S. Hrg. 111–18

LEARNING FROM THE PAST: LESSONS FROM THE BANKING CRISES OF THE 20TH CENTURY

HEARING

BEFORE THE

CONGRESSIONAL OVERSIGHT PANEL

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

THURSDAY, MARCH 19, 2009

Printed for the use of the Congressional Oversight Panel

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LEARNING FROM THE PAST: LESSONS OF THE BANKING CRISES OF THE 20TH CENTURY

THURSDAY, MARCH 19, 2009

U.S. CONGRESS,
CONGRESSIONAL OVERSIGHT PANEL,
Washington, DC.

The Panel met, pursuant to notice, at 10:01 a.m. in room 208–209, U.S. Capitol Visitor Center, Elizabeth Warren, Chairman of the Panel, presiding.

Attendance: Elizabeth Warren [presiding], Richard H. Neiman, Damon Silvers, Bo Lundgren, Richard Katz, David Cooke, and Eugene White.

OPENING STATEMENT OF ELIZABETH WARREN, CHAIR, CONGRESSIONAL OVERSIGHT PANEL

The CHAIRMAN. This hearing is called to order.

Good morning. My name is Elizabeth Warren. I am the chair of the Congressional Oversight Panel.

Last October, Congress established this Panel to oversee the expenditure of funds from the so-called Troubled Assets Relief Program. It is our duty to issue monthly reports and to evaluate Treasury's administration of that program.

In its first report, the Panel asked Treasury a series of fairly tough questions about TARP on behalf of the taxpayers. The very first question we asked consisted of only four words, but probably the most important four words in the report. What is Treasury's strategy?

The lack of a strategy from Treasury has never been clearer than it has been this week, as outrage has spread across the country over the millions of dollars awarded in bonuses to executives at AIG. This entire issue could have been avoided. If Treasury had developed and clearly articulated a comprehensive strategy to deal with this crisis from the beginning, rather than announcing and abandoning inconsistent plans, issues such as executive bonuses would have been addressed early on in the agreements with participating financial institutions.

This lack of a clear strategy is also hampering our economic recovery. The markets need predictability. Investors are reluctant to take risks. Business people are hesitant to take on new obligations when no one is sure about our overall strategy.

Certainly, the most important person—the most appropriate person to speak to Treasury's strategy would be the Treasury Secretary, and it had been the strong hope of the Panel to have Secretary Geithner here today to testify. While we understand that he has many pressing concerns right now, it is very disappointing that Secretary Geithner did not make it a priority to be here.

The development of a strategy requires an overview of the problems and of possible solutions. To advance that conversation, we believed that we could learn a great deal from prior financial crises. That is why we have called today's hearing "Learning from the Past: Lessons of the Banking Crises of the 20th Century."

We understand that this crisis is different from past calamities. No examples will ever provide a perfect analogy. That said, while George Washington may not have known the difference between a credit default swap and a hybrid ARM—and I suspect he didn't—he had a powerful learning experience with a bank crisis.

In 1792, during his first term as President, our young Nation suffered a severe panic that froze credit. Subsequent Presidents faced similar challenges, as have leaders from across the globe. And so, it is important that we reflect on the efforts of policymakers who have steered their nations during some very dark hours.

It is also important that we reflect on the efforts of other governments that have confronted similar circumstances but failed to restore the banking system and restart economic growth.

We have invited four very thoughtful experts to join us here today in embarking on that reflection. Richard Katz is a veteran journalist, editor-in-chief of The Oriental Economist, and the author of two books on Japan's banking crisis of the 1990s. Mr. Katz will testify about what has become known by policymakers as Japan's "Lost Decade."

Bo Lundgren is the director general of the Swedish National Debt Office. As Minister for Fiscal and Financial Affairs, Director General Lundgren led the effort to steer Sweden out of a banking crisis in 1992.

David C. Cooke is the former executive director of the Resolution Trust Corporation, which helped steer us out of the savings and loan crisis of the 1980s by taking over more than 700 financial institutions.

And lastly, Eugene White is professor of economics at Rutgers University. Professor White has written widely about the Great Depression and will testify about how the lessons of the 1930s apply to today's crisis.

Welcome to all of you.

There is no longer any question that we sit at a critical moment in history. The decisions made by our Government leaders today will have an impact for generations. While we cannot fix this crisis with one hand and prevent all future crises with the other, we must use all of the knowledge and lessons of the past to ensure that prior mistakes are not repeated and that success is not ignored.

That is why we greatly appreciate that our distinguished witnesses have taken the time to be here with us today. We have your statements in full, and they will be made part of the record. But we will start with our conversation with you in just a few minutes.

In the meantime, I would like to recognize the Deputy Chair of the Panel, Damon Silvers, and ask Damon if he has opening remarks. Mr. Silvers.

[The prepared statement of Ms. Warren follows:]

CONGRESSIONAL OVERSIGHT PANEL

Elizabeth Warren, Chair   Sen. John E. Sununu   Rep. Jeb Hensarling   Richard H. Neiman   Damon Silvers

Opening Statement of Elizabeth Warren
Chair, Congressional Oversight Panel

Learning from the Past: Lessons of the Bank Crises of the 20th Century

March 19, 2009

Good morning.

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The lack of a strategy from Treasury has never been clearer than it has this week as outrage spread across the country over the millions of dollars awarded in bonuses to executives at AIG. This entire issue could have been avoided. If Treasury had developed and clearly articulated a comprehensive strategy to deal with this crisis from the beginning, rather than announcing and abandoning inconsistent plans, issues such as executive bonuses would have been addressed early on in the agreements with participating financial institutions.

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And so it is important that we reflect on the efforts of policymakers who have steered their nations out of some very dark hours. It is also important that we reflect on the efforts of other governments that have confronted similar circumstances, but failed to restore the banking system and restart economic growth.

We have invited four thoughtful experts to join us today in embarking on that reflection.

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There is no longer any question that we sit at a critical moment in history. The decisions made by government leaders today will have an impact that lasts for generations. While we cannot fix this crisis with one hand and prevent all future crises with the other – economist Alan Meltzer has said that "capitalism without failure is like religion without sin" – we must use all of the knowledge and lessons of the past to ensure that prior mistakes are not repeated and that successes are not ignored. That is why we greatly appreciate that all of our distinguished witnesses have taken the time to come and be here with us today.

We have your statements in full. They will be made a part of the record and guide our future work. We ask today that you summarize your testimony, and that you keep your remarks to five minutes so that we have enough time for questions.

I would also like to recognize His Excellency, The Swedish Ambassador Jonas Hafström. Your Excellency, we are honored to have you here with us today and appreciate the opportunity to learn from the challenges your nation was able to overcome.

Lastly, I would like to thank Patrick McGreevy and Brian Phillips of the Oversight Panel staff for their hard work in putting together this hearing.

STATEMENT OF DAMON SILVERS, DEPUTY CHAIR, CONGRESSIONAL OVERSIGHT PANEL

Mr. SILVERS. Thank you, Madam Chair.

Let me begin by expressing my profound appreciation to the witnesses for joining us here today, and particularly to Mr. Lundgren for traveling from Sweden to be with us for this hearing.

Recently, Thomas Hoenig, the president of the Federal Reserve Bank of Kansas City, gave a speech in which he praised the work of Mr. Lundgren and his colleagues in addressing the Swedish banking crisis of the 1990s. This speech was called to my attention by Mr. Hoenig's Senator, Senator Brownback of Kansas, and I ask that it be entered into the record of this hearing.

[The information referred to follows:]

TOO BIG HAS FAILED

Thomas M. Hoenig
President and Chief Executive Officer
Federal Reserve Bank of Kansas City

Omaha, Neb.
March 6, 2009

Two years ago, we started seeing a problem in a specialized area of financial markets that many people had never heard of, known as the subprime mortgage market. At that time, most policymakers thought the problems would be self-contained and have limited impact on the broader economy. Today, we know differently. We are in the midst of a very serious financial crisis, and our economy is under significant stress.

Over the past year, the Federal government and financial policy makers have enacted numerous programs and committed trillions of dollars of public funds to address the crisis. And still the problems remain. We have yet to restore confidence and transparency to the financial markets, leaving lenders and investors wary of making new commitments.

The outcome so far, while disappointing, is perhaps not surprising.

We have been slow to face up to the fundamental problems in our financial system and reluctant to take decisive action with respect to failing institutions. We are slowly beginning to deal with the overhang of problem assets and management weaknesses in some of our largest firms that this crisis is revealing. We have been quick to provide liquidity and public capital, but we have not defined a consistent plan and not addressed basic shortcomings and, in some cases, the insolvent position of these institutions.

