes from Thanksgiving until January 9th to allow time for implementation of the modification program.

- Subprime Fast-Track Loan Modification Framework: Treasury worked with the American Securitization Forum to develop a loan modification framework to allow servicers to modify or refinance loans more quickly and systematically. Subprime ARM borrowers who are current but ineligible to refinance may be offered a loan modification freezing the loan at the introductory rate for five years.

Q.4. If there were a troubled asset that threatened the viability of critically important public infrastructure systems, would EESA provide the Treasury Department the authority to purchase such a troubled asset? Would you interpret such a purchase to be consistent with the purposes of the Act?

A.4. According to the EESA, the Secretary of the Treasury may purchase from a financial institution any financial instrument, that he determines, after consultation with the Chairman of the Board of Governors of the Federal Reserve System to be necessary to promote financial market stability. In such an instance, the Secretary must transmit such a determination to the appropriate committees of Congress. The Secretary will make those decisions on a case-by-case basis.

Q.5. During the discussions leading to the passage of the Emergency Economic Stabilization Act of 2008, Treasury asked for $700 billion primarily to purchase troubled assets at auction. Secretary Paulson testified that "This troubled asset purchase program on its own is the single most effective thing we can do to help homeowners, the American people and stimulate our economy." [Senate Banking Committee hearing on September 23, 2008.] Days after enactment of the law, Treasury changed its main focus from asset purchases and decided to first infuse capital in large financial institutions. Please describe the analysis that supported the initial Treasury plan and identify the assumptions that later proved to be inaccurate, causing Treasury to abruptly change the principle focus of the TARP to buying preferred stock.

A.5. In the discussions with the Congress in mid-September during consideration of the financial rescue package legislation, Treasury focused on an initial plan to purchase illiquid mortgage assets in order to remove the uncertainty regarding banks' capital strength. At the same time, Treasury worked hard with the Congress to build maximum flexibility into the law to enable Treasury to adapt our policies and strategies to address market challenges that may arise.

In the weeks after Secretary Paulson and Chairman Bernanke first went to the Congress, global and domestic financial market conditions deteriorated at an unprecedented and accelerating rate. One key measure Treasury assessed was the LIBOR-OIS spread—a key gauge of funding pressures and perceived counterparty credit risk. Typically, 5–10 basis points, on September 1, the one-month spread was 47 basis points. By September 18th, when Treasury first went to Congress, the spread had climbed 88 basis points to 135 basis points. By the time the bill passed, just two week later on October 3, the spread had climbed another 128 basis points to 263 basis points. By October 10, LIBOR-OIS spread rose another 75 basis points to 338 basis points. During this period, credit markets effectively froze. The commercial paper market shut down, 3-month Treasuries dipped below zero, and a money market mutual fund "broke the buck" for only the second time in history, precipitating a $200 billion net outflow of funds from that market.

Given such market conditions, Secretary Paulson and Chairman Bernanke recognized that Treasury needed to use the authority and flexibility granted under the EESA as aggressively as possible to help stabilize the financial system. They determined the fastest, most direct way was to increase capital in the system by buying equity in healthy banks of all sizes. Illiquid asset purchases, in contrast, require much longer to execute and would require a massive commitment of funds.

Treasury immediately began designing a capital program to complement the asset purchase programs under development. Since launching the program on October 14, 2008, Treasury has invested $192.3 billion of the $250 billion Capital Purchase Program in 257 institutions in 42 states across the country, as well as Puerto Rico.

Following that, as Treasury continued very serious preparations and exploration of purchasing illiquid assets, scale became a factor; for an asset purchase program to be effective, it must be done on a very large scale. With $250 billion allocated for the CPP, Treasury considered whether there was sufficient capacity in the TARP for an asset purchase program to be effective. In addition, each dollar invested in capital can have a bigger impact on the financial system than a dollar of asset purchase; capital injections provide better "bang for the buck."

It also became clear that there was a need for additional capital for non-bank financial institutions and support of the non-bank financial market. A large contingency also arose that threatened the financial system, as Treasury had to restructure the Federal Reserve's loan to AIG, using $40 billion of TARP funds. This action was taken to prevent the collapse of a systemically significant financial institution and the impact such a collapse would have on the system and economy. In addition, Treasury was required to use TARP funds to support Citigroup.

Treasury also realized that it would have to take actions to support the non-banking market, a critical source of funds for consumers and small and large businesses, by supporting the securitization market. Such measures would help bring down interest rates on auto loans, credit cards, student loans and small business loans and could be achieved with a more modest allocation from the TARP. Therefore, Treasury committed to provide $20 billion of TARP resources in support of a $200 billion Federal Reserve facility—the Term Asset-Backed Securities Loan Facility (TALF).

As such, Treasury's assessment at this time is that the purchase of illiquid mortgages and mortgage-related securities is not the most effective way to use TARP funds.

Q.6. The conservatorship of Fannie Mae and Freddie Mac has resulted in the unintended consequence of increasing the borrowing costs for the Federal Home Loan Banks (FHLBs) since the markets apparently now view them as having a more distant relationship to the government than the GSEs in conservatorship. Additionally, the decision by the FDIC to guarantee senior debt of financial institutions has raised funding costs for Fannie Mae and Freddie Mac because the market apparently does not view the $200 billion backstop provided to the enterprises as an equivalent guarantee. Given the stated purpose of putting the enterprises in conservatorship—to ensure a stable housing market, to lower mortgage interest rates, and to make sure the enterprises could actively purchase agency MBS—what steps is the Treasury considering to address these problems?

A.6. Treasury, working in concert with the Federal Reserve and FHFA, has been closely monitoring financial markets, particularly credit markets in terms of the impact and consequences of our actions. While the GSEs and not the Federal Home Loan Banks were placed into conservatorship with access to $100 billion through the senior preferred purchase agreement, all three entities have access to the GSE Credit Facility which Treasury established at the time of conservatorship. As a result, all three entities, including the FHLB, have access to enormous liquidity limited only by the amount of collateral which they have on their balance sheet. This credit facility was established specifically to level the playing field for the FHLBs. Furthermore, Treasury's purchases of MBS of FRE and FNM since September, also set up after the conservatorship, have instilled confidence in the overall mortgaged-backed securities (MBS) markets. The recent actions by the Federal Reserve Bank of New York to purchase the debt and MBS of the GSEs have also added confidence, thus lowering borrowing costs across the board, including those of FHLB. In fact, since the conservatorship was announced, the spread on FHLB 2-year debt, a benchmark issue, has declined from nearly 86 basis points above the comparable two-year Treasury to less than 45 basis points—in line with that of FNM and FRE—an enormous difference in borrowing costs and a primary result of the joint actions of Treasury and the Federal Reserve.

With regard to the FDIC guaranteed debt portfolio, while these securities have an explicit FDIC guarantee, they still do not possess the liquidity and depth of the GSE Agency or Treasury markets. Hence, some large institutions cannot be as actively involved in these markets since they need to purchase in very large size. As an example, about $115 billion of FDIC bank debt has been issued, while the agencies have over $3 trillion in debt outstanding. Partially as a result of this, the GSEs are able to borrow at a lower spread to Treasuries than FDIC backed debt. In fact, as mentioned above, 2–year benchmark FDIC backed debt on average trades 60 basis points above comparable 2-year Treasuries while GSE debt trades about 45 basis points above such Treasuries—i.e. the GSE borrowing costs are cheaper. Moreover, the life of the senior preferred agreement is in perpetuity for any debt issued between now and December 31, 2009 and for any tenor, while the FDIC debt program is limited to debt issued out three years and expires June 30, 2009—a major difference.

Q.7. As you know, since it was rescued by the Federal Reserve, AIG was engaged in lobbying activities at the state level. Specifically, the company was lobbying against certain requirements for mortgage brokers. The company subsequently promised to stop these activities. What steps has the Treasury Department taken to make sure that the entities receiving federal assistance are not engaged in lobbying, particularly in lobbying against important protections for borrowers? Did the Treasury Department consider putting any lobbying restrictions on the entities that it funds under the TARP?

A.7. As part of the agreement with AIG announced on November 10, 2008, AIG must be in compliance with the executive compensation requirements of Section 111 of EESA. AIG must comply with the most stringent limitations on executive compensation for its top five senior executive officers, and Treasury is requiring golden parachute limitations and a freeze on the size of the annual bonus pool for the top 60 company executives. Additionally, AIG must continue to maintain and enforce newly adopted restrictions put in place by the new management on corporate expenses and lobbying as well as corporate governance requirements, including formation of a risk management committee under the board of directors.

Q.8. I commend the Administration for following through with Section 112 of EESA by convening an international summit on November 15. In announcing the summit yesterday, the White House explained that leaders of the G20 and key international financial institutions will review progress on measures taken to address the financial crisis and to discuss principles for reform of regulatory and institutional regimes going forward. Please describe what the Treasury and Federal Reserve intend to accomplish through this summit and the subsequent working group meetings that will follow the summit—specifically, what types of principles for regulatory and institutional modernization will the United States pursue in the international community? Will these principles include protections for consumers and households which form the foundation of economic prosperity in our country as well as other countries?

A.8. The international summit was extraordinarily successful. It resulted in a five-page statement by the participating leaders as well as a 47-point action plan of quite specific actions, both in the near term and in the longer term. There were six key takeaways from the summit. First, there was broad agreement on the importance of the countries of the G20 taking and implementing pro-growth investment—pro-growth policies to stimulate our economies. Second, the leaders pledged to improve our regulatory regimes so to ensure that all financial markets, all financial products, and all financial market participants are subject to appropriate regulation or oversight. Related to this was a pledge of enhancing international cooperation among regulators and between regulators and international financial institutions. Third, one of the significant reforms that was agreed on was the need to reform international financial institutions to give greater representation to emerging market and developing economies. Fourth, there was an affirmation of free market principles, and, also importantly, the leaders expressly rejected protectionism. The final takeaway was a recognition and commitment to address the needs of the poorest, both by honoring our aid commitments, and by ensuring that the World Bank and IMF are adequately resourced so that they can help developing countries through this crisis. And here note was taken of the new liquidity facilities of the IMF, as well as the recent very large package announced by the World Bank, to support needs for trade finance and promote infrastructure development.

Q.9. The Treasury announced plans to invest $250 billion to strengthen the balance sheet of banks and the rest of the TARP money to provide relief to banks struggling with troubled assets. How much money will Treasury devote to provide relief for the millions of Americans struggling with troubled mortgages?

A.9. The existing TARP programs have exhausted the $350 billion in TARP funds that already have been authorized by Congress. Not all of those funds have yet been disbursed, and given the unpredictability and severity of the current financial crisis, Treasury believes it is prudent to reserve some of our TARP capacity to maintain not only our flexibility in responding to unforeseen events, but also that of the next Administration.

Separately from the TARP, Treasury has acted aggressively to keep mortgage financing available and develop new tools to help homeowners. Specifically, Treasury has achieved the following three key accomplishments:

- To support the housing and mortgage market, Treasury acted earlier this year to prevent the failure of Fannie Mae and Freddie Mac, the housing GSEs that affect over 70 percent of mortgage originations.
- October 2007, Treasury helped establish the HOPE NOW Alliance, a coalition of mortgage servicers, investors and counselors, to help struggling homeowners avoid preventable foreclosures.
- Treasury worked with HOPE NOW, FHFA and the GSEs to achieve a major industry breakthrough in November 2008 with the announcement of a streamlined loan modification program that builds on the mortgage modification protocol developed by the FDIC for IndyMac.

Q.10. What is your position on the use of funds by financial institutions under the CPP to acquire other institutions? Does your position depend on whether the other institution is healthy or failing?

A.10. The Treasury believes that banks and their management and shareholders are in the best position to determine whether acquisitions or mergers make sense. Acquisitions and mergers in the banking industry are also reviewed by the appropriate Federal banking agencies, which must consider the impact on the relevant communities as well as financial and managerial information. As noted above, the purpose and the focus of the CPP is the stability of the financial system. The program is not designed to, nor does it focus on, encourage or discourage acquisitions or mergers.