We understandably would prefer not to "nationalize" these businesses, but in reacting as we are, we nevertheless are drifting into a situation where institutions are being nationalized piecemeal with no resolution of the crisis.

With conditions deteriorating around us, I will offer my views on how we might yet deal with the current state of affairs. I'll start with a brief overview of the policy actions we have been pursuing, but I will also provide perspective on the actions we have taken and the outcomes we have experienced in previous financial crises. Finally, I will suggest what lessons we might take from these previous crises and apply to working our way out of the current crisis.

In suggesting alternative solutions, I acknowledge it is no simple matter to solve. People say "it can't be done" when speaking of allowing large institutions to fail. But I don't think that those who managed the Reconstruction Finance Corporation, the Resolution Trust Corporation, the Swedish financial crisis or any other financial crisis were handed a blueprint that carried a guarantee of success. I don't accept that we have lost our ability to solve a new problem, especially when it looks like a familiar problem.

Current Policy Actions and Problems

Much has been written about how we got into our current situation, most notably the breakdowns in our mortgage finance system, weak or neglected risk management practices, and highly leveraged and interconnected firms and financial markets. Because this has been well-documented, today I will focus on the policy responses we have tried so far and where they appear to be falling short.

A wide range of policy steps has been taken to support financial institutions and improve the flow of credit to businesses and households. In the interest of time, I will go over the list quickly.

As a means of providing liquidity to the financial system and the economy, the Federal Reserve has reduced the targeted federal funds rate in a series of steps from 5.25 percent at mid-year 2007 to the present 0 to 25 basis-point range. In addition, the Federal Reserve has instituted a wide range of new lending programs and, through its emergency lending powers, has extended this lending beyond depository institutions.

The Treasury Department, the Federal Reserve and other regulators have also arranged bailouts and mergers for large struggling or insolvent institutions, including Fannie Mae and Freddie Mac, Bear Stearns, WaMu, Wachovia, AIG, Countrywide, and Merrill Lynch. But other firms, such as Lehman Brothers, have been allowed to fail.

The Treasury has invested public funds, buying preferred stock in more than 400 financial institutions through the TARP program. TARP money has also been used to fund government guarantees of more than $400 billion of securities held by major financial institutions, such as CitiGroup and Bank of America. In addition, the Federal Reserve and the Treasury Department have committed more than $170 billion to bail out the troubled insurance company AIG.

Other actions have included increased deposit insurance limits and guarantees for bank debt instruments and money market mutual funds.

The most recent step is the Treasury financial stability plan, which provides for a new round of TARP spending and controls, assistance for struggling homeowners, and a plan for a government/private sector partnership to buy up bad assets held by financial institutions and others.

The sequence of these actions, unfortunately, has added to market uncertainty. Investors are understandably watching to see which institutions will receive public money and survive as wards of the state.

Any financial crisis leaves a stream of losses embedded among the various participants, and these losses must ultimately be borne by someone. To start the resolution process, management responsible for the problems must be replaced and the losses identified and taken. Until these kinds of actions are taken, there is little chance to restore market confidence and get credit markets flowing. It is not a question of avoiding these losses, but one of how soon we will take them and get on to the process of recovery. Economist Allan Meltzer may have expressed this point best when he said that "capitalism without failure is like religion without sin."

What Might We Learn from Previous Financial Crises?

Many of the policy actions I just described provide support to the largest financial institutions, those that are frequently referred to as "too big to fail." A rationale for such actions is that the failure of a large institution would have a systemic impact on the economy. It is emphasized that markets have become more complex, and institutions – both bank and nonbank entities – are now larger and connected more closely through a complicated set of relationships. Often, they point to the negative impact on the economy caused by last year's failure of Lehman Brothers.

History, however, may show us another experience. When examining previous financial crises, in other countries as well as in the United States, large institutions have been allowed to fail. Banking authorities have been successful in placing new and more responsible managers and directors in charge and then reprivatizing them. There is also evidence suggesting that countries that have tried to avoid taking such steps have been much slower to recover, and the ultimate cost to taxpayers has been larger.

There are several examples that illustrate these points and show what has worked in previous crises and what hasn't. A comparison that many are starting to draw now is with what happened in Japan and Sweden.

Japan took a very gradual and delayed approach in addressing the problems in its banks. A series of limited steps spread out over a number of years were taken to slowly remove bad assets from the banks, and Japan put off efforts to address an even more fundamental problem – a critical shortage of capital in these banks. As a result, the banks were left in the position of having to focus on past problems with little resources available to help finance any economic recovery.

In contrast, Sweden took decisive steps to identify losses in its major financial institutions and insisted that solvent institutions restore capital and clean up their balance sheets. The Swedish government did provide loans to solvent institutions, but only if they also raised private capital.

Sweden dealt firmly with insolvent institutions, including operating two of the largest banks under governmental oversight with the goal of bringing in private capital within a reasonable amount of time. To deal with the bad assets in these banks, Sweden created well-capitalized asset management corporations or what we might call "bad banks." This step allowed the problem assets to be dealt with separately and systematically, while other banking operations continued under a transparent and focused framework.

The end result of this approach was to restore confidence in the Swedish banking system in a timely manner and limit the amount of taxpayer losses. Sweden, which experienced a real estate decline more severe than that in the United States, was able to resolve its banking problems at a long term net cost of less than 2 percent of GDP.

We can also learn a great deal from how the United States has dealt with previous crises. There has been a lot written attempting to draw parallels with the Great Depression.

The main way that we dealt with struggling banks at that time was through the Reconstruction Finance Corporation.

Without going into great detail about the RFC, I will note the four principles that Jesse Jones, the head of the RFC, employed in restructuring banks. The first step was to write down a bank's bad assets to realistic economic values. Next, the RFC would judge the character and capacity of bank management and make any needed and appropriate changes. The third step was to inject equity in the form of preferred stock, but this step did not occur until realistic asset values and capable management were in place. The final step was receiving the dividends and eventually recovering the par value of the stock as a bank returned to profitability and full private ownership.

At one point in 1933, the RFC held capital in more than 40 percent of all banks, representing one-third of total bank capital according to some estimates, but because of the four principles of Jesse Jones, this was all carried out without any net cost to the government or to taxpayers.

If we compare the TARP program to the RFC, TARP began without a clear set of principles and has proceeded with what seems to be an ad hoc and less-than-transparent approach in the case of banks judged "too big to fail." In both the RFC and Swedish experiences, triage was first used to set priorities and determine what institutions should be addressed immediately. TARP treated the largest institutions as one. As we move forward from here, therefore, we would be wise to have a systematic set of principles and a detailed plan to guide us.

Another example we need to be aware of relates to the thrift problems of the 1980s. Because the thrift insurance fund was inadequate to avoid the losses embedded in thrift balance sheets, an attempt was made to cover over the losses with net worth certificates and expanded powers that were supposed to allow thrifts to grow out of their problems. A notable fraction of the thrift industry was insolvent, but continued to operate as so-called "zombie" or "living dead" thrifts. As you may recall, this attempt to postpone closing insolvent thrifts did not end well, but instead added greatly to the eventual losses and led to greater real estate problems.

A final example -- our approach to large bank problems in the 1980s and early 1990s -- shows that we have taken some steps to deal with banking organizations that are considered "too big to fail" or very important on a regional level.

The most prominent example is Continental Illinois' failure in 1984. Continental was the seventh-largest bank in the country, the largest domestic commercial and industrial lender, and the bank that popularized the phrase "too big to fail." Questions about Continental's soundness led to a run by large foreign depositors in May of 1984.

But looking back, Continental actually was allowed to fail. Although the FDIC put together an open bank assistance plan and injected capital in the form of preferred stock, it also brought in new management at the top level, and shareholders, who were the bank's owners, lost their entire investment. The FDIC also separated the problem assets from the bank, which left a clean bank to be restructured and eventually sold. To liquidate the bad assets, the FDIC hired specialists to oversee the different categories of loans and entered into a service agreement with Continental that provided incentive compensation for its staff to help with the liquidation process.

A lesson to be drawn from Continental is that even large banks can be dealt with in a manner that imposes market discipline on management and stockholders, while controlling taxpayer losses. The FDIC's asset disposition model in Continental, which used incentive fees and contracts with outside specialists, also proved to be an effective and workable model. This model was employed again in the failure of Bank of New England in 1991, the failures of nearly all of the large banking organizations in Texas in the 1980s, and also for the Resolution Trust Corporation, which was set up to liquidate failed thrifts.

Resolving the Current Crisis

Turning to the current crisis, there are several lessons we can draw from these past experiences.