More generally, Treasury believes that when failing bank is acquired by a healthy bank, the community of the failing bank is better off than if the bank had been allowed to fail. Branches and financial services in that community are usually preserved. Costs to the taxpayers via the FDIC deposit fund are also lower than had the bank been allowed to fail. Prudent mergers and acquisitions can strengthen our financial system and our communities, while protecting taxpayers.

Q.11. We have received reports that insurance companies are in talks with Treasury to allow access to the TARP program.

Q.11.a. Has any decision been made about whether insurance companies may take part in the TARP program, and what is the rationale for inclusion?

A.11.a. The Treasury Department is analyzing the inclusion of insurance companies, including how to apply the CPP to bank holding companies and thrift holding companies with insurance company subsidiaries.

Q.11.b. Given that insurance companies are not federally regulated (at least, not on their insurance business), what exact oversight will be done to ensure safety and soundness of the companies?

A.11.b. Regulation of insurance companies is undertaken at the state level, not by the Treasury Department, and Treasury does not interfere in these regulatory-supervisory matters. Treasury also does not regulate the institutions which have chosen to participate in the voluntary CPP program, as they are regulated by their primary Federal regulators.

Separately, in March of 2008, Treasury published an extensive *Blueprint for a Modernized Regulatory Structure* that proposes a framework and many specific recommendations for reforming our financial regulatory system, including in the area of insurance. However, Treasury is using TARP to stabilize the financial system today, while regulatory modernization will likely take several years to complete.

Q.12. Each agency represented at the hearing has aggressively used the tools at their disposal in dealing with the crisis. However, sometimes the use of those tools has led to unintended consequences. For instance, when the Treasury Department guaranteed money market funds, it led to a concern on deposit insurance and bank accounts. When the FDIC guaranteed bank debt, it had an effect on GSE borrowing costs, which in turn directly affects mortgage rates. Acknowledging that there is often a need to act quickly in these circumstances, please explain what steps and processes you have employed to inform other agencies about significant actions you undertake to ensure that there are not serious adverse unintended consequences and that your actions are working in concert with theirs.

A.12. Throughout the financial crisis, the Secretary has been in very close contact with the other members of the President's Working Group on Financial Markets (the Federal Reserve, the SEC, and the CFTC) and the heads of the FDIC, OCC, and OTS. To the maximum extent possible, programs have been developed cooperatively among these different agencies.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM BRIAN D. MONTGOMERY

Q.1. You are rightly proud to have been able to launch the HOPE for Homeowners plan in so short a period of time, and I thank you and the other agencies involved for your efforts. In the end, of course, the goal is to help homeowners. Please provide the Committee with information regarding your outreach efforts to lenders, housing counselors, and borrowers. What steps have you taken to sign up lenders? How many lenders are currently participating? What steps have you taken to ensure borrowers know about the program?

A.1. FHA conducted the first national training session for lenders and counselors in Atlanta, Georgia, on November 13 and 14. Approximately 600 industry representatives attended the session. FHA staff provided a comprehensive overview of the program, explaining everything from borrower eligibility criteria to servicing requirements to FHA's monitoring practices on HOPE for Homeowners loans. The attendees were very attentive, asking excellent questions and engaging in substantive dialogue.

The next national FHA training session will be at the Neighborworks Training Institute, to be held in Washington, DC, from December 8th through December 12th. Additional counselor-specific training will be conducted in an on-line course offered by Neighborworks as well. Other lender and counselor training sessions will be performed on a smaller scale, at the local and regional level.

FHA has posted a calendar of training and outreach events on the FHA.gov Web site, to provide consumers, counselors, and lenders with a tool to look up events by date, location, sponsor, and intended audience. The listing of events will be updated on a regular basis, as the Board agencies continue to work with industry partners to set up additional sessions. At each of the events, staff from one or several of the HOPE for Homeowners Board agencies will present information on the program. The Web-based calendar of events can be found at *www.fha.gov.* As of November 20, 56 sessions had been scheduled. The national training schedule and a description of the events held by headquarters staff are included as attachments.

Recognizing that timely outreach from the lender community to struggling consumers is critically important, a form has been added to the Web site for FHA-approved lenders to sign up for the H4H program. There are currently more than 200 brokers included on the list, which is available for consumers on FHA.gov. Unfortunately, we have had very few originating lenders sign up for the program to date. The lending community not only needs time to understand the unique statutory requirements of the H4H Program but also to modify their protocols and practices, train their staff and update their technology systems before they can responsibly offer it to consumers. Consumers are strongly encouraged to contact their servicing lender and any subordinate lien holders since their participation is vital for a refinance into a HOPE for Homeowners mortgage.

With regards to borrower outreach, FHA and our partner agencies are executing an integrated consumer advertising campaign across a variety of media including radio, print, and the Internet. We are engaging HUD's target audiences through various online channels, while maintaining the FHA.gov portal in support piece in a variety of our marketing activities communications channel. We have also leveraged HUD's field network and industry partners to expand reach. Two online applications are being developed by the Federal Reserve to post on the FHA Web site. FHA also developed an online training course for housing counselors with Neighborworks that will be posted on the Web sites of both organizations.

Q.2. What impediments do you see to the use of the HOPE for Homeowners program?

A.2. There are a number of specialized requirements that make this program very different from, and more difficult than, any other mortgage product the lending community has offered and/or helped consumers to access.

FHA fully recognizes the challenging policy decisions that the Congress and the Administration had to make to ensure that any program designed to serve homeowners in need did not place undue financial burden on American taxpayers. Nevertheless, the lending community has consistently cited several key shortcomings and expressed concern that the program was unnecessarily complicated. The primary concerns raised repeatedly are that the program:

1. imposes excessive costs on consumers
2. directs unfair payments to the Federal government, at the expense of both lenders and consumers
3. restricts eligibility so severely that few homeowners in need can qualify

In line with these general concerns, FHA makes the following specific recommendations for Congressional actions needed to modify the program to increase uptake.

- Eliminate SEM and SAM altogether
- Permit subordinate liens to be placed behind HOPE for Homeowners mortgages
- Reduce 1.5% annual premium
- Remove restrictive eligibility criteria, including:
  - No intentional defaults
  - No false information on previous loan
  - No fraud over previous 10 years
  - No ownership of other residential real estate
  - March 1, 2008 DTI affordability measure
- Remove 1st payment default provision

FHA looks forward to providing Congress with a full account of the concerns we have been presented to begin the dialogue about additional legislative changes that would improve program participation.

Q.3. As you note in your testimony, FHA's loan volume has skyrocketed over the past two years. Its market share has grown from

2 percent to 17 percent. Please explain how FHA has handled this huge increase in volume without compromising the quality of the loans it has insured. Please provide the Committee data on the types of loans insured (purchase money, term refinance, cash out refinance, and others); the characteristics of the loans (LTVs, sources of downpayments, terms, and other relevant data); characteristics of the borrowers (credit scores and other relevant data); and any other information you think the Committee could use to evaluate the new book of business.

A.3. The attached report provides statistics on FHA's increased loan volume.

Characteristics of Single-Family Loans Insured by FHA in FY2008

U.S. Department of Housing and Urban Development
Office of Housing
December 2008

Table 1. FHA Single Family Insurance Endorsements in FY 2008 By State, with Shares by Loan Purpose

State	Number of Endorsements	Shares by Loan Purpose: Purchase	Rate-and-Term Refinance	Cash Out Refinance
US	**1,087,443**	**58.09%**	**26.60%**	**15.31%**
AK	2,732	59.3	24.9	15.8
AL	22,206	60.7	23.9	15.4
AR	11,893	64.3	21.6	14.1
AZ	33,643	65.8	19.7	14.5
CA	49,718	83.5	9.0	7.5
CO	31,644	56.2	33.0	10.8
CT	11,548	53.1	26.9	20.0
DC	1,265	45.9	26.8	27.3
DE	4,089	46.1	28.0	25.9
FL	53,419	63.9	19.0	17.1
GA	55,539	56.2	29.6	14.2
HI	799	44.4	22.5	33.0
IA	9,842	52.2	31.1	16.7
ID	8,200	50.4	24.3	25.3
IL	45,240	39.1	40.8	20.1
IN	35,437	54.7	30.5	14.8
KS	12,039	58.1	29.0	13.0
KY	18,069	56.1	28.4	15.5
LA	12,095	65.0	19.3	15.7
MA	12,310	50.9	32.6	16.5
MD	32,297	37.6	36.8	25.6
ME	3,120	54.2	29.6	16.3
MI	41,901	51.1	38.0	10.9
MN	17,519	63.1	24.7	12.2
MO	31,824	42.7	39.1	18.2
MS	8,773	60.9	23.8	15.3
MT	3,664	58.1	21.0	20.9
NC	38,340	53.6	30.1	16.3
ND	2,286	75.5	13.2	11.3
NE	6,159	57.8	31.0	11.2
NH	2,983	49.5	34.6	16.0
NJ	31,753	38.2	34.1	27.7
NM	8,080	54.8	25.7	19.5
NV	14,652	74.6	15.8	9.6
NY	30,386	55.6	24.4	20.0
OH	50,164	55.3	30.6	14.1
OK	17,178	70.8	18.3	10.9
OR	11,782	46.4	28.9	24.7
PA	39,071	57.5	23.4	19.1
PR	7,375	67.3	17.0	15.7
RI	2,846	51.0	32.6	16.4
SC	16,104	58.1	26.0	15.9
SD	2,246	58.5	24.8	16.7

Table 1. FHA Single Family Insurance Endorsements in FY 2008 By State, with Shares by Loan Purpose

State	Number of Endorsements	Shares by Loan Purpose		
		Purchase	Rate-and-Term Refinance	Cash Out Refinance
TN	31,740	54.0	29.0	17.0
TX	96,595	85.4	14.5	0.2
UT	22,203	50.2	28.0	21.8
VA	34,699	53.1	26.8	20.1
VI	27	51.9	7.4	40.7
VT	721	43.1	37.2	19.7
WA	25,510	44.7	29.3	26.0
WI	16,705	39.2	41.0	19.7
WV	3,998	60.7	22.0	17.3
WY	3,015	59.5	21.4	19.1

Table 2. FHA Single Family Insurance Endorsements, FY 2008

LTV Distribution of Loans by Loan Purpose

Loan Purpose	LTV Classes Up to 90%	91-95%	96-98%	MISS[a]	Number of Loans	Share of Loans
Purchase	6.41%	5.99%	87.37%	0.22%	631,652	58.09%
FHA loan, rate-and-term refinance[a]	11.59	15.03	8.02	65.35	78,793	7.25
Conventional loan, rate-and-term refinance	30.93	43.66	25.39	0.02	207,828	19.11
Cash-out Refinance[b]	44.78	53.62	1.59	0.02	169,167	15.56
All	17.44%	21.26%	56.43%	4.87%	1,087,440	100.00%

[a]FHA rate-and-term refinancings occur through streamline processes that do not generally require a property appraisal.

[b]Cash-out refinancings are fully-underwritten loans that replace both conventional and FHA-insured loans. Over 90% of these (14.04% of all loans) are replacement loans for conventional financing.

Source: US Department of HUD

Table 3. FHA Single Family Insurance Endorsements, FY 2008

FICO Distribution of Loans by Loan Purpose

Loan Purpose	FICO Score Class 680-850	640-679	600-639	560-599	500-559	300-499	MISS[a]
Purchase	33.30%	21.70%	22.67%	13.52%	5.79%	0.51%	2.51%
FHA loan, rate-and-term refinance[a]	7.05	7.62	8.16	4.37	2.53	0.58	69.69
Conventional loan, rate-and-term refinance	20.21	23.93	28.21	16.64	8.81	1.25	0.95
Cash-out Refinance	19.53	22.64	27.13	17.49	10.68	1.47	1.06
All	26.76	21.25	23.37	14.07	6.89	0.81	6.85

[a]FHA rate-and-term refinancings occur through streamline processes that do not generally require collection of credit reports or the scores generated from those reports.

Source: US Department of HUD

Table 4. FHA Single Family Insurance Endorsements, FY 2008

LTV and FICO Distribution of Fully Underwritten Loans[a]

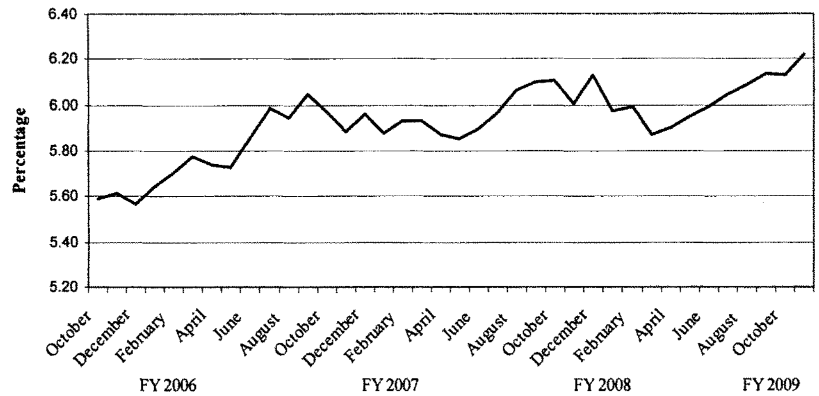
LTV Class	FICO Score Class							Shares by LTV Class
	680-850	640-679	600-639	560-599	500-559	300-499	MISS[b]	
Up to 90	3.06%	3.44%	4.73%	3.62%	2.34%	0.35	0.36%	17.90
91-95	5.69	5.39	5.76	3.03	1.46	0.17	0.24	21.74
96-98	19.49	13.45	14.03	8.16	3.42	0.31	1.33	60.21
Shares by FICO Class	28.24%	22.28%	24.52%	14.82%	7.23%	0.82%	1.94%	100.00%

[a]Excludes FHA (streamline) rate-and-term refinancings.

[b]MISSing represents loans underwritten with nonstandard credit histories.

Source: US Department of HUD

Figure 1. Average Interest Rates on FHA Fixed-Rate Loans By Fiscal Year and Month



Source: US Dept of HUD

Table 5. FHA Single-Family Insurance
Sources of Downpayment Funds for Home Purchase Loans
By Fiscal Year

Fiscal Year	Owner	*Nonprofit*[a]	Relative	Government Agency	Employer
2006	48.74%	32.78%	12.93%	5.43%	0.13%
2007	47.52	35.09	12.02	5.25	0.12
2008	52.01	32.78	12.13	2.98	0.10
2009[b]	58.16	25.32	14.50	1.92	0.11

[a]At least 97 percent of all nonprofit downpayment gifts are paid for by property sellers.

[b]Insurance endorsements for the first two months, October and November. The statutory ban on seller-funded downpayment assistance took effect for all loans originated in October. However, there is generally a three month lag between application and final insurance endorsement of a closed loan. Therefore, the full effect of the ban should be seen in January and February endorsements.

Source: US Dept of HUD

Table 6. FHA Single Family Endorsements by Income Class[a]

Fiscal Year	Very Low	Low	Moderate	Middle	High	Unknown	Totals
2005	54,021	152,093	78,133	48,495	63,131	3,392	399,265
2006	43,875	137,181	79,062	53,190	74,871	939	389,118
2007	33,925	122,606	82,917	62,493	100,605	87	402,633
2008	69,806	281,019	201,683	159,905	307,966	292	1,020,671
Percentage Growth in 2008	106	129	143	156	206	236	153
Income-Class Shares of Total Endorsements (%)							
2005	13.53	38.09	19.57	12.15	15.81	0.85	100.00
2006	11.28	35.25	20.32	13.67	19.24	0.24	100.00
2007	8.43	30.45	20.59	15.52	24.99	0.02	100.00
2008	6.84	27.53	19.76	15.67	30.17	0.03	100.00
Claim-Rate Multiplies, Relative to the Moderate Income Class[b]							
Avg 2000-2005	1.90	1.34	1.00	0.79	0.56	0.33	1.14

[a]These are the income classes used for Fair Market Rent determination: Very Low = up to 50 percent of area median income (AMI); Low = 51 – 80 percent of AMI; Moderate = 81-100 percent of AMI; Middle = 101-120 percent of AMI; High = above 120 percent of AMI.

[b]Claim-rate multiples are calculated by comparing to-date claim rates across Income classes and within each endorsement fiscal year. The averages shown here are within each income class and across endorsement fiscal years. The Moderate income class is uses as the base case because its claim rates tend to be closest to the overall FHA portfolio rates.

Source: US Department of HUD; claim data are as of October 31, 2008.

Q.4. Each agency represented at the hearing has aggressively used the tools at their disposal in dealing with the crisis. However, sometimes the use of those tools has led to unintended consequences. For instance, when the Treasury Department guaranteed money market funds, it led to a concern on deposit insurance and bank accounts. When the FDIC guaranteed bank debt, it had an effect on GSE borrowing costs, which in turn directly affects mortgage rates.

Acknowledging that there is often a need to act quickly in these circumstances, please explain what steps and processes you have employed to inform other agencies about significant actions you undertake to ensure that there are not serious adverse unintended consequences and that your actions are working in concert with theirs.

A.4. Developing a risk-oriented business plan early in the H4H Program's implementation was an essential element designed to assist the Oversight Board to ensure that the processes, procedures, and communication requirements are put in place to do what Congress has directed it to do. The H4H team has developed a business plan that builds on the considerable work already completed by the agencies to develop the Program. It is a living document with a key purpose to assist the Oversight Board and its member agencies to sufficiently: (1) identify and prioritize Program risks, and to (2) develop action plans and strategies to sufficiently mitigate the highest Program risks.

In developing this business plan the agencies operated under the key assumptions: (1) HUD is operating the program, (2) there is a strong preference to leverage HUD's existing processes, and (3) to appropriately assess risk and provide risk mitigation strategies, it is critically important to focus on elements that are unique to the H4H program as these areas may pose the highest risks to the Program and agencies administering the Program. This includes identifying the new or adapted business processes that will be required. The risk identification also includes externalities that may be outside of the agencies' control.

As the HOPE for Homeowners Program moves from its Startup Phase (July 30–October 1) into its Implementation Phase (October 1–December 31), the staffs of the Treasury Department, FDIC, and Federal Reserve have less need for active involvement in the day-to-day matters of the Program. Other than resources contributed to unfinished implementation of the Program's implementing regulations and mortgagee letters, these staff efforts will shift to a monitoring role over this transitional period. By the end of this Implementation Phase, FHA management and staff will be expected to operate the program, and the Oversight Board and its member agencies will together monitor program performance, make recommendations for refinements or enhancements based on feedback from the Program's results and (if relevant) changes in the economic and housing market environment, and their own analyses. Staffs from the agencies will continue to communicate regularly and coordinate Oversight Board meetings and affairs, including required monthly reports to Congress. The Treasury Department, FDIC, and Federal Reserve will of course be responsive to requests for resources and assistance if needed, including but not limited to possible exigent circumstances in the economy and/or housing market.

To facilitate this transition and to put in motion the changed roles, the four agencies will initiate a more formal set of staff structures and processes aimed at fulfilling these responsibilities and maintaining attendant controls and information flows. The chart below summarizes these structures and processes.

Questions for the Hearing on "Turmoil in the U.S. Credit Markets: Examining Recent Regulatory Responses"
October 23, 2008

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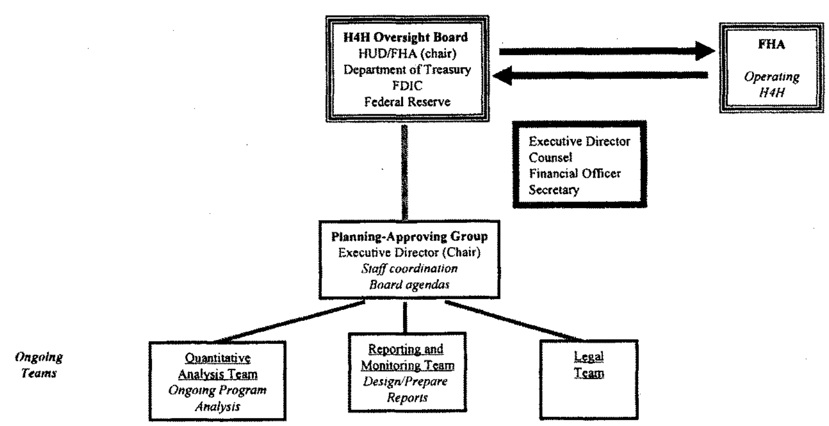
To facilitate this transition and to put in motion the changed roles, the four agencies will initiate a more formal set of staff structures and processes aimed at fulfilling these responsibilities and maintaining attendant controls and information flows. The chart below summarizes these structures and processes.

HOPE for Homeowners Oversight Board
[Proposed] Ongoing Program Organization



Date	Event	Description	Audience	Number of attendees
10/1	FHA Conference Call	Introductory conference call to announce program roll out.	Industry; Consumers	600+
10/1	Inside Mortgage Finance.	Conference call on FHA modernization included questions on H4H.	Industry	300+
10/2	Federal Reserve	H4H briefing	Consumer affairs office and outreach staff.	12 regional banks.
10/6	National Council of State Housing Finance Agencies.	H4H briefing	State Finance Agencies.	30 states.
10/7	FHA Conference Call	H4H briefing	Counselors	200+
10/8	Housing summit	2 sessions on H4H; general overview and more in-depth.	Government officials; lenders; counselors.	600+
10/14	American Bankers Association (ABA).	H4H briefing	ABA members	250+
10/15	FHA Conference Call	H4H briefing targeted to top 30 FHA lenders and FHA liaisons.	Industry; government officials.	500+
10/15	FHA Conference Call	H4H briefing and discussion of outreach efforts.	Counselors	100+
10/16	National Council of State Housing Finance Agencies.	H4H briefing	State Finance Agencies.	20 states.
10/27	FHA Field Briefing	Field briefing for FHA and HUD staff who perform outreach activities.	Government officials	100+
10/30	Inside Mortgage Finance.	H4H briefing	Industry	200+
11/5	FHA Conference Call	H4H briefing	Industry	200+
11/6	Federal Housing Finance Agency.	H4H briefing	Government officials	100+
11/13–14	National H4H Training Conference.	National 2-day extensive training program on H4H.	Industry; Counselors	600+
11/19	National Press Club Event.	Sec. Preston announces programmatic changes to H4H product.	Media	100+
11/20	Mortgage Bankers Association.	Issues with implementing H4H	Industry	100+
12/4	Independent Community Bankers of America.	H4H briefing	Industry	300+
12/5	Neighborworks	Taped three hour online training course.	Counselors	n/a
12/8–9	Neighborworks	Two day training event	Counselors	tbd

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM JAMES B. LOCKHART, III

Q.1. There has been significant confusion in the marketplace regarding the status of debt offered by Fannie Mae and Freddie Mac. Specifically, there is confusion as to whether or not that debt is guaranteed by the federal government. Your revised testimony makes it clear that the federal government is not directly guaranteeing the debt. Rather, the government has provided a $100 billion capital backstop to each enterprise with which it can pay all its debts.

However, the failure to extend this guarantee has had a number of unintended consequences in light of the government's decision to explicitly guarantee senior debt for other financial institutions. For example, the press reports that the cost of raising debt for both Fannie Mae and Freddie Mac has gone up significantly since the latter decision. In addition, the two enterprises have apparently been unable to raise anything but short-term funding. This leads to a number of questions:

Q.1.a. Was FHFA consulted in the deliberations regarding guarantee of bank debt? If so, was any consideration given to the possibility that such a guarantee might undermine the ability of the enterprises to fund themselves effectively?