- First, the losses in the financial system won't go away – they will only fester and increase while impeding our chances for a recovery.
- Second, we must take a consistent, timely, and specific approach to major institutions and their problems if we are to reduce market uncertainty and bring in private investors and market funding.
- Third, if institutions -- no matter what their size -- have lost market confidence and can't survive on their own, we must be willing to write down their losses, bring in capable management, sell off and reorganize misaligned activities and businesses, and begin the process of restoring them to private ownership.

How can we do this today in an era where we have to deal with systemic issues rising not only from very large banks, but also from many other segments of the marketplace? I would be the first to acknowledge that some things have changed in our financial markets, but financial crises continue to occur for the same reasons as always – over-optimism, excessive debt and leverage ratios, and misguided incentives and perspectives – and our solutions must continue to address these basic problems.

The process we use for failing banks -- albeit far from perfect in dealing with "too big to fail" banks -- provides some first insight into the principles we should establish in dealing with financial institutions of any type.

Our bank resolution framework focuses on timely action to protect depositors and other claimants, while limiting spillover effects to the economy. Insured depositors at failed banks typically gain full and immediate access to their funds, while uninsured depositors often receive quick, partial payouts based on expected recoveries.

To provide for a continuation of essential banking services, the FDIC may choose from a variety of options, including purchase and assumption transactions, deposit transfers or payouts, bridge banks, conservatorships, and open bank assistance. These options focus on transferring important banking functions over to sound banking organizations with capable management, while putting shareholders at failed banks first in line to absorb losses.

Other important features in resolving failing banks include an established priority for handling claimants, prompt corrective action, and least-cost resolution provisions to protect the deposit insurance fund and, ultimately, taxpayers and to also bring as much market discipline to the process as possible.

I would argue for constructing a defined resolution program for "too big to fail" banks and bank holding companies, and nonbank financial institutions. It is especially necessary in cases where the normal bankruptcy process may be too slow or disruptive to financial market activities and relationships. The program and resolution process should be implemented on a consistent, transparent and equitable basis whether we are resolving small banks, large banks or other complex financial entities.

How should we structure this resolution process? While a number of details would need to be worked out, let me provide a broad outline of how it might be done.

First, public authorities would be directed to declare any financial institution insolvent whenever its capital level falls too low to support its ongoing operations and the claims against it, or whenever the market loses confidence in the firm and refuses to provide funding and capital. This directive should be clearly stated and consistently adhered to for all financial institutions that are part of the intermediation process or payments system. We must also recognize up front that the FDIC's resources and other financial industry support funds may not always be sufficient for this task and that Treasury money may also be needed.

Next, public authorities should use receivership, conservatorship or "bridge bank" powers to take over the failing institution and continue its operations under new management. Following what we have done with banks, a receiver would then take out all or a portion of the bad assets and either sell the remaining operations to one or more sound financial institutions or arrange for the operations to continue on a bridge basis under new management and professional oversight. In the case of larger institutions with complex operations, such bridge operations would need to continue until a plan can be carried out for cleaning up and restructuring the firm and then reprivatizing it.

Shareholders would be forced to bear the full risk of the positions they have taken and suffer the resulting losses. The newly restructured institution would continue the essential services and operations of the failing firm.

All existing obligations would be addressed and dealt with according to whatever priority is set up for handling claims. This could go so far as providing 100 percent guarantees to all liabilities, or, alternatively, it could include resolving short-term claims expeditiously and, in the case of uninsured claims, giving access to maturing funds with the potential for haircuts depending on expected recoveries, any collateral protection and likely market impact.

There is legitimate concern for addressing these issues when institutions have significant foreign operations. However, if all liabilities are guaranteed, for example, and the institution is in receivership, such international complexities could be addressed satisfactorily.

One other point in resolving "too big to fail" institutions is that public authorities should take care not to worsen our exposure to such institutions going forward. In fact, for failed institutions that have proven to be too big or too complex to manage well, steps must be taken to break up their operations and sell them off in more manageable pieces. We must also look for other ways to limit the creation and growth of firms that might be considered "too big to fail."

In this regard, our recent experience with ad hoc solutions to large failing firms has led to even more concentrated financial markets as only the largest institutions are likely to have the available resources for the type of hasty takeovers that have occurred. Another drawback is that these organizations do not have the time for necessary "due diligence" assessments and, as we have seen, may encounter serious acquisition problems. Under a more orderly resolution process, public authorities would have the time to be more selective and bring in a wider group of bidders, and they would be able to offer all or portions of institutions that have been restored to sound conditions.

Concluding Thoughts

While hardly painless and with much complexity itself, this approach to addressing "too big to fail" strikes me as constructive and as having a proven track record. Moreover, the current path is beset by ad hoc decision making and the potential for much political interference, including efforts to force problem institutions to lend if they accept public funds; operate under other imposed controls; and limit management pay, bonuses and severance.

If an institution's management has failed the test of the marketplace, these managers should be replaced. They should not be given public funds and then micro-managed, as we are now doing under TARP, with a set of political strings attached.

Many are now beginning to criticize the idea of public authorities taking over large institutions on the grounds that we would be "nationalizing" our financial system. I believe that this is a misnomer, as we are taking a temporary step that is aimed at cleaning up a limited number of failed institutions and returning them to private ownership as soon as possible. This is something that the banking agencies have done many times before with smaller institutions and, in selected cases, with very large institutions. In many ways, it is also similar to what is typically done in a bankruptcy court, but with an emphasis on ensuring a continuity of services. In contrast, what we have been doing so far is every bit a process that results in a protracted nationalization of "too big to fail" institutions.

The issue that we should be most concerned about is what approach will produce consistent and equitable outcomes and will get us back on the path to recovery in the quickest manner and at reasonable cost. While it may take us some time to clean up and reprivatize a large institution in today's environment -- and I do not intend to underestimate the difficulties that would be encountered -- the alternative of leaving an institution to continue its operations with a failed management team in place is certain to be more costly and far less likely to produce a desirable outcome.

In a similar fashion, some are now claiming that public authorities do not have the expertise and capacity to take over and run a "too big to fail" institution. They contend that such takeovers would destroy a firm's inherent value, give talented employees a reason to leave, cause further financial panic and require many years for the restructuring process. We should ask, though, why would anyone assume we are better off leaving an institution under the control of failing managers, dealing with the large volume of "toxic" assets they created and coping with a raft of politically imposed controls that would be placed on their operations?

In contrast, a firm resolution process could be placed under the oversight of independent regulatory agencies whenever possible and ideally would be funded through a combination of Treasury and financial industry funds.

Furthermore, the experience of the banking agencies in dealing with significant failures indicates that financial regulators are capable of bringing in qualified management and specialized expertise to restore failing institutions to sound health. This rebuilding process thus provides a means of restoring value to an institution, while creating the type of stable environment necessary to maintain and attract talented employees. Regulatory agencies also have a proven track record in handling large volumes of problem assets – a record that helps to ensure that resolutions are handled in a way that best protects public funds.

Finally, I would argue that creating a framework that can handle the failure of institutions of any size will restore an important element of market discipline to our financial system, limit moral hazard concerns, and assure the fairness of treatment from the smallest to the largest organizations that that is the hallmark of our economic system.

MR. SILVERS. In this Panel's first report, our very first question was what is Treasury's strategy? I hope that this hearing and the further work of the Panel and its staff will enable us to better understand what Treasury's strategy is and how it measures up to the lessons of history.

In the written testimony we have received from today's witnesses, there were some distinct common points. Financial crises tend to follow asset bubbles. Two, financial institutions are reluctant to admit their true condition, and there is a tendency for regulators and other political bodies to indulge them in this wishful thinking. Three, financial institutions with weak balance sheets, large financial institutions, contribute to a downward economic spiral by pulling back on lending activity.

The testimony suggests successful strategies for dealing with these common dynamics include, one, giving a Government agency clear authority to restructure the banks; two, being completely transparent about the strategy and operations of that agency; three, having that agency value bank assets on a realistic basis; four, holding bank executives accountable for their mistakes; five, being prepared to combine haircuts for bank investors with public funds to either, one, wind up truly failed institutions or, two, revive savable institutions with adequate capital; and six, above all, to move quickly to accomplish these tasks.

It is noteworthy that in the three successful examples we are considering today, in no case did effective action result from trying to keep shareholders of zombie banks alive or from deferring to the incumbent management of those banks around key decisions such as asset evaluation or executive pay.

On the positive side, the written testimony suggests that effective action often turns out to be less expensive than it appears at first, while delay in acting to restructure sick banks appears associated with increases in the ultimate cost to the public. This appears to be a striking feature of the testimony we have received on the most recent U.S. experience of financial institution failure, the S&L bailout.

Of course, every country is unique. And while we in the United States benefit from the dollar's status as reserve currency on the one hand, on the other hand, we cannot rely on someone else's consumer demand to rescue us, and to some extent, it seems both Japan and Sweden were able to rely on U.S. consumers to rescue them.

Ironically, the United States has until very recently had a fairly decentralized banking system. But now our banking system looks more like Sweden's and Japan's than it does the U.S. system of the Depression era or even the late 1980s. And it seems that while we have many sick smaller banks, the FDIC is so far able to resolve them. It is the sick mega banks that are driving the crisis.

While this Panel is awaiting a more detailed statement of the new administration's strategy, I believe the unstated strategy pursued by the Bush administration in the 4 months following the passage of the Emergency Economic Stabilization Act of 2008 was essentially to offer a mix of implicit and explicit guarantees backed up by equity infusions in the hope of buying time for markets to become more rational and bank balance sheets to recover. The fundamental assumption behind this strategy was that time was on our side.

This Panel has held field hearings in Nevada and in Prince George's County, Maryland, where we have heard firsthand from homeowners and seen the assets underlying at least the first rounds of our financial crisis. I am convinced that the fundamental assumption of the Bush administration's approach—that time was on our side—was mistaken because the fall in asset prices at its heart was rational.

Subprime loans and everything derivative upon them are not now and will never be worth their face value. The borrowers cannot pay their exploitative terms. The collateral is not worth and will never be worth on a present value basis anywhere near the value of the loans made on them.

The reality of these losses, combined with the dramatic concentration in the financial sector that has left us with four mega banks, is a profound procyclical force, deepening the recession and worsening the bank crisis.

Spoon feeding capital to broken institutions will not bring them back to life, nor will indulging in fantasies of reviving the real estate bubble. Having the Government buy bad assets will either fully reveal the weakness of bank balance sheets if done at fair prices, or if done at inflated prices will simply be a way of hiding the largest regressive wealth transfer in U.S. history, a wealth transfer that will still not be big enough to revive the sickest big banks.

Most of all, the reality of losses and weak balance sheets is that time is not on our side, just as time was not the cure in any of the case studies. Time without action was not the cure in any of the case studies we are looking at today.

The Obama administration now faces the choice of continuing a failed strategy based on mistaken assumptions or looking to the lessons of history to craft a new strategy consistent with the values of responsibility, transparency, and shared sacrifice that President Obama has rightly asked our nation to embrace.

I look forward to hearing from our witnesses today on the lessons of history.

[The prepared statement of Mr. Silvers follows:]

Opening Statement of Damon Silvers
Congressional Oversight Panel
Learning from the Past: Lessons of the
Bank Crises of the 20th Century
March 19, 2009

Let me begin by expressing my profound appreciation to the witnesses for joining us here today, and particularly to Mr. Lundgren for traveling from Sweden to be with us for this hearing. We are also honored by the presence of the His Excellency, Ambassador Hafstron. Recently, the Thomas Hoenig, the President of the Federal Reserve Bank of Kansas City, gave a speech in which he praised the work of Mr. Lundgren and his colleagues. This speech was called to my attention by Mr. Hoenig's Senator, Senator Brownback of Kansas, and I ask that it be entered into the record of this hearing.

In this Panel's first report, our very first question was, "what is Treasury's strategy?" I hope that this hearing and the further work of the Panel and its staff will enable us to better understand what Treasury's strategy is and how it measures up to the lessons of history.

In the written testimony we have received from today's witnesses, there are some distinct common points.

1. Financial crises tend to follow asset bubbles;
2. Financial institutions are reluctant to admit their true financial condition, and there is a tendency for regulators and other political bodies to indulge them in this wishful thinking;
3. Financial institutions with weak balance sheets contribute to a downward economic spiral by pulling back on lending activity;

The testimony suggests successful strategies for dealing with these common dynamics include:

1. Giving a government agency clear authority to restructure the banks
2. Being completely transparent about the strategy and operations of that agency;
3. Having that agency value bank assets on a realistic basis
4. Holding bank executives accountable for their mistakes
5. Being prepared to combine haircuts for bank investors with public funds to either (1) wind up truly failed institutions or (2) revive saveable institutions with adequate capital;
6. And above all, to move quickly to accomplish these tasks.

It is noteworthy that in the three successful examples we are considering today, in no case did effective action result from trying to keep shareholders of zombie banks alive, or from deferring to the incumbent management of those banks around key decisions such as asset valuation or executive pay.

On the positive side, the written testimony suggests that effective action often turns out to be less expensive than it appears at first, while delay in acting to restructure sick banks appears associated with increases in the ultimate costs to the public. This is a particularly striking feature of the testimony we have received on the most recent U.S experience of financial institution failure—the S&L bailout.

Of course, every country is unique. While we benefit from the dollar's status as reserve currency, on the other hand, we cannot rely on someone else's consumer demand to rescue us—as to some extent it seems both Japan and Sweden were able to rely on U.S. consumers to rescue them.

Ironically the United States has until very recently had a fairly decentralized banking system. But now our banking system looks more like Sweden's and Japan's than it does the U.S. system of the Depression era or even the late 1980's. And it seems that while we have many sick smaller banks, the FDIC is so far able to resolve them. It is the sick mega banks that are driving the crisis.

While this Panel is awaiting a more detailed statement of the new Administration's strategy, I believe the unstated strategy pursued by the Bush Administration in the four months following the passage of the Emergency Economic Stabilization Act of 2008 was essentially to offer a mix of implicit and explicit guarantees, backed up by equity infusions, in the hope of buying time for markets to become rational and bank balance sheets to recover. The fundamental assumption behind this strategy was that time was on our side.

This Panel has held field hearings in Nevada and in Prince Georges County, Maryland, where we have heard firsthand from homeowners and seen the assets underlying at least the first rounds of our financial crisis. I am convinced that the fundamental assumption of the Bush Administration's approach, that time was on our side, was mistaken, because the fall in asset prices at its heart was rational. Subprime loans and everything derivative upon them are not now and will never be worth their face value. The borrowers cannot pay their exploitative terms. The collateral is not worth and will never be worth on a present value basis anywhere near the value of the loans made on them.

The reality of these losses, combined with the dramatic concentration in the financial sector that has left us with 4 megabanks, is a profound procyclical force, deepening the recession and worsening the bank crisis. Spoonfeeding capital to broken institutions will not bring them back to life, nor will indulging in fantasies of reviving the real estate bubble. Having the government buy bad assets will either fully reveal the weakness of bank balance sheets, if done at fair prices, or if done at inflated prices will simply be a way of hiding the largest regressive wealth transfer in U.S. history—a wealth transfer that will still not be big enough to revive the biggest sick banks.

Most of all, the reality of losses and weak balance sheets is that time is not on our side, just as it was not the cure in any of the case studies we are looking at today.

The Obama Administration now faces the choice of continuing a failed strategy based on mistaken assumptions, or looking to the lessons of history to craft a new strategy consistent with the values of responsibility, transparency and shared sacrifice that President Obama has rightly asked our nation to embrace.

I look forward to hearing from our witnesses today on the lessons of history.

The CHAIRMAN. Thank you very much, Mr. Silvers.
Mr. Neiman.

STATEMENT OF RICHARD H. NEIMAN, MEMBER, CONGRESSIONAL OVERSIGHT PANEL

Mr. NEIMAN. Thank you.

Good morning, and thank you all for appearing here today.

It is especially appropriate that we are meeting here to discuss the strategies that have been used successfully in past crises, both here in the U.S. and around the world.

The current financial turmoil has demonstrated just how interconnected the global markets have become. What began as a wave of defaults in the subprime sector of the U.S. housing market was transmitted across the world, impacting seemingly unrelated products, distant markets, and billions of people.

This is certainly not the first time that financial dislocations have occurred. But the increasing interconnectedness of the capital markets amplifies the shocks, which could, in turn, delay recovery unless all affected countries work together in a coordinated response.

In developing that response, it is critical that we understand what strategies have worked in the past and what obstacles stand in the way of an effective solution. We can't afford to overlook past lessons learned. As they say, those who cannot remember the past are condemned to repeat it.

But, while there are similarities among all financial crises, no two are exactly the same. The prevailing conditions in the broader economy and the type of financial institutions involved provide a dynamic that makes every situation unique, requiring a unique solution.

And there is no one regulatory approach that is immune from systemic shocks. The financial crisis has affected countries with diverse systems, including the UK with its more consolidated regulatory structure.

However, understanding why certain strategies worked in other contexts can help us develop the right strategy in our own circumstances. And while there is no ready prescription for solving the crisis of today, there are time-tested principles that we can adapt to our present situation.

One of the most important aspects of any successful strategy involves restoring consumer and investor confidence in the financial system. Instilling that confidence depends in part upon the Treasury Department articulating a clear strategy for moving forward and then clearly communicating the metrics to be used in measuring our progress in delivering on that strategy and in meeting our goals.