Q.1.b. Is any thought being given, or are any discussions underway regarding providing the enterprises with the same guarantee as has been given to other financial institutions?

Q.1.c. One outcome of these increased funding costs is an increase in mortgage interest rates. According to the *Wall Street Journal* (October 30, 2008; "Mortgage Plan Isn't Cutting Rates"), rates for 30-year fixed rate mortgages have climbed to 6.64%, up from the prior week's 6.24%. Given the fact that one of FHFA's stated purposes for putting the enterprises into conservatorship was to support the housing market, including with increased purchases of agency MBS, what can be done about these higher funding costs? Is this funding problem undermining the ability of the enterprises to meet its mission of maintaining a stable and orderly housing market?

Q.1.d. Please provide the Committee with data showing the change in funding costs for the enterprises from just prior to the conservatorship to the announcement of the guarantee for senior debt of financial institutions to the present. Please provide data on the associated mortgage rates over the same period of time.

A.1.a–d Getting mortgage rates down more in line with declines in Treasury yields has the potential to provide significant benefit to troubled housing markets. As the attached chart and tables show, the establishment of the conservatorships was accompanied by a quick drop in mortgage rates of more than 40 basis points, and spreads of Enterprise yields above Treasury yields fell comparably. Those gains appeared to erode over the next few weeks, with continued bad news about financial institutions and the economy. The announcement of FDIC insurance for senior debt of insured depository institutions coincided with further widening of yield spreads and higher mortgage interest rates. However, it is important to note that yields on GNMA mortgage-backed securities (MBS), which are guaranteed with the full faith and credit of the U.S. Government performed comparably with yields on MBS guaranteed by the Enterprises. FHFA received a pre-announcement notification of the senior debt guarantees. We are unaware of any plans to extend those guarantees to the Enterprises, something that might require legislation. Subsequently, the Fed's announcement of $500 billion of MBS purchases and $100 billion of GSE debt purchases caused a significant decline in Enterprise yields spreads and in mortgage rates, bringing interest rates on 30-year fixed-rate loans to their lowest level in the nearly 38 years' history of Freddie Mac's survey.

Q.1.e. In addition, the funding for the Federal Home Loan Banks (FHLB) has also been rising. In fact, it is our understanding that

FHLB debt is even more expensive than debt issued by the enterprises. What is being done to address this problem?

Q.1.f. All the housing GSEs are increasingly dependent on short term financing. What challenges will it pose if the GSEs are increasingly forced to depend on short-term financing to carry on their operations?

A.1.e-f: Debt of the Federal Home Loan Banks initially benefitted similarly to that of the Enterprises following the establishment of the Enterprise conservatorships. Shortly thereafter, however, Bank yields rose relative to Enterprise yields. While debt yields of all GSEs had been very close, differentials of as much as 60 basis points opened up at 2, 3, and 5-year maturities. While HERA gave Treasury authority to buy unlimited quantities of debt from any of the housing GSEs, the preferred stock agreements were only made with Fannie Mae and Freddie Mac because the Banks did not need that kind of support. Nonetheless, the market seemed to view them as less protected. Since the Fed's debt purchase plans were announced in late November, though, yields spreads among the different GSEs have tightened and returned to near normal amounts. All of the housing GSEs, and especially the Enterprises depend to some extent on their ability to issue intermediate-term debt. That was nearly impossible in the fall, but recently increased investor interest has permitted GSE issues of debt with maturities of as long as five years. Conditions are still far from satisfactory, but improving. In the meantime, purchases by the Treasury under its GSE MBS Purchase Facility have augmented those of the Enterprises and the Fed.

Q.1.g. In a recent story, *Business Week* reported that FHFA was requiring enterprises to buy troubled mortgage assets. Is this true? If so, what is the policy rationale for doing this?

A.1.g The story was unfounded. We did not require the Enterprises to buy troubled assets. We believe they can best serve the housing and mortgage markets primarily by using their resources to maintain a liquid secondary mortgage through purchasing and guaranteeing new loans. In addition, we have been encouraging them to reduce foreclosures and mitigate losses by aggressively modifying their own troubled loans and setting a standard for others.

Q.2 Section 110 of the Emergency Economic Stabilization Act of 2008 (ESA) requires FHFA to "Implement a plan that seeks to maximize assistance for homeowners" in order to avoid preventable foreclosures. Please describe in detail your agency's plan in this regard, and any steps that have already been taken to implement this plan.

A.2.

a. FHFA Expertise: FHFA employs examiners and executives who have expertise and/or experience in default management, nonperforming loans, loss mitigation and REO management. These individuals provide supervision and oversight of both enterprises in these areas.

b. Enterprise Internal Controls. For the last 18–months, FHFA has focused on the loss mitigation and REO management areas. FHFA has reviewed the enterprises' internal policies and procedures, seller/servicer guides, bulletins and announcements, as well as the internet sites and published materials to support servicers' loss mitigation efforts, activities and reporting.

c. Enterprise Reporting. FHFA consistently receives internal monthly and quarterly management reports for non-performing loans that include loss mitigation efforts. To compliment these internal reports, starting in 2008, FHFA required the enterprises to submit a monthly report on loss mitigation activities. Data from those reports are aggregated with results posted to FHFA's website. FHFA's *Foreclosure Prevention Report* (formerly, *Mortgage Metrics Reports*) provides the most comprehensive data on loss mitigation efforts (in comparison to HOPE NOW and the OCC/OTC reports), and continuously reports on the loss mitigation performance ratio. This ratio has clearly brought transparency to and focus on the enterprises' efforts in assisting borrowers.

For 2009 reporting, FHFA has enhanced reporting requirements effective with data for January loss mitigation actions. The additional data elements relate to expanded modification types (as required by EESA), the reason/s for default, default status (e.g., bankruptcy, military indulgence, government seizures, probate), property condition, and occupancy status.

d. FDIC Loan Modification Program. FHFA worked with the FDIC and the enterprises to pilot the FDIC/IndyMac loan modification program, announced August 20, 2008. FHFA initiated work on this effort in August 2008. Both enterprises initiated the pilot in October.

e. Streamlined Modification Program (SMP). FHFA became actively involved with HOPE NOW Alliance members and the enterprises in October with the goal of rolling out a streamlined modification program. The program was announced November 11th and rolled out December 15th. To enhance the success of this program, both enterprises suspended the scheduling of and scheduled foreclosure sales on occupied properties for the period November 26th to January 31st. The suspension allows borrowers in foreclosure the opportunity to cure the serious delinquency with a loan modification.

f. Loss Mitigation Programs. The enterprises, offer other loss mitigation programs to assist borrowers in saving their homes—forbearance plans, payment plans, a standard loan modification and a delinquency advance program (e.g., Fannie Mae's HomeSaver Advance program.) For borrowers who are unable to make a payment at the most liberal modified terms, both enterprises offer short sales, deeds-in-lieu and charge-offs in lieu of foreclosure.

g. Loan Modification Issues. FHFA has worked with both enterprises in reviewing accounting, trust and capital issues that may disincent the enterprises from being aggressive with modifications. Those issues have been addressed. The enterprises have a solid understanding of FHFA's desired objective of keeping borrowers in their homes. In particular, Fannie Mae announced major changes to its trust that allow for more flexibility with loan modifications.

h. Interagency Efforts. FHFA has continued to work with HOPE NOW Alliance members, the OCC, OTS, HUD, FDIC and Treasury to discuss industry issues and concerns, and the enterprises' in particular. Results of this communication have allowed FHFA to obtain third party views on how well the enterprises are doing, and what they could be doing better or differently.

i. Non-Agency Investments. FHFA has taken an active role in communicating with PLS servicers, trustees and investors to encourage them to adopt the SMP program, or a comparable program acceptable to all PLS investors and in compliance with PLS pooling and servicing agreements. FHFA has supplemented these conversations with meetings with American Securitization Forum (ASF) officers. Doing so has not only helped borrowers whose loan are in PLS securities, but also the enterprises who own 20% of PLS securities.

Q.3. Discussions with a number of entities, from major lenders and servicers to housing counselors, reveal that Fannie Mae and Freddie Mac are resisting efforts to do loan modifications. Please describe the efforts being undertaken by the two enterprises, and the FHLBs, to engage in loss mitigation. Specifically, what are the loss mitigation policies of the GSEs? What barriers do you see in these policies to moving toward a more systematic approach to loan modifications?

A.3.

a. Loan Modification Efforts. FHFA's oversight and supervision of the enterprises doesn't confirm the view that the enterprises are resisting efforts to do loan modifications. In fact, since the early 1990s, both enterprises have been leaders in the loss mitigation area, and set the standards for what is best practice for the industry.

In discussing this observation with both enterprises, two points were made. First, many servicers were unaware of the authority the enterprises had delegated to them to review and approve loan modifications in their behalf. Second, the enterprises strongly believed the proper way to assist a borrower and modify the loan is through the standard rather than the streamlined process. The standard process requires a customized approach to working with the borrower and his/her circumstances based on a cash-flow budget. The streamlined process requires an approach that is less borrower-specific, and makes assumptions about the borrower's ability to pay at modified terms based on a ratio analysis.

Initially, the enterprises resisted efforts to adopt a streamlined modification program, because it wouldn't necessarily address the individual borrower's unique situation. Because of rising delinquencies, the increase in properties in the foreclosure process, and servicers' capacity limitations, the enterprises worked actively with HOPE NOW Alliance members, and agreed to SMP program guidelines.

b. Communication from External Parties. When an external party has contacted FHFA regarding the enterprises' actions, we follow up with the enterprise on the specific concern. As a result, either FHFA and/or the enterprise contacts the external party. In addition, FHFA will discuss the situation and circumstances, and determine if there is a more general or broader issue that requires attention. Recently, a housing counseling agency contacted FHFA regarding concerns around Fannie Mae's decisions on loan modification requests. FHFA met with the counseling agency, and asked it to provide specific examples (cases) where borrowers had requested modifications that were not approved by Fannie Mae. Fannie Mae was very open to this and agreed to do so. Generally, FHFA has found it to be more beneficial and productive to work with specific examples and instances, than to address broad generalizations.

c. Loss Mitigation Performance. As reported in FHFA's monthly and quarterly Foreclosure Prevention Reports through September 2008:

1. Loss Mitigation Performance Ratio. The enterprises' loss mitigation ratio has fluctuated from 46.9 percent to 64.8 percent from January to September, and averaged 54.6 percent. That ratio measures the number of borrowers who were helped versus those who needed help (were destined for foreclosure.) FHFA's 2009 performance goals target a 25 percent increase in loan modifications over 2008 actuals.
2. Loss Mitigation—Borrower Retained Property. Loss mitigation actions that allowed the borrower to retain his or her property represented 93 percent of all loss mitigation actions—139,381 in total. Of that number, 49,128 were completed payment plans, 45,179 were delinquency advances, and 44,458 were loan modifications.
3. Completed Foreclosures. Completed foreclosures as a percent of new foreclosures initiated averaged 32.7 percent for the enterprises, but 41.5 percent for OCC/OTS servicers and 42.8 percent for HOPE NOW servicers.

d. Loss Mitigation Policies, Procedures and Processes. Both enterprises have internal policies and procedures, seller/servicer guides, and bulletins and announcements, as well as internet sites and materials to support servicers' loss mitigation efforts and activities. To compliment those, the enterprises provide training materials and training (on-line and classes) in loss mitigation.

e. Barriers. Reported barriers to effective loan modifications are not an outgrowth of enterprise policies. They are:

1. Subordinate liens. There are a high number of loans with subordinate second liens. A successful workout often requires the cooperation of the second lien holder, who may/may not be represented by the first mortgage servicer.
2. Unable to Contact/Locate. Servicers are often unable to assess the borrower's financial position and/or get him or her to commit to a loan modification because the borrower can' be contacted, is evading the servicer's calls or letters, and/or has abandoned the property. In many cases, the properties were purchased as investment properties. The borrowers never intended to live in them. If the property looses value and/or the borrower has trouble renting the property, the borrower is inclined to walk away from a bad investment.
3. Bankruptcy. Borrowers in bankruptcy cannot be contacted directly by the servicer for a workout—even though they may take this action in an effort to save their homes. Therefore, the population of borrowers who can be solicited for a loan modification is reduced.
4. Fraud/Misrepresentation. Given that some loans were originated under low or no documentation programs, a review of

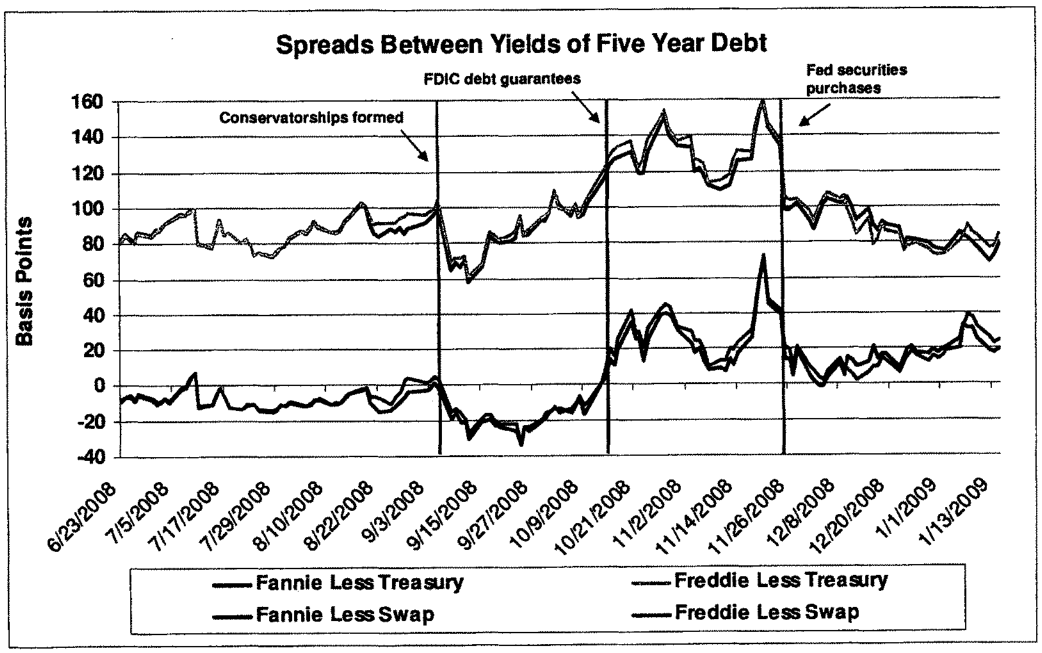
the defaulted borrower's situation may reveal that the borrower never made the income to support the mortgage in the first place. Efforts to modify the loan may be unsuccessful as the borrower may have no ability to pay at even the most favorable terms.

Q.4. Each agency represented at the hearing has aggressively used the tools at their disposal in dealing with the crisis. However, sometimes the use of those tools has led to unintended consequences. For instance, when the Treasury Department guaranteed money market funds, it led to a concern on deposit insurance and bank accounts. When the FDIC guaranteed bank debt, it had an effect on GSE borrowing costs, which in turn directly affects mortgage rates.

Acknowledging that there is often a need to act quickly in these circumstances, please explain what steps and processes you have employed to inform other agencies about significant actions you undertake to ensure that there are not serious adverse unintended consequences and that your actions are working in concert with theirs.

A.4. We meet frequently with other agencies to discuss policy issues and planned significant actions. HERA specifically provided for consultation with the Federal Reserve on implementation of new powers and sharing of information about the condition of our regulated entities. It also created the Federal Housing Finance Oversight Board, which meets at least quarterly and includes the Secretaries of Treasury and HUD, as well as the Chairman of the SEC. The Senior Preferred Stock Purchase Agreements signed between the Enterprises and Treasury ensure consultation or agreement with the Treasury on many aspects of the Enterprises activities. The EESA created the Financial Stability Oversight Board, which includes the same members as the FHFA Oversight Board plus the Federal Reserve Chairman. It has met seven times, and staff have met frequently. In addition, we have met informally with these agencies and others numerous times in the past few months to discuss issues, policies, and planned actions. We worked closely, for example, with the Treasury and HUD, and consulted with the FDIC, in developing the Streamlined Modification Program adopted by the Enterprises and a majority of the portfolio lenders participating in the private sector alliance HOPE NOW to reduce foreclosures.

Enterprise Debt Spreads to Treasuries and Swaps



Source: OFHEO based on data from Bloomberg Financial LP.

Five-Year Enterprise Debt Spreads to Treasuries and Swaps

	Fannie Less Treasury	Freddie Less Treasury	Fannie Less Swap	Freddie Less Swap	30-Year FRM Mortgage Commitment Rate[1]
6/23/2008	80.9	80.3	-8.65	-9.25	
6/24/2008	85.1	84.7	-6.45	-6.85	
6/25/2008	82.7	81.9	-5.45	-6.25	
6/26/2008	81.2	80.4	-8.35	-9.15	6.45
6/27/2008	86	85.5	-4.75	-5.25	
6/30/2008	84.2	83.7	-7.55	-8.05	
7/1/2008	87.5	86	-9.35	-10.85	
7/2/2008	87.3	87.5	-9.55	-9.35	
7/3/2008	90.5	90.9	-7.5	-7.1	6.35
7/4/2008	n/a	n/a	-9	-9.7	
7/7/2008	96.4	95.7	-1.35	-2.05	
7/8/2008	95.8	95.6	-0.75	-0.95	
7/9/2008	98.1	97.4	4.45	3.75	
7/10/2008	99.4	99	7.55	7.15	6.37
7/11/2008	80.2	79.3	-11.35	-12.25	
7/14/2008	77.9	78.1	-10.9	-10.7	
7/15/2008	83.6	83.7	-6.15	-6.05	
7/16/2008	92.8	92.6	-1.35	-1.55	
7/17/2008	84.6	84.7	-6.25	-6.15	6.26
7/18/2008	85.9	85.9	-12.95	-12.95	
7/21/2008	80.6	80.6	-13.05	-13.05	
7/22/2008	82.4	82.7	-11.35	-11.05	
7/23/2008	79.3	79.4	-10.95	-10.85	
7/24/2008	73.6	73.2	-10.65	-11.05	6.63
7/25/2008	74.7	75.3	-13.85	-13.25	
7/28/2008	72.4	72.9	-14.9	-14.4	
7/29/2008	73.9	74.8	-14.2	-13.3	
7/30/2008	77.4	77.6	-10.7	-10.5	
7/31/2008	78.5	78.6	-11.6	-11.5	6.52
8/1/2008	82.4	83.2	-9.8	-9	
8/4/2008	87	87.4	-11.6	-11.2	
8/5/2008	85.4	85.8	-12.1	-11.7	
8/6/2008	88.8	89.2	-10.55	-10.15	
8/7/2008	92.3	91.3	-8.15	-9.15	6.52
8/8/2008	88.9	89.3	-8.05	-7.65	
8/11/2008	86.3	86.6	-11.2	-10.9	
8/12/2008	86.4	85.4	-10.15	-11.15	
8/13/2008	86.8	86.3	-9.7	-10.2	
8/14/2008	92	91.2	-6.9	-7.7	6.52
8/15/2008	94.6	94.1	-4.5	-5	
8/18/2008	102.1	101.5	-2.4	-3	
8/19/2008	99.5	100.2	-2.05	-1.35	
8/20/2008	91.5	95.2	-9.8	-6.1	
8/21/2008	85	90.7	-12.2	-6.5	6.47
8/22/2008	83.9	91.6	-14.9	-7.2	
8/25/2008	87.5	91.4	-14.55	-10.65	

Five-Year Enterprise Debt Spreads to Treasuries and Swaps

	Fannie Less Treasury	Freddie Less Treasury	Fannie Less Swap	Freddie Less Swap	30-Year FRM Mortgage Commitment Rate[1]
8/26/2008	85.9	91	-11.4	-6.3	
8/27/2008	88.7	93.9	-8.9	-3.7	
8/28/2008	85.1	94.5	-6.6	2.8	6.4
8/29/2008	88.2	96.1	-3.8	4.1	
9/1/2008	n/a	n/a	n/a	n/a	
9/2/2008	91.3	95.4	-3.05	1.05	
9/3/2008	93.4	97.7	-1.95	2.35	
9/4/2008	95.3	98.3	1.5	4.5	6.35
9/5/2008	99.3	104.4	-2	3.1	
9/8/2008	65.1	69.8	-19.65	-14.95	
9/9/2008	69.1	71.8	-16.35	-13.65	
9/10/2008	66.7	72	-21.05	-15.75	
9/11/2008	70.5	72.5	-21	-19	5.93
9/12/2008	58	61.3	-30.85	-27.55	
9/15/2008	66.2	68	-20.1	-18.3	
9/16/2008	72.3	75.9	-20.2	-16.6	
9/17/2008	83.8	86.5	-19.6	-16.9	
9/18/2008	82.3	84.3	-22.65	-20.65	5.78
9/19/2008	80.6	82	-23.59	-22.19	
9/22/2008	80.8	84.5	-25.58	-21.88	
9/23/2008	82.8	87.1	-26.25	-21.95	
9/24/2008	94.5	95.1	-33.8	-33.2	
9/25/2008	84.1	83.7	-23.68	-24.08	6.09
9/26/2008	84.8	87	-26.23	-24.03	
9/29/2008	92.7	93.6	-20.1	-19.2	
9/30/2008	92.4	94.5	-18.32	-16.22	
10/1/2008	97.6	97.7	-15.12	-15.02	
10/2/2008	108.2	109.3	-13.4	-12.3	6.1
10/3/2008	101.6	99.4	-13.65	-15.85	
10/6/2008	94.7	97.3	-16.25	-13.65	
10/7/2008	100.8	101.6	-10.9	-10.1	
10/8/2008	94	94.5	-7.36	-6.86	
10/9/2008	95.8	101	-16.6	-11.4	5.94
10/10/2008	102.4	106	-12.71	-9.11	
10/13/2008	n/a	n/a	n/a	n/a	
10/14/2008	116.3	121.3	3.43	8.43	
10/15/2008	122.7	128.6	14.06	19.96	
10/16/2008	126.9	131.9	10.5	15.5	6.46
10/17/2008	127.1	133.2	19.35	25.45	
10/20/2008	130.4	136.8	34.9	41.3	
10/21/2008	124	127.6	24.85	28.45	
10/22/2008	119.1	122	26.4	29.3	
10/23/2008	119	126.5	13.55	21.05	6.04
10/24/2008	130.4	137.3	25.2	32.1	
10/27/2008	145.2	149.2	38.8	42.8	
10/28/2008	149.5	154.1	40.25	44.85	