Your testimony today will provide vital information for the Panel as we continue to advise Congress about the effectiveness of the Treasury's strategy, and I look forward to your statements and the question and answer period.

Thank you.

The CHAIRMAN. Thank you.

So let us get down to business. As we do, I want to thank Patrick McGreevy and Brian Phillips of the Oversight Panel for their hard work in putting together this hearing. I don't want to take the chance that I will forget at the end because we have gotten so engaged in this conversation.

I would also like to pause to recognize His Excellency, the Swedish ambassador Jonas Hafstrom. Your Excellency, we are honored to have you here. And we appreciate the opportunity to learn from the challenges that your nation faced and how you dealt with them. We very much look forward to this. Thank you for joining us.

So let us start with Director General Lundgren. I remind you all we have your statements, your written statements in full, and they will be made part of the official record. So if you could hold your oral comments to 5 minutes, that will give us a little time to be able to ask questions.

Mr. Lundgren.

STATEMENT OF BO LUNDGREN, DIRECTOR GENERAL, SWEDISH NATIONAL DEBT OFFICE

Mr. LUNDGREN. Thank you very much, and thank you for the invitation.

Let me start with the differences between the Swedish banking crisis and what is happening now in the U.S. and, indeed, in the global context. Size, of course, Sweden being a small country. We had a regional crisis. This is a global crisis.

This is a more complex crisis. We had a rather pure one with ordinary loans, not so much securitized. And we had another political situation. My advice is that if you have a banking crisis, please have it after elections, not before elections because after the election, it is much easier to build political consensus. We enjoyed that, and I would say that that is a very, very good situation to be in, listening to political debate in the U.S.

There are, on the other hand, similarities as well. I mean, first of all, we are—both the U.S. and Sweden are market economies, even though I hear sometimes from commentators that we are a socialist country. The problem is that is not quite true. We have socialized, to a large extent, people's incomes. But the business sector is very free and market oriented.

We have the same challenges that we had in the '90s and that the U.S. stands for today. One is to maintain liquidity in the financial system, and that, I would say, was taken care of then and is taken care of now.

The second thing is to restore confidence in the financial sector, and that means that depositors and investors have to be feeling secure. And you have, thirdly, to restore the capital base. If you want to avoid or minimize credit crunch effects in the economy, of course, you need to have a capital base for lending. And if private sector investors don't invest, then government has to invest.

In Sweden, in the beginning of the '90s, we had seven large and medium-sized banks that altogether had 90 percent of the markets, and then a couple of hundred smaller banks as well, mostly savings banks. The roots to the crisis was a speculation bubble in real estate mainly, same kind of roots as today.

When I took office in October '91, we already had the bubble bursting, and we had problems in one of the big banks, the partially already nationalized Nordbanken, and we got problems also in a big savings bank at that time. Initially, we worked case by case, but found out during spring '92 that we were on the verge of having a systemic crisis. And in the autumn of '92, we came to a situation close to the one that the U.S. experienced after Lehman's when confidence was totally lost.

We had prepared for that moment some months, and what we did then with the support of the opposition, since I talked about the political consensus being there, was to implement a package with two main ingredients. One was a blanket guarantee for depositors and creditors. Of course, not for shareholders. Shareholders have to pay first. That is a principle we used.

We also had the right from parliament to be able to reconstruct and to restore the system, per se, by taking much different measures to unwind banks that should be liquidated, to capitalize banks that could be capitalized and then work again. We had a full assortment of tools to be able to use, and we had also a situation where we had an unlimited economic frame.

We dared not to ask for a frame where we had to go back to parliament again because that would have increased the fright about the situation, and we didn't want to take too much. So we got an unlimited frame, which was a good thing.

We didn't ask to own banks, which, being a center-right government and myself being market liberal, we wanted to avoid nationalization of banks. On the other hand, if you have to do it as part of a crisis management, so be it. Then you have to do it.

Governments are not very good at running banks, but obviously, this time around, the former owners or the owners today hasn't been very good either. And if you do it as a part of a crisis management in order to save all the taxpayers' money, you should do it.

We used the banks we took over, which was only two that were nationalized, the concept of a good bank/bad bank, in order to have management in the good banks being able to concentrate on the future and also to be able to get rid of or handle the bad loans, the nonperforming loans in a manner what we could recover as much as possible of the original loans. And it really worked quite well.

We thought it could take up to 10, 15 years, but it took approximately 5 years before we could unwind these entities. We used transparency. Valuation was vital, of course. We had to have a situation where people trusted what we were doing and trusted, and the investors and others could trust that the estimates on the situation in the banks were correct as well, so we had rather tough mark-to-market valuation rules, which also helped us.

Altogether, we got rather soon out of the crisis. Already in 1994, after 2 years, the bank system together was profitable once again.

Thank you.

[The prepared statement of Mr. Lundgren follows:]

Testimony of Bo Lundgren
Director General, Swedish National Debt Office

Congressional Oversight Panel

March 19th 2009

BACKGROUND

The Swedish banking crisis in the early 1990s was mainly the result of a real estate bubble following the well over-due deregulation of credit markets in 1985. In an economic environment with high inflation and a tax system that stimulated borrowing, the stage was set for speculation. The fact that exchange controls were retained until 1989 accentuated this development. There was what you might call a 'bathtub effect', where predominantly speculative investments were more or less confined to the limited domestic commercial real estate market.

When the bubble burst, as real estate prices started to fall in 1990, all of the seven largest banks, with a market share of 90 per cent, suffered heavy losses, primarily from loans to commercial real estate. Credit losses in those years added up to approximately one fifth of total lending, which was equivalent to 12 per cent of Sweden's annual GDP. The stock of non-performing loans was much larger than the banking sector's aggregate equity capital. Five of the seven largest banks needed, and obtained, additional capital from either the Government or from their owners.

The crisis in the financial sector emerged at the same time as the real economy entered into recession. Households, which had also increased their indebtedness substantially since the deregulation of the credit market, increased their savings to repay their loans. There was a considerable decline in domestic demand, resulting in negative growth, and a substantial increase in public sector deficit.

When I assumed political responsibility for the financial sector in October 1991, immediate efforts were required to manage the situation at two banks: Nordbanken and Första Sparbanken. Nordbanken was partly in private hands, but the Government was the majority owner and had a special responsibility (we later bought the shares that were privately owned in order to manage the problems in the bank more efficiently). Our analysis of Första Sparbanken, Sweden's largest savings bank, showed that it was 'too-big-to-fail', not least because of huge foreign funding. That made it necessary to contribute to a solution.

Our initial approach was to separate the treatment of problems that arose at particular banks. Meanwhile, the Government introduced measures to allow foreign banks to establish subsidiaries in order to mitigate the effects and enhance competition. We also abolished property tax on commercial real estate to help stabilize the market.

One key objective was to ensure that our crisis management would be characterised by the greatest possible transparency. This would contribute towards bolstering confidence in the financial sector and in our crisis management as such. One step towards this was the introduction of clear rules for how non-performing loans would be reported and property valued.

POLITICAL CONSENSUS

During the spring of 1992, the situation got worse for the two banks that had already received support and severe problems arose for a third, Gota bank. It became clear to us that we were approaching a systemic crisis. We began to work on general measures that would be needed to avert a collapse.

Conditions in the Swedish economy continued to deteriorate and the position of the banks became gradually more strained. Gota bank was unable to continue operations without Government support. In September, in the face of a general loss of access to foreign currency funding, it was deemed necessary to issue a blanket guarantee for all non-equity claims on Swedish banks.

We endeavoured to establish broad political consensus. Discussions with the main opposition party, the Swedish Social Democratic Party, (which had supported previous measures) resulted in it being possible for an action programme, introduced in September 1992, to be approved by a substantial majority in the Riksdag (Swedish Parliament). This meant that we achieved the desired effect prior to the formal decision by the Riksdag.

BLANKET GUARANTEE AND BANK SUPPORT

The cornerstone of this package of measures (see Appendix) was a general guarantee for all creditors and depositors (Sweden did not have a deposit guarantee at that time) with Swedish banks. Risk capital, in the form of share capital and perpetual subordinated loans, was not covered by the guarantee. The principle was that the share capital was first to be used to cover credit losses and write-downs.

The guarantee would remain in force until the stability of the financial system was no longer under threat and could be discontinued without jeopardizing the rights of creditors. We stated that discontinuation would require a new decision by the Riksdag.

This undertaking meant that the lender of last resort, the Riksbank (Sweden's Central Bank), was in a position to provide banks with liquid assets in domestic or foreign currency so they could unquestionably meet their commitments. In particular, foreign currencies were deposited with the banks on a very large scale to make up for decreased foreign loans. Gradually, banks could also resume their funding in interbank markets, backed by the support from the Government guarantee.