Five-Year Enterprise Debt Spreads to Treasuries and Swaps

	Fannie Less Treasury	Freddie Less Treasury	Fannie Less Swap	Freddie Less Swap	30-Year FRM Mortgage Commitment Rate[1]
10/29/2008	139.6	143.9	39.1	43.4	
10/30/2008	137	139.5	34.15	36.65	6.46
10/31/2008	134.4	136.8	30.09	32.49	
11/3/2008	133	139.8	22.5	29.3	
11/4/2008	119.9	126.9	17.15	24.15	
11/5/2008	121.3	126	19.71	24.41	
11/6/2008	117.3	124.2	12.2	19.1	6.2
11/7/2008	112	113.8	8.13	9.93	
11/10/2008	109.7	114.5	8.6	13.4	
11/11/2008	n/a	n/a	7.4	13.4	
11/12/2008	112	118.1	13.7	19.8	
11/13/2008	116.7	125.7	10.65	19.65	6.14
11/14/2008	125.8	131.9	17.65	23.75	
11/17/2008	126.1	130.5	25.75	30.15	
11/18/2008	139.7	143.6	39.08	42.98	
11/19/2008	151.2	153.6	58.72	61.12	6.04
11/20/2008	158.8	160.2	71.1	72.5	
11/21/2008	144.3	146.8	45.27	47.77	
11/24/2008	133.9	136.6	38.9	41.6	
11/25/2008	98.5	105.4	14.32	21.22	
11/26/2008	98.5	103.3	14.3	19.1	5.97
11/27/2008	n/a	n/a	4.53	10.13	
11/28/2008	101.7	104.2	18.55	21.05	
12/1/2008	91.9	97	4.82	9.92	
12/2/2008	86.8	92.5	1.5	7.2	
12/3/2008	94	98.8	-1.25	3.55	5.53
12/4/2008	100.8	104.2	-1.05	2.35	
12/5/2008	103.8	107.9	3.5	7.6	
12/8/2008	101.7	104.6	11.45	14.35	
12/9/2008	101.8	106.1	4.7	9	
12/10/2008	104.8	98.3	14.53	8.03	
12/11/2008	100	92.5	13.35	5.85	5.47
12/12/2008	92.2	84.4	9.47	1.67	
12/15/2008	98.3	92.9	12.04	6.64	
12/16/2008	89.5	78.1	20.77	9.37	
12/17/2008	86.6	82.2	14.4	10	
12/18/2008	91.3	89.3	16.87	14.87	5.19
12/19/2008	89.8	86.6	16.54	13.34	
12/22/2008	87.6	84.8	8.9	6.1	
12/23/2008	77.3	74.7	14.84	12.24	
12/24/2008	82.2	77.7	19.3	14.8	
12/25/2008	n/a	n/a	21.08	18.08	5.14
12/26/2008	81.2	79.2	17.65	15.65	
12/29/2008	79.4	75.7	16.42	12.72	
12/30/2008	77	73.6	19.11	15.71	
12/31/2008	75.5	72.7	17.2	14.4	

Five-Year Enterprise Debt Spreads to Treasuries and Swaps

	Fannie Less Treasury	Freddie Less Treasury	Fannie Less Swap	Freddie Less Swap	30-Year FRM Mortgage Commitment Rate[1]
1/1/2009	n/a	n/a	18.82	15.62	5.1
1/2/2009	75.4	73.6	19.85	18.05	
1/5/2009	85.2	80.4	24.9	20.1	
1/6/2009	83.3	82.9	32.9	32.5	
1/7/2009	81.5	89.5	30.95	38.95	
1/8/2009	79	85	30.9	36.9	5.01
1/9/2009	76.8	83.7	25.3	32.2	
1/12/2009	69.2	77	18.25	26.05	
1/13/2009	72.5	78	17.34	22.84	
1/14/2009	78.7	84.4	19.15	24.65	

Sources: Bloomberg Financial LP, Federal Reserve Board H15, and Freddie Mac.

[1] Commitment rates represent 3-day averages of rates based on a survey of lenders.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM ELIZABETH A. DUKE

AIG

Q.1. Former AIG CEO Hank Greenberg recently wrote a letter that was reported in the Washington Post as saying, “Unless there is immediate change to the structure of the Federal loan [to AIG], the American taxpayer will likely suffer a significant financial loss.” (Washington Post, November 3, 2008). However, in the Federal Reserve Board’s report to the Senate Banking Committee about the Fed’s actions with respect to AIG under Section 13(3) of the Federal Reserve Act, the Board told the Committee that it does not expect the loans to result in any losses to the Federal Reserve System or the taxpayer. Can you please explain why Mr. Greenberg is incorrect?

A.1. Outstanding advances to AIG under the credit facility initially provided to AIG on September 16, 2008 (the Revolving Credit Facility) are secured by the pledge of assets of AIG and its primary nonregulated subsidiaries, including AIG’s ownership interest in its regulated U.S. and foreign subsidiaries. AIG has announced a comprehensive and global divestiture program to raise funds to repay the Revolving Credit Facility. These dispositions will include subsidiaries that rank among the largest and most prominent businesses in the industry.

As part of our oversight activities arising from our role as a lender to AIG, Federal Reserve staff, assisted by expert advisers that we have retained, reviews this divestiture program and closely monitors the company’s progress in implementing the divestiture program’s objectives on an ongoing basis, as well as cash flows and financial condition. The Federal Government’s restructuring of its financial relationship with AIG announced on November 10, 2008, which includes the acquisition of $40 billion in newly issued Senior Preferred Stock of AIG by the U.S. Treasury, and the modification of some of the initial terms of the Revolving Credit Facility, should enhance AIG’s ability to repay the Facility by, among other things, providing additional time to execute its asset disposition plan. Given the substantial assets of AIG and the senior and secured position of the Revolving Credit Facility, the Board expects that the Revolving Credit Facility will not result in any net loss to the Federal Reserve or taxpayers.

Advances to Maiden Lane II LLC (ML II) and to Maiden Lane III LLC (ML III) under the credit facilities established to partially fund the acquisition of certain AIG-related assets by these special purpose vehicles are secured by a lien on all of the assets held by ML II and ML III respectively. Given the expected amounts to be realized from the cash flows produced by these assets as well as the proceeds from disposition of these assets over time, and the subordinated positions of AIG in ML II and ML III, the Board does not expect any net cost to the taxpayers as a result of the failure to repay the credit extended by the Federal Reserve to ML II and ML III.

Q.2. What is the total sum of money the Federal Reserve System has lent to AIG through any and all actions undertaken by the Federal Reserve, including the Commercial Paper Funding Facility

(CPFF)? What process was used to determine AIG's eligibility to participate in the CPFF? Did the Federal Reserve consider the fact that AIG was already subject to special Fed lending when deciding AIG's eligibility to participate in the CPFF?

A.2. As initially structured in September 2008, the Revolving Credit Facility allowed AIG to borrow up to $85 billion. From inception of this Facility to November 5, 2008, the total aggregate amount of borrowings were approximately $77.0 billion, of which approximately $16.0 billion was repaid on or before that date. In connection with the U.S. Treasury's announcement that it would acquire $40 billion in AIG Senior Preferred Stock in November, the proceeds of which were used to repay amounts outstanding under the Facility, the total amount of credit permitted to be outstanding under the Facility was reduced to $60 billion. As of December 31, 2008, AIG had approximately $38.9 billion in advances outstanding under the Facility.

Four AIG affiliates, AIG Funding, Inc., International Lease Finance Corporation, Curzon Funding LLC, and Nightingale Finance LLC, have borrowed from the CPFF. Under the terms of the CPFF, these four affiliates may borrow an aggregate amount of up to approximately $20.9 billion from that Facility. As of November 5, 2008, these four affiliates had borrowed an aggregate amount of approximately $15.2 billion under the CPFF. By its terms, the CPFF is available to any U.S. issuer of commercial paper that meets the eligibility requirements of the Facility. Among other requirements, the commercial paper financed through the CPFF special purpose vehicle must be rated A–1/P–1/F–1 by a major nationally recognized statistical rating organization. The fact that a particular issuer may be eligible to borrow under; or be affiliated with an eligible borrower under, other credit facilities established under section 13(3) of the Federal Reserve Act does not disqualify the issuer under the terms of the CPFF. For example, affiliates of primary dealers that have access to the Primary Dealer Credit Facility are not ineligible to borrow under the CPFF. The four AIG affiliates that are borrowers from the CPFF meet the eligibility criteria of that Facility.

The Federal Reserve Bank of New York (FRBNY) is authorized to provide up to $22.5 billion in senior secured credit to ML II to partially fund its acquisition of approximately $40 billion (par value) in residential mortgage-backed securities from AIG. As of December 31, 2008, the FRBNY had lent $19.5 billion to ML II. As a result of the ML II credit facility, on December 12, 2008, the Securities Borrowing Facility for AIG, through which the FRBNY could lend up to $37.8 billion in cash to AIG in exchange for collateral in the form of investment grade securities that were being returned by AIG's securities lending counterparties, was terminated. On November 5, 2008, before the Securities Borrowing Facility was terminated, AIG had borrowed approximately $19.9 billion under that Facility. All borrowings under the Securities Borrowing Facility were repaid in full when the facility was terminated on December 12, 2008.

The FRBNY is authorized to provide up to $30 billion in senior secured credit to ML III to partially fund its acquisition of approximately $69 billion (par value) of multi-sector collateralized debt obligations (CDOs) protected by credit default swaps (CDS) and similar contracts written by AIG. As of December 31, 2008, FRBNY had lent $24.3 billion to ML III.

Q.3. What is AIG's market capitalization? Is the present value of AIG's equity and assets (using mark-to-market accounting) greater than AIG's liability to the Federal Reserve?

A.3. As explained in response to Question 1, advances under the Revolving Credit Facility are to be repaid with the proceeds of asset sales by AIG, including the disposition of many of its major U.S. and foreign insurance subsidiaries. The shares of the insurance subsidiaries of AIG are not themselves publicly traded or valued on a mark-to-market basis. Based on its recent common stock price, as of year-end 2008, AIG's market capitalization was approximately $4.2 billion. However, current market capitalization is not necessarily a reliable indicator of the value that the purchasers of AIG's businesses, which rank among some of the most prominent in the industry, will pay for these assets and thus the amount of proceeds that will be received from the disposition of these businesses. As stated above, in light of the substantial assets of AIG and the senior and secured position of the Revolving Credit Facility, the Board expects that the Revolving Credit Facility will not result in any net loss to the Federal Reserve or taxpayers.

Q.4. How has AIG used the funding the System has provided, and what analysis have you done to conclude that the loans will be repaid?

A.4. Consistent with the terms of the Revolving Credit Facility, AIG has used the proceeds of advances under the Revolving Credit Facility for general corporate purposes, including as a source of liquidity to pay obligations as and when they become due. Since the establishment of the Facility, a significant portion of the Facility proceeds has been used to meet continued cash requirements associated with AIG's securities lending program and for collateral calls related to its portfolio of CDS and similar contracts AIG had written on multi-sector CDOs. In the future, draws on the Revolving Credit Facility are not expected to be used for these purposes to a significant extent because the credit facilities provided to ML II and ML III are designed to address the liquidity pressures on AIG related to these factors. Draws on the Facility going forward may continue to be used for other general corporate purposes, such as to repay maturing debt obligations and provide operating funds, loans or capital to the company's subsidiaries.

See the answer to Question 1 for a description of the steps Federal Reserve staff is taking with regard to assessing whether outstanding advances under the Revolving Credit Facility will be repaid.

Q.5. Has the Federal Reserve put any restrictions on the lobbying activities of AIG?

- Have any other restrictions been placed on AIG's business or other activities?

A.5. As is usual in commercial lending transactions involving distressed borrowers, the Federal Reserve has certain rights as a creditor under the loan documentation relating to the Revolving Credit

Facility, such as the right to require that overall corporate governance be acceptable to the Federal Reserve. Other provisions in the loan documentation include a prohibition, while the Federal Reserve Facility is outstanding, on making certain types of shareholder distributions, such as payment of dividends on common stock, and a requirement to submit to the Federal Reserve as lender a significant number of financial statements and reports that address a broad range of topics relating to the financial condition and future prospects of AIG. Regarding restrictions on its business, AIG may not make material changes to its business activities without the consent of the Federal Reserve, and may not enter into new swap transactions except under policies approved by the Federal Reserve or to hedge or mitigate risks.

Although the Federal Reserve loan documentation does not specifically address AIG's lobbying activities, as a condition of the Treasury's acquisition of $40 billion in Senior Preferred Stock under the Troubled Assets Relief Program (TARP), AIG must maintain and implement a written policy on lobbying, governmental ethics, and political activities that, among other things, applies to AIG and all of its subsidiaries and affiliated foundations. This policy may not be materially amended without the prior written consent of the Treasury.

Q.6. While financial problems in AIG Financial Products have been detailed by the Federal Reserve and the press, specifically regarding credit default swaps, Board staff has indicated that the life insurance company held by AIG may also have financial problems. Please detail these financial problems. Please indicate whether any of the loans, and if so, what amount, has been spent in the life insurance, and other insurance companies.

A.6. During the first three quarters of 2008, AIG reported significant losses arising primarily from other-than-temporary-impairment charges on its investment portfolio, which was the result to a significant extent of declines in the market values of mortgage-backed securities AIG held in connection with the securities lending program operated by AIG's regulated insurance subsidiaries. To address the losses from this activity during the period from inception of the Federal Reserve's Revolving Credit Facility to November 5, 2008, AIG had used about $19 billion of advances from the Facility to make capital contributions to its insurance companies or to repay obligations to the securities lending program. The ML II credit facility was designed to help AIG address these positions. ML II acquired from AIG's insurance subsidiaries, in return for cash, the residential mortgage-backed securities that these subsidiaries held as part of the securities lending program. These actions allow ML II to manage and realize the underlying value of these securities over the longer term, and relieve AIG and its insurance subsidiaries from the short-term volatility in the mark-to-market value of these assets in the current economic environment. These actions also were designed to enhance the safety and soundness and overall financial condition of the insurance companies.

Q.7. In return for the Federal Reserve loan, the federal government now controls almost 80 percent of AIG.

- What federal entity is/will control this large share of AIG?

- What decisions have been made about how this control will be exercised?
- How many Federal Reserve or other federal staff are currently on-site at AIG? Please detail the roles of these staff.

A.7. Under the terms of the Revolving Credit Facility as amended, AIG will issue shares of perpetual, non-redeemable convertible preferred stock to a trust that will hold the stock for the benefit of the U.S. Treasury. The preferred stock is convertible into 77.9 percent of AIG's outstanding common stock. Decisions regarding the exercise of any voting rights associated with this preferred stock and regarding any disposition of the stock to third parties will be made by the independent trustees of the trust. In addition to this equity interest, the Treasury Department, in connection with its acquisition of $40 billion of senior preferred stock of AIG under the TARP, also received warrants to purchase 2 percent of the common stock of AIG. Control over these instruments is exercised by the Treasury Department in compliance with the rules and conditions applicable to the TARP.

A team of approximately 10 Federal Reserve staff, led by a Senior Vice President of the FRBNY, has primary responsibility for managing and implementing the oversight of AIG provided for in the loan documentation relating to the Revolving Credit Facility. Federal Reserve staff are on-site at AIG to monitor the company's funding, cash flows, use of proceeds, and progress in pursuing its divestiture plan. Federal Reserve representatives are also in regular contact with AIG senior management and attend all AIG board meetings and board committee meetings.

Q.8. Board staff has indicated that the Federal Reserve has not taken a close look at the solvency of the insurance companies held by AIG because those activities are regulated at the state level. Is this correct? Has the Federal Reserve done a thorough analysis of AIG's insurance companies, including their solvency?

A.8. Under the existing statutory framework, the relevant state insurance regulatory authorities have the primary responsibility for determining the financial condition of AIG's insurance company subsidiaries. This includes the authority to take action to resolve regulated insurance companies that fail to meet the state regulator's capital, solvency, and other regulatory requirements. As a lender to MG, the Federal Reserve closely monitors the cash flow, earnings, and general financial condition of the company on a consolidated basis, which includes reviewing financial information on all of the company's major subsidiaries, including the insurance subsidiaries. In carrying out this oversight responsibility, the Federal Reserve coordinates on an ongoing basis with the appropriate state insurance authorities.

EESA

Q.9. What actions has the Board taken to implement a plan under Section 110 of the Emergency Economic and Stabilization Act of 2008 with respect to foreclosure mitigation for mortgages or mortgage-backed securities held, owned, or controlled by or on behalf of a Federal Reserve Bank?

A.9. Section 110 of the Emergency Economic Stabilization Act directs Federal property managers, to the extent that they hold, own, or control mortgages, mortgage-backed securities, and other assets secured by residential real estate (residential mortgage assets), to "implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages, and considering net present value to the taxpayer, to take advantage of the HOPE for Homeowners Program under section 257 of the National Housing Act or other available programs to minimize foreclosures." Section 110 generally provides that the Federal Reserve Board (Board) is a Federal property manager with respect to any mortgage, mortgage-backed securities, or pool of such securities (residential mortgage assets) held, owned, or controlled by or on behalf of a Federal Reserve Bank other than residential mortgage assets that are held, owned, or controlled by or on behalf of a Federal Reserve Bank "in connection with open market operations under section 14 of the Federal Reserve Act (12 U.S.C. 353), or as collateral for an advance or discount that is not in default."

The Board is currently not a Federal property manager for any residential mortgage assets within the scope of section 110. To the extent that residential mortgage assets are held, owned or controlled by the Federal Reserve Banks, these assets are held, owned or controlled in connection with open market operations or as collateral for advances or discounts that are not in default, such as the credit extended to Maiden Lane LLC.[1]

Nonetheless, the Board is in the final stages of developing a foreclosure mitigation policy for use by the Federal Reserve Banks. In addition to applying this policy in situations required by section 110, the Board will consider whether there are situations in which it is appropriate and feasible for the Board to apply the policy voluntarily.

In developing this policy, the Board has consulted with the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and other governmental and industry representatives, and has carefully considered recent developments and changes to industry protocols relating to foreclosure mitigation. The Board expects to finalize and vote on this policy soon and will promptly submit a copy of its policy once approved to Congress. The goal of the policy will be fully consistent with the requirements and goals of section 110 to offer distressed homeowners a sustainable loan modification when such action would result in a higher expected net present value (NPV) than would be expected through foreclosure.

- Specifically, what goals has the Board established for the number or percentage of mortgages that should be modified to comply with the Act?

Any portfolio that becomes subject to the Board's foreclosure mitigation policy will contain unique characteristics, such as the number of whole residential mortgage loans versus residential mortgage-backed securities, the percentage of senior mortgage loans versus subordinate mortgage loans, and the number of per-

[1] Maiden Lane LLC is the limited liability company to which a portfolio of assets was transferred in connection with a loan by the Federal Reserve Bank of New York, which facilitated the acquisition of The Bear Stearns Companies Inc. by JPMorgan Chase & Co.

forming loans versus non-performing loans. To account for these variables, the Board does not expect to establish a pre-set number or percentage of loans that must be modified under its policy.

However, as noted above, the Board's over-arching goal under the policy will be to try to keep consumers in their homes by offering sustainable loan modifications when the expected NPV of a loan modification would be greater than the expected NPV of the net proceeds to be received through foreclosure.

- What process has the Board established to communicate the plan, including modification goals, to Maiden Lane or the regional Federal Reserve Bank that would serve as the agent for the Board in carrying out its duty under the law?

As noted above, the Board is in the final stages of developing a foreclosure mitigation policy to guide the Federal Reserve Banks in the event that the Board becomes a Federal property manager. The Board will transmit that policy to the Reserve Banks and require that the Reserve Banks, and any agents they may hire to assist in the management or servicing of the mortgage portfolios subject to section 110, abide by the policy.

- How many Bear Stearns loans have been modified to date and what were the terms?

Wells Fargo & Company (Wells Fargo) and EMC Mortgage Corporation currently act as the servicers of the whole residential mortgages that serve as collateral for the loan to Maiden Lane LLC. Both Wells Fargo and EMC Mortgage are members of the HOPE NOW Alliance and utilize industry standard protocols for loan modifications that are consistent with the standards and guidelines established by the HOPE NOW Alliance. Loan modifications for mortgages that serve as collateral for the loan to Maiden Lane LLC have been offered to delinquent borrowers who are facing other-than-temporary economic hardships, but who may have the capacity to perform on the loan following a modification of terms that provides an expected NPV greater than what would be expected through foreclosure. Workout plans, which are not formal loan modifications, are offered to borrowers with temporary problems and need assistance bringing their account current through short-term modifications to their payments.

The ability to offer loan modifications and workout plans for loans that serve as collateral for the extension of credit to Maiden Lane LLC is contingent on whether the subject assets are whole mortgage loans rather than mortgage-backed securities. Because mortgage-backed securities are pools of mortgages in which the Federal Reserve Bank only holds a fractional interest along with other investors, the Reserve Bank does not have direct control over the servicing of those residential mortgage assets. The majority of residential mortgage assets that serve as collateral for the loan to Maiden Lane LLC are in the form of residential mortgage-backed securities. Moreover, all of the residential whole loans in the portfolio were performing as of March 14, 2008, when Maiden Lane LLC acquired the portfolio.

As of November 30, 2008, slightly more than 11 percent of the residential mortgage whole loans that serve as collateral for the loan to Maiden Lane LLC and that were both nonperforming and more than 60 days past due had been permanently modified through a reduction in interest rate, an extension of term, a deferral or reduction in the principal balance, or a combination of such actions. Typically, permanent loan modifications initially are considered when borrowers become 60 days or more past due.

The number of permanent loan modifications is expected to increase in the coming months. A significant portion of the loans currently 60 days or more past due only reached this stage recently and, as you know, the loan modification process, even under the best of circumstances, can take time, as the borrower must be contacted and appropriate analysis conducted to confirm that a modification is both appropriate and sustainable. Moreover, the loan modifications currently offered to borrowers for the loans backing the credit extension to Maiden Lane LLC become permanent only after a borrower makes three timely payments under the modified terms. Therefore, the number of permanently modified loans is expected to increase as more delinquent borrowers are contacted and finish the negotiation process and as borrowers that are in their three-month verification period fulfill their obligations and receive permanent loan modifications.

In addition, many delinquent borrowers are receiving flexible terms and assistance that may lead to loan workouts in forms other than formal loan modifications—for example, short sales or in the case of borrowers facing temporary financial hardships, a repayment plan. These workouts are not included in the stated percentage of loan modifications.

Q.10. I commend the Administration for following through with Section 112 of EESA by convening an international summit on November 15th. In announcing the summit, the White House explained that leaders of the G20 and key international financial institutions will review progress on measures taken to address the financial crisis and to discuss principles for reform of regulatory and institutional regimes going forward. Please describe what the Federal Reserve and Treasury Department intend to accomplish through this summit and the subsequent working group meetings that will follow the summit—specifically, what types of principles for regulatory and institutional modernization will the United States pursue in the international community? Will these principles include protections for consumers and households which form the foundation of economic prosperity in our country as well as other countries?

A.10. In a statement released following their November 15 meeting, the G–20 Heads of State articulated five key principles that will govern efforts by the official sector to reform the global financial system. These principles include strengthening transparency and accountability of financial markets and financial institutions, enhancing sound regulation, promoting integrity in financial markets, reinforcing international cooperation, and reforming international financial institutions. These efforts are constructive and should help to make the global financial system more robust and resilient. The Federal Reserve is working with its counterparts in the G–20 to identify and implement specific measures that will contribute to achieving these five principles. Initiatives to protect consumers and households are central to these efforts. The statement from the G–20 Heads of States emphasized that bolstering consumer protection is an essential step toward protecting the integrity of global financial markets. Consumers and households benefit both directly and indirectly as the financial system becomes stronger, better regulated, and more transparent.

Commercial Paper Funding Facility

Q.11. What real assets are securing loans made under the CPFF to special purpose vehicles?

A.11. The loans made under the CPFF to the special purpose vehicle (SPV) are collateralized by the highly rated commercial paper purchased by, and the fees collected by, the SPV.

Q.12. What has the Federal Reserve done to clarify the effect of the CPFF on the daily rates reported in the Board's H–15 data release?

- What has the Board done to make clear that the support provided by the CPFF has altered the overall commercial paper rate?
- Does the H–15 data still represent an actual market rate, without credit enhancement by the CPFF or any other recent government action?