The Government was also given the mandate to implement such measures as might be required to restore the stability of the financial system. This involved support for the continuation of operations at sustainable banks or support for the orderly reconstruction or winding up of banks that could not be expected to become profitable in the long term. Support could be granted in the form of loans, guarantees, or injection of capital.

One vital issue was the scope of financial frame we should request of the Riksdag. If we were to choose a frame that was too small, we might be compelled to ask for further funds, which might then be perceived to mean that we did not have a firm grip on the situation. On the other hand, if we asked for too much, this might be perceived as indicating that the situation was far worse than it actually was. The solution decided on – in consensus with the political opposition – was an unlimited frame.

BANK SUPPORT AUTHORITY

We decided that bank support issues would be dealt with by a separate authority, the Bank Support Authority, so that other essential work within the Ministry of Finance was not impeded. Decisions made by this authority were to be submitted to the Ministry of Finance for final approval.

As the Bank Support Authority could not become formally operational until early May 1993, the work was initiated by a special group at the Ministry of Finance. In addition to the three banks that already had Government support, applications were received from three other banks: SEB, Swedbank and Föreningsbanken. Only one of the seven largest banks (Handelsbanken) did not apply for Government support.

The banks that applied for support had to be assessed according to objective criteria, in order to determine the extent and the forms of support. The bank's current situation, and financial and macroeconomic developments, formed a point of departure for this assessment. The banks were split into three categories (a method that I might mention was based on the categories used for a corresponding purpose when dealing with the banking crisis in the United States in 1933):

- A bank belonging to Category A was not considered to fall below the capital adequacy requirement, but may need support in the form of, for instance, temporary guarantees,

- A bank belonging to Category B could possibly fall below the capital adequacy requirement temporarily, but after a period satisfy the requirement once again. This type of bank might need more extensive government support in the form of loans or a capital infusion if the owners neither wanted to, nor had the capacity to, inject capital.

- A bank belonging to Category C was unlikely to become profitable, even in the long term. This type of bank should be completely or partly wound up at the lowest cost possible.

Banks eligible for support were obliged to comply with government requirements and submit to government supervision and control as to how the aid was used. Costs were to be carried by the bank that received the support but recovery of costs was put off until this became feasible with reference to the bank's financial situation.

It was an explicit objective to avoid government ownership of banks, but we did not exclude this option should it prove to be necessary. Any nationalisation would be temporary and would not involve the central government as owner running bank operations according to principles differing from those applicable to private banks.

TRANSPARENCY

When it came to the principles for assessing the need and structure of support for individual banks, a fundamental issue was how to calculate loan losses and the extent of non-performing loans.

There were two conceivable strategies. One involved calculating expected loan losses and write-down requirements on the basis of the current market values for existing collateral, usually in the form of real estate. That would provide a clear, open account of the magnitude of the problems and the support required. Given the broad acceptance of the methods behind the assessments, this ought to enhance the credibility of the process.

However, if, for instance, the property values were unduly low, it might also involve a risk of producing an exaggerated picture of the true extent of the problems.

The other strategy would be to try to defer reported losses for as long as is legally possible and use the banks' earnings to write the losses off gradually. One advantage of such an approach is that the banks might not be obliged to dispose of assets that they held as collateral at prices considerably less than their long-term market value. However, it has the very serious drawback of presupposing that the problems can be resolved comparatively quickly. Otherwise it might possibly exacerbate the problems. One example of this is how the savings bank crisis was dealt with in the United States in the 1980s.

For me, there was no doubt about which method to choose to build credibility. Our management of the bank crisis was to be based on openness and transparency. So a great deal of work began on valuing the loans and collateral held at each bank in order to ascertain how much support was needed and provide it without delay. A separate Valuation Board was set up to ensure that the values assigned to real-estate collateral were reasonably close to the mark. This Board checked the banks' valuations during the support process.

MORAL HAZARD

Of course, the general guarantee for creditors involves a risk that the banks might continue implementing transactions entailing considerable risks and that depositors and creditors would refrain from making their own assessments of the risks of an investment.

At the same time, this was counteracted by the strict handling of the banks and a clear message that the shareholders were entirely responsible for their own risks. If the Government needed to infuse any capital, the Government would also have a corresponding influence, even if this went so far as to involve nationalisation. Legislation was introduced to facilitate negotiations, whereby the Bank Support Authority was empowered to make decisions on support, even in cases where an agreement had not been reached with the bank.

However, the potential cost that might arise owing to the risks of undesirable conduct had to be balanced against the greater cost to the real economy that would be incurred owing to the continued lack of confidence if the general guarantee was not introduced. To abstain from responding to a deep crisis based on concerns for what might happen in the future is in any case not an option. A true crisis is not the time for such fine points.

TURNAROUND

In January 1993, it seemed to me that substantial support would probably be needed for all of the banks that had applied. During the spring, however, the macro-economic improvement contributed to a quicker recovery and a more favourable trend in the stock of non-performing loans.

This development in conjunction with tough conditions for government support (government capital would mean corresponding government ownership) made two banks, SEB and Swedbank, look for private capital. They withdrew their application for support in the autumn and repaid all of the Government's expenses. A guarantee was issued for Föreningsbanken, but never had to be used.

Gota bank was nationalized and Nordbanken, which was already government-owned, was reconstructed. The viable parts of Gota bank were later merged with Nordbanken

BAD BANKS

'Bad banks' (Securum and Retriva) were formed for the nationalised banks, Nordbanken and GOTA respectively and the main parts of the bad loans were transferred to these banks. The aim was first to allow the management to concentrate on normal banking operations and second to deal with the bad loans more efficiently.

Securum and Retriva were capitalised on the basis of the valuation of the loans and were given the task of selling their assets at a pace that was feasible so that as much could be recovered as possible. We originally estimated that it might be possible to run the operation for close on 10 to 15 years, but developments moved considerably more rapidly than that. They were already wound up by 1997, with a better result than expected.

The technique of having 'bad banks' was also used by other banks, though entirely without any Government involvement. These cases therefore did not involve Government 'bad bank' that also received assets from private banks. Since each bank had its own 'bad bank', the issue of how to value the transferred assets did not become critical. An approximate value was sufficient since the bank and the 'bad bank' had the same owner.

FINAL COST

The blanket guarantee and the special legislation were abolished July 1st 1996.

Altogether, the amount paid out in support to the bank sector amounted to 65 billion kronor (SEK), the equivalent of a little more than 4 per cent of GDP at that time. The bad loans in Securum and Retriva were wound up more favourably and quickly (already by 1997) than I had dared to expect.

Securum and Retriva produced a surplus, which together with the partial privatisation of Nordbanken (now Nordea) and its remaining value, means that expenditure on bank support has been almost been totally recovered.

Of course, costs were incurred for the economy in general in the form of wider spreads and disruptions, albeit limited, to the supply of credit. However, the macro-economic recovery after the bubble had burst was faster because the banking crisis was handled in a decisive manner. Fundamentally, these effects should be seen as damages done by the events that led to the financial crisis. Once a bubble has been inflated, it is inevitable that the process required to bring the economy back on track entails significant costs to society.

THEN AND NOW

There are, of course, differences between the current crisis and the Swedish crisis, but there are also similarities, not least regarding the basic functions that have to be dealt with by the Government

Today's crisis, in contrast to the Swedish crisis, is global; it originates from a country that is significantly larger than Sweden and, even if it does have its roots in the real estate market, the situation is more complex owing to extensive securitisation and more developed financial markets.

Despite these differences, the main tasks for a government (and a central bank) are the same:

* To maintain liquidity in the financial system.

* To restore confidence in the financial system.

* To restore the capital base in the banking sector to counteract credit crunch.

In the current crisis, it was basically possible to maintain liquidity primarily by initiatives by the central banks. However, it is obvious that confidence is still impaired and that uncertainty prevails regarding capital supply.

In order to restore confidence in the financial system and facilitate sufficiently adequate financing from stakeholders other than central banks, it is necessary to convince investors that they are not at risk of being adversely affected by losses as a consequence of a crash.

This can be achieved in various ways. All banks were closed for a week in conjunction with the handling of the crisis in the United States in 1933. One bank in each Federal Reserve district was subsequently reopened following a review that showed that they were solvent. After that, other solvent banks were opened in pace with them having been analysed. In this way, a kind of government guarantee was provided for these banks.

When the situation became unsustainable in Sweden , we chose to issue the general guarantee for creditors. This restored confidence and we were able to move on and deal with the problems within each respective bank without the uncertainty that prevails today.

In my opinion, it should be possible to utilise methods that at least have similar effects as a general guarantee today as well. The cost that arises if a guarantee is utilised does not have to be more that what would ensue from the implicit guarantee that, in reality, prevails in most countries today.

There does not have to be a greater need for government capital infusion if the owners of the banks know that the Government will require ownership corresponding to their capital contribution. This will lead to banks endeavouring to find private capital. If they are unsuccessful, the Government must also act to avoid losses for creditors and to maintain the total capital base for lending.

A counter argument is of course the risk that banks will behave recklessly in the absence of market forces that limit their ability to take risks. It should be possible to reduce this through intensified supervision and clear rules regarding the responsibility of owners and the banks' management. However, the potential costs that might arise must be balanced against the high socioeconomic costs that would arise if confidence in the financial system cannot be restored.

The capital required to restore the capital dissipated owing to credit losses and write-downs of assets must be provided if lending capacity is to be maintained. This should be done in the first instance through private capital infusion. The Government must inject capital if this proves to be impossible. In order to encourage private solutions, the Government should, in accordance with the principles of a market economy, lay down conditions for government capital injections with a corresponding dilution of the existing capital, even when this may involve temporary nationalisation.

The other main conclusions that I believe you can draw from my experiences of the Swedish banking crisis are that:

- Government intervention is unavoidable if you are facing a systemic crisis.
- Prompt action is important. A comprehensive approach is better than a piecemeal strategy.
- Transparency enhances confidence and promotes the public legitimacy of the measures that have to be taken.
- Broad political consensus and resolute political actions taken by the political system are probably more important than any of the technical aspects on how to deal with the crisis. This also enhances confidence, not least internationally, in our ability to deal with the crisis.
- In order to limit moral hazard and get public support, it is important to have a stronger approach and deal with the banks firmly, enforcing the principle that losses are to be covered in the first place by the capital provided by the shareholders. If that means that banks must be nationalised, then so be it. They can be privatised again at a later stage.

The CHAIRMAN. Thank you very much, Mr. Lundgren.

I should point out the buzzing is nothing to be alarmed about. It indicates that there is a vote going on on the floor, to alert members that they need to be elsewhere, and that is one of the reasons we don't have one of our members with us.

Mr. Katz, could you speak to us of Japan?

Mr. KATZ. Yes, and——

The CHAIRMAN. Push the little red button.

STATEMENT OF RICHARD KATZ, EDITOR-IN-CHIEF, THE ORIENTAL ECONOMIST

Mr. KATZ. First of all, thank you for having me.

Japan is mostly lessons in mistakes to avoid. I very much agree with the comments made by members of the committee. The crisis is very, very different in the U.S. In Japan, there was a crisis in the real economy of goods and services that was reflected in the banking crisis, mostly about plain vanilla loans. Twenty percent of GDP was just bad debt.

In the U.S., most of the nonfinancial sector outside of autos is actually quite healthy. The U.S. crisis is a problem in the shadow banking system of asset-backed securities and derivatives, not even so much the commercial banking system or the commercial banking part of the banking holding companies, but really the shadow banking system. So it is a more complicated problem, but not as deeply penetrating into the overall economy. So that is different, and that has pluses and minuses.

Some lessons. One, the truth shall set you free. Japan hid from itself the depths of the problem, denied, covered up. I mean, criminal fraud cover-up. In the U.S., we created regulations that actually prevented us from even monitoring the size of credit default swaps or knowing the amount of counterparty risk. And the notion that we don't sell financial derivatives on exchanges like we sell corn futures and stocks is just asking for trouble.

So regulations requiring greater transparency, and putting derivatives on public exchanges, would certainly be a remedy. That would allow us to avoid the counterparty risk like AIG and allow us to just know what is going on as well as regulate it.

Second, some people have got to go jail. Two reasons. One, they deserve to. When bank executives press loan officers to approve loans that they know are probably fraudulent and then they pass them on by securitizing them, that has got to be against the law. If it is not against the law, then the Congress has got to remedy that.

The second reason is that the public will not approve spending hundreds of billions of dollars if they think you are bailing out banker crooks. That is one of the reasons it took Japan so long to inject public capital into the banks.

In the U.S. S&L crisis, hundreds of U.S. banker crooks went to jail. In Japan, few, if any, went to jail. So to get public support for that kind of money, the public has to feel that they are the ones being bailed out, not the malefactors of great wealth.

Thirdly, you do need a capital injection. Japan finally combined the capital injection with an upside for taxpayers, and the capital injection has got to be combined with insistence that that be used to write off the tax to toxic assets. In Japan, it took them about 6 or 7 years to finally inject some money. But initially, they injected the money so the banks could continue bailing out the zombie borrowers.

When the Koizumi administration, after about a year in power, finally decided to go after the problem, they insisted that the toxic assets actually be written off the books. It took about 3 years to do it. The social dislocation was actually less than they had feared.

So the U.S. needs to inject enough capital so that banks can afford to write off the bad loans—the Japanese banks were very, very thinly capitalized—but it also has to have the controls to make sure it is being used to get rid of toxic assets. The record on bank nationalization in Japan is actually a mixed record, which I can discuss in the Q&A, if you would like.

Mark-to-market accounting is procyclical the way it is being used now. That needs to be adjusted. A large part of the capital losses of banking institutions is actually mark-to-myth writedowns because, in fact, capital markets have gotten panicked. So, there is irrationality in terms of these derivative prices relative to the level of the original asset. You could have the original loans being paid on time. And yet the securities based on them have lost a third of their value.

Fiscal and monetary stimulus is absolutely essential. You cannot cure the crisis without it because you have to have a cushion underneath the economy to prop up the economy. It is inherently depressive to wipe out all of this wealth or to recognize the wealth that has already been written off.

So you have to have that cushion. Japan did it in such a stop-go fashion that they gave fiscal stimulus a bad name, just as I fear some of the stuff we have done has given markets a bad name around the world.

So you need fiscal and monetary stimulus, but you need it as anesthesia for the surgery of curing the banking problem of toxic assets. If you use it as heroin to dull the pain and avoid the surgery, as Japan did for 10 years, then you have bigger costs, more pain, more losses in the end.

Japan needed regulatory institutional changes. We certainly do. I think the heart of the U.S. crisis was an orgy of deregulation, which basically gave financial executives incentives to act like buccaneers, creating loans they knew to be dubious, selling them off to pension funds of teachers and plumbers and bank tellers. And that, I believe, is the heart of the crisis.

It is not excessive debt, per se. It is that the debt was used for worse than useless projects. I have figures here showing actually the debt level in the United States is not as bad as many people suppose. The problem is how the money was used and the fact that the shadow banking system is so obscure that the players don't know what anything is worth. The markets are frozen.

I will stop there.

[The prepared statement of Mr. Katz follows:]

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LESSONS FOR US FROM JAPAN'S BANKING CRISIS

Testimony for
Congressional Oversight Panel
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Key Lessons

Differences in the Nature of the Crisis

Japan's experience is mostly a lesson in mistakes to avoid. In addition, the banking crisis in Japan has very different roots from the American problem. In Japan, the root of the problem was in plain vanilla loans because too many nonfinancial companies were losing money. The banking crisis reflected a crisis in the real economy. Too many firms made products that were not worth what it cost to make them. The losses on bad debt added up to 20% of GDP. Behind every bad debt was a "bad borrower" that needed to be downsized or even liquidated. But, given the weakness of Japan's governmental social safety net, a person's current job at their current employer was the main social safety net. Fear of job losses and corporate failures made policymakers reluctant even to admit the problem, let alone solve it. It took Japan ten years before it seriously began to resolve the bad debt problem at the heart of the banking crisis. The presence of money-losing zombies willing to cut prices to the bone in order to survive made it difficult for healthier firms to sell at profitable prices. Because of the life support given to the zombies by the banks, most of the firms that ended up going under were often more efficient than those who were propped up due to political connections. To some degree, it was survival of the least fit. The good news is that, once the Koizumi-Takenaka team began serious efforts at resolving the problem in mid-2003, it just took a couple years to bring the NPL ratio down to manageable levels with a lot less social dislocation than had been feared (though, as discussed below, at a long-term cost to household income and consumer spending).

In the US, the converse is true. It is not problems in the real economy that are causing a financial crisis, but a financial crisis that is causing problems in the real economy. Outside the auto sector, most US nonfinancial companies are in good shape. There are far more losses due to markdown of derivatives than from actual defaults on loans. The October 2008 IMF report on Global Financial Stability put the losses from actual defaults on loans at only one-third of total losses, the rest coming from markdowns of securities (see details in appendix). But the "shadow banking system" of unregulated mortgages by nonbanks and derivatives has become dysfunctional. Its crisis is now causing a crisis in the real economy via a credit crunch. The debt problem of most nonfinancial companies and households is not the cause of America's crisis, but its result.