A.12. On November 5, 2008 we added the following footnote to the H–15 release:

Financial paper that is insured by the FDIC's Temporary Liquidity Guarantee Program is not excluded from relevant indexes, nor is anyfinancial, nonfinancial, or asset-backed commercial paper that may be directly or indirectly affected by one or more of the Federal Reserve's liquidity facilities. Thus the rates published after September 19, 2008, likely reflect the direct or indirect effects of the new temporary programs and, accordingly, likely are not comparable for some purposes to rates published prior to that period.

The commercial paper rates published on the H–15 release have and continue to be a reflection of actual transactions that take place in the U.S. commercial paper market. We have never screened out transactions with third-party credit enhancements.

Q.13. What analysis has the Federal Reserve undertaken to determine which markets usually use the 90-day commercial paper rate in conducting their business?

- Which of the markets, if any, did the Fed determine use this rate regularly in their business operation?
- What steps, if any, has the Federal Reserve taken to assure that the actions to lower the costs of issuing commercial paper are not having an adverse impact on other markets which are pegged to the 90-day financial commercial paper?
- Was a similar analysis conducted with respect to possible implications for markets that use other short term (under 365-day) commercial paper as a result of the establishment of the CPFF?
- What steps, if any, has the Federal Reserve taken to assure that the actions to lower the costs of issuing commercial paper is not having an adverse impact on those other markets?

A.13. By law, the reimbursement rates on student loans are tied to the 90–day financial CP rate. In addition, dealers report that some financial contracts (e.g., derivatives) settle on certain CP rates published by the Federal Reserve.

The link of the reimbursement rate on student loans to the 90-day financial CP rate has become problematic for student lenders, because their cost of funds tends to be tied to Libor, and the spread between Libor and the fmancial CP rate has moved against them. Importantly, the wider spread likely reflects pressures on the Libor rate as well as the CP rate. In addition, this spread first widened a few weeks before the CPFF began operation.

To ensure that market participants fully understand our methodology for calculating CP rates, we published the following announcement on the Federal Reserve's commercial paper website on November 5, the first paragraph of which was also added (as already mentioned in our response to Question 11) as a footnote to the Federal Reserve's H–15 release:

CLARIFICATION OF CRITERIA CONSIDERED FOR COMMERCIAL PAPER RATES

Financial paper that is insured by the FDIC's Temporary Liquidity Guarantee Program is not excluded from relevant indexes, nor is any financial, nonfinancial, or asset-backed commercial paper that may be directly or indirectly affected by one or more of the Federal Reserve's liquidity facilities. Thus the rates published after September 19, 2008, likely reflect the direct or indirect effects of the new temporary programs and, accordingly, likely are not comparable for some purposes to rates published prior to that period.

Through November 4, the documentation on the "About" page of this release indicated that paper issued under "credit-enhanced programs" was excluded from the samples of issues used to calculate reported rates. This wording was intended to convey that asset-backed commercial paper was excluded from the calculation of financial rates. Indeed, consistent with that intent, the Federal Reserve has, since 2006, published a separate rate series for asset-backed commercial paper. To avoid confusion, the reference to "credit-enhanced programs" will be dropped.

Too Big to Fail

Q.14. When Chairman Bernanke testified before this Committee in support of emergency legislation to stabilize the economy, he acknowledged that we have a "serious 'too big to fail' problem in this country," and that "it is much worse than we thought it was coming into this crisis." Ironically, as Gary Stern, President of the Federal Reserve Bank of Minneapolis points out, "The too-big-to-fail problem . . . has been exacerbated by actions taken over the past year to bolster financial stability." In surveying the financial landscape, one is struck by the fact that we are seeing increased consolidation of financial institutions—not just of commercial banks, but including enormous combinations of commercial and investment banks. In fact, news-reports indicate that a number of the institutions that received capital injections are using them to do additional acquisitions.

- Are such consolidations increasing our "too big to fail" problem, thereby increasing the problem of moral hazard? If so, what do we do about it?

A.14. Working with the Treasury, the FDIC, and other agencies, the Federal Reserve believes that we must take all steps necessary to minimize systemic risk. We are also concerned about actions that increase moral hazard. As the Federal Reserve has previously noted, the acquisition of a troubled financial institution by a healthy firm can significantly mitigate risks to the financial system as a whole, preserve banking services in affected communities, and reduce the costs to taxpayers. Although preserving market discipline and avoiding moral hazard are extremely important, in exceptional circumstances it may be necessary for the government to intervene to protect financial and economic stability by taking steps to avoid the threat that could result from the failure of a major financial institution when financial markets are already quite fragile. The problems that result from moral hazard and the existence of institutions that are "too big to fail" must be addressed through prudent decisionmaking by government agencies, regulatory changes, improvements in the financial infrastructure, and other measures designed to prevent reoccurrence of threats to overall financial stability. Reforming the system to address these problems should be a top priority for lawmakers and regulators.

Q.15. Each agency represented at the hearing has aggressive!), used the tools at their disposal in dealing with the crisis. However, sometimes the use of those tools has led to unintended consequences. For instance, when the Treasury Department guaranteed money market funds, it led to a concern on deposit insurance and bank accounts. When the FDIC guaranteed bank debt, it had an effect on GSE borrowing costs, which in turn directly affects mortgage rates.

Acknowledging that there is often a need to act quickly in these circumstances, please explain what steps and processes you have employed to inform other agencies about significant actions you undertake to ensure that there are not serious adverse unintended consequences and that your actions are working in concert with theirs.

A.15. For many years, the Federal Reserve has worked with other government agencies—including the Treasury Department, the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the other banking agencies—through the President's Working Group on Financial Markets and in other forums, to foster the safety and soundness of financial institutions and the stability of financial markets. During the financial crisis, this collaboration has increased greatly, and includes regular conference calls at the principals' level as well as formal and informal staff contacts with a range of other agencies to exchange information on financial developments and to discuss possible policy responses.

Such interactions have contributed importantly to the policy response to the crisis. Indeed, in some cases joint decisions by multiple agencies are required to take particular policy steps. For example, in order for the FDIC to invoke the systemic risk exception to the general requirement for least-cost resolution of a troubled insured depository institution, both the FDIC and Federal Reserve Boards must recommend such a step by two-thirds majorities and the Secretary of the Treasury, in consultation with the President, must determine that a least-cost resolution would have serious adverse effects on economic conditions or financial stability, and that a non-least-cost resolution would avoid or mitigate such adverse effects. This process, which involves considerable interaction between the three agencies at both the staff level and the principals' level, has been undertaken three times this fall, in connection with the difficulties of Wachovia and Citibank and with the establishment of the FDIC's Temporary Liquidity Guarantee Program. Similarly, some other policy actions have involved more than one agency, and so by necessity have required extensive inter-agency consultation. An example is the Term Asset-Backed Securities Loan Facility, which calls for an equity investment by the Treasury Department and credit provided by the Federal Reserve. Even when joint action not been formally required to adopt a particular policy, the Federal Reserve has found it useful to exchange views regarding the possible policy in order to benefit from the assessments of other agencies. In many cases such consultations have been organized by Treasury Department and have included a wide range of government agencies.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR ENZI FROM ELIZABETH A. DUKE

Q.1. As someone with extensive background in the banking industry, what is your opinion of the recent action taken by the SEC and FASB to clarify mark-to-market accounting regulations? Do you feel such clarification was beneficial for our banking industry? What about the financial market as a whole?

A.1. As the question indicates, the SEC and FASB issued a press release on September 30, 2008 containing certain clarifications related to the fair value accounting guidance contained in FASB Statement No. 157, *Fair Value Measurements*, for the benefit of auditors and preparers of financial statements. Subsequently, the FASB issued FASB Staff Position No. FAS 157–3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*. Those formal actions were supplemented by a number of roundtable sessions and other meetings and presentations during which SEC and FASB staff discussed practical challenges involved in performing fair value measurements in markets that have become significantly less active.

Generally, guidance was helpful to banks and financial markets because it addressed some of the challenges of measuring fair values in inactive markets. However, this guidance did not significantly reduce the uncertainties around the quality of fair value measurements that users and investors are experiencing. This may indicate that additional information and guidance may be necessary to address these uncertainties. The Federal Reserve is supportive of further efforts by the SEC and the FASB to clarify existing fair value accounting guidance.

In addition, as the SEC completes its study of "mark-to-market" accounting by January 2, 2009 as required by the Emergency Economic Stabilization Act of 2008, we will review the report and consult with the SEC regarding additional steps that may be deemed necessary in light of recent market events. If necessary, such steps could range from modifications of accounting requirements to additional clarification of existing guidance. Combined with steps that have already been completed to provide clarifying guidance, we trust that actions taken in response to the SEC study will benefit both the banking industry and the financial market as a whole.

Q.2. It is possible this committee will be revisiting the regulation of credit default swaps (CDS) and other previously unregulated derivative contracts in the near future. Do you believe the proper entity to regulate such financial products is the Federal Reserve? If not, which regulator is best suited to oversee these financial products in your opinion?

A.2. On November 14 the President's Working Group on Financial Markets (PWG) announced a broad set of policy objectives to guide efforts to address the full range of challenges associated with CDS and other OTC derivatives, including improving the transparency and integrity of the CDS market, enhancing risk management of OTC derivatives, further strengthening the OTC derivatives market infrastructure, and strengthening cooperation among regulatory authorities. The Federal Reserve believes that this cooperative approach to these issues, which draws on the strengths and broad existing authority of the various federal agencies, is likely to be more effective at addressing these concerns than assigning authority to oversee CDS to the Federal Reserve or any other single agency.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM ELIZABETH A. DUKE

Q.1. I am gravely concerned, about a situation whereby banks are taking advantage of AIG's low credit rating to make a windfall off of transactions they have with our nation's mass transit agencies. Is the Treasury willing to appoint a senior official to work with the Fed, the IRS, and these public transit agencies to make sure taxpayer money is protected? Given the urgent nature of this situation I would like an answer to this question by Tuesday October 28. (Please contact my staffer Hal Connolly at 202–224–4744 if you have any further questions)

Q.2. Our nation's public transit agencies are potentially liable for payments in the hundreds of millions of dollars to banks due to the downgrading of AIG through LILO/SILO leveraged leases. Does the Treasury and the Fed think it appropriate that these banks are in a position to make a windfall at the expense of these public agencies? Without action by the Treasury banks stand to gain all of the benefits the IRS has declared to be inappropriate. Has the IRS backed away from its previous position on these leases?

A.1.–A.2. As you indicate, a number of transit authorities have issued obligations that were guaranteed in whole or in part by

American International Group, Inc. (MG) as part of complex, tax-driven lease transactions.

It was precisely for the purpose of limiting the potential adverse effects on the economy of the failure of AIG that the Federal Reserve, on September 16, 2008, extended a line of credit to AIG in the amount of $85 billion. The Federal Reserve was concerned that the disorderly failure of MG during the current period of economic turmoil and fragile markets would have wide-ranging systemic effects and exacerbate the already troubled economic situation.

Since that time, the Federal Reserve, working with the Department of the Treasury, has taken additional actions to help restore confidence in AIG to allow it to maintain its credit ratings and conduct its business while it engaged in an orderly restructuring. On November 10, 2008, the Federal Reserve restructured its credit facility and agreed to provide two additional liquidity support facilities to AIG. At the same time, the Department of the Treasury provided an emergency injection of capital to the company.

While the Federal Reserve has used its authority to provide liquidity to AIG, the Federal Reserve does not have authority to cure the potential technical defaults on the transit authority bonds, which are based on the credit ratings of MG. The credit ratings for AIG are not established by the Federal Reserve, though the actions of the Federal Reserve and the Treasury in providing funding to MG have helped to stabilize those ratings. We understand that the transit authorities are in discussions with lenders to find mutually agreeable ways to cure the potential defaults.

We recognize the importance of mass transit to communities, both as a matter of the economic contribution that mass transit makes to urban communities in particular and in the effects it has on the lives of users of mass transit. This is an important issue that we are monitoring carefully.