If Japan had acted in time and properly, it could have avoided a decade of stagnation, even though its myriad structural flaws would still have caused years of problems. There is no reason that America has to suffer a "lost decade." (For a more detailed discussion of the differences between the two crises, see the Appendix below after the charts, "The Japan Fallacy," an essay in the March/April *Foreign Affairs*.) Even though the nature of the crises is different, there are some valuable lessons the US can learn from examining Japan.

Cause: Excess Savings vs. Regulatory Failure (Can Bubbles Be Prevented?)

There is a popular theory that the main cause of the US financial crisis is a global imbalance in savings and investment. Excess savings in China, Japan and other countries flowed to the US, feeding an investment binge. This is seen as a parallel to the excess savings in Japan that fed a real estate bubble there. In my view, global imbalances in saving and borrowing were a secondary factor compared to the home-grown explosion in unregulated derivatives and a housing bubble unconstrained by traditional lending rules (along with parallel problems in some other countries). As the bubble took off in 2003-07, the combined purchases of long-term US securities by Japan and China averaged a mere 1.5% of US GDP per year. By contrast, housing construction and related expenditures accounted for as much as a quarter of US GDP growth. Excess borrowing was a manageable problem. What turned that problem into catastrophe was that so much of the borrowing was funneled into worse-than-useless projects by a broken financial system which gave financial executives incentives to act like buccaneers. For example, the *New York Times* reported on December 27, 2008 that top executives at Washington Mutual (WaMu) pressured loan officers to approve mortgage applications even when those officers warned of possible fraud. Pumping out lots of "liar loans" earned WaMu abundant fees, thereby generating high bonuses for its executives. WaMu left others holding the bag by selling securitized mortgages to the pension funds of teachers and bank tellers. Former Fed chair Alan Greenspan refused to apply powers given him by Congress to apply standard prudential mortgage regulations regarding downpayment and documentation to nonbank mortgage originators.

In Japan, excess savings (mainly in the business sector rather than households) was a chronic problem. It fed the 1980s bubble. But that made that excess savings so inflammatory was a systemic flaw in the banking system. Banks lent based on collateral and had very poor credit screening and no gradient of interest rates based on risk. If a borrower had property valued at ¥1 billion yen, it could borrow against that property as collateral. If loose monetary policy led to a binge of investment in property that doubled the value of the original property to ¥2 billion, the owner could then borrow even more, in an ever-growing vicious cycle. To each loan officer, the loan looked valid. From the standpoint of the system as a whole, it was a recipe for disaster.

Excess savings was a necessary condition of the Japanese bubble, but not a sufficient condition. In the US case, the key factor was regulatory failure. How do those who deny the pivotal role of financial deregulation explain the much lower rate of home foreclosures in cases where traditional regulations were enforced? Among loans guaranteed by Fannie Mae, most of which meet traditional standards regarding downpayment and proof of ability to pay, only 0.65% were in foreclosure as of the third quarter of 2008 versus 21% for subprime adjustable rate mortgages.

Greenspan famously argued that bubble cannot be prevented; rather, policymakers can only clean up the mess afterwards. But that presumes that the Fed's only tool is monetary policy that paints with too broad a brush. Proper regulatory policy that enforced traditional prudential banking regulations about downpayments and documentation could have greatly limited this bubble. All bubbles are not created equal. Some can be limited.

Better To Do Too Much Than Too Little

Japan spent years denying and delaying until the problem became much more intractable. In a crisis like this, it is much better to do too much than too little. Japan's policymakers thought time was on their side; that the banks could "grow out of the problem." In reality, in this sort of situation, time is the enemy. If one step doesn't work, try another. The nature of the financial crisis is more complicated than in Japan and involved uncharted waters. But activism is much better than doing nothing out of fear of error.

The Truth Shall Set You Free

There are many reasons why Japan took ten years to really begin solving its nonperforming loan crisis, why there were ten years of "denial, dithering and delay." Part of it was a conscious cover-up by the Ministry of Finance and the banks, who believed that revealing the extent of bad loans would cause a crisis of confidence. Banks, under guidance from the MOF, literally cooked the books and, years later, some executives were indicted for this. Each time a bank failed, it was found that the official balance sheet was inaccurate. Beyond that, the policymakers and bank executives created a system that hid from themselves how bad it really was.

The US has done something similar by virtually outlawing the monitoring of derivatives under a law passed in 2000 (Commodity Futures Modernization Act). The total volume of Credit Default Swaps (CDS), a key factor in the crisis was unclear, as was counterparty risk because financial derivatives, unlike corn futures, are not traded on public exchanges. If you buy a share of GE from Merrill, and Merrill goes bankrupt, your stock in GE is still good. But if you buy a CDS from AIG, and AIG fails, you're out of luck. Capital markets are designed to handle calculable risk, but they cannot handle complete uncertainty as to volume and price. Even in cases where the underlying assets, e.g. commercial mortgages, have a fairly low default rage, commercial mortgage backed securities (CBMS) fell to 32% below book value in December, based purely on panic and uncertainty. We need regulations that let the shadow banking system come out of the shadows and quick action to create a market and a price, e.g. by government purchases of assets.

Culprits Need To Face Criminal And Civil Penalties ("Someone's got to go to jail")

One reason it took Japan so long to inject government capital into the banks was because the voters felt the money would just go to bail out the banks, rather than themselves. In the US, as a result of the S&L crisis, hundreds of banker crooks went to prison; voters accepted a bailout because they were ultimately being bailed out. In Japan, though some bankers and officials were put on trial for fraud, few, if any, spent time in prison. The US needs to inject further large amounts of capital into the financial system. The public will not support such indispensable funds this if the purpose is to finance bonuses and $30,000 commodes. As noted earlier, due to perverse executive compensation system, bank executives pressured loan offices to approve mortgages even when the officers warned of possible fraud. Surely, peddling paper known to be dubious is worthy of criminal and civil investigation. If such actions do not, in fact, violate current law, then it is time for the Congress to improve the law.

Is AIG America's "Jusen" Scandal? The 1995 "jusen" scandal in Japan, misuse of taxpayers' money to bailout housing subsidiaries for which there were no depositors—only politically-connected investors in bonds (e.g. the farmers' cooperative)—raised a firestorm of voter outrage. It was one reason it took Japan so long to provide the capital injection banks needed. The AIG scandal, if not contained, could have a similar impact in the US. When a capital injection finally was approved in Japan in 1998, one reason it was accepted by voters was that reformers in both the Liberal Democratic Party and the opposition-controlled Upper House insisted on proper conditionality.

Capital Injection Needed, But Must Have Upside For Taxpayers

Another reason that Japan took so long to solve its NPL problem was that its banks were so thinly capitalized. The banks could not afford to write-down or write-off all the bad debt without becoming insolvent. At each point, the banks and policymakers decided that the pain of write-offs to the banks—as well as downsizing or liquidation of the borrowers—was greater than the pain of further delay. So, they kept arguing that the banks didn't need the money; they could "grow out of the problem." The result was to extend the crisis and make the economy worse. The preservation of "zombie borrowers" turned marginal firms into sick ones. Eventually, around 1999, the government injected capital, but not enough. Also, it did so via preferred shares that could eventually be turned into common shares if not paid back. The upside for taxpayers was limited. Moreover, for the next few years, the capital was used to preserve "zombie borrowers" through debt waivers and rescheduling, rather than getting the bad debt off the books. Not until 2002-03 did the Koizumi administration really push a serious reduction in NPLs though write-offs, and other measures. This was financed through covert means—virtually zero interest for depositors to finance interest rates for borrowers as low as 0.25% for 6% of borrowers and between 0.25% and 0.5% for another 6%. Plus, it was financed by real wages cuts. The result is low consumer income leading to low consumer spending and inordinate dependence on exports. That is why the global downturn is now hurting Japan so much worse than the US or Europe. The US needs to inject enough capital so that banks and other financial intermediaries can get the toxic assets off their books. But there has to be an equity position that gives taxpayers an upside as these firms recover.

Separate Toxic Assets From Good Assets

As long as the Japanese banks had so much toxic assets on their books, they found it hard to lend and investors were reluctant to provide more equity to the banks. Banks shifted their asset portfolio from loans to government bonds, which, among other things, limited the multiplier effect of monetary stimulus. (Most of the reason for the decline of bank loans was not a credit crunch but a lack of demand by borrowers). After the toxic assets were removed, banks gradually began to perform normally again. In the US, removal of the toxic assets is absolutely necessary, especially because their size and value is so uncertain. This requires not only public capital injections but, in light of the disarray among derivatives, perhaps some market-making by the government through its own purchases. That had been one ingredient in the initial notion of TARP and now Fed efforts at backing securitization for certain types of loans.

Adjust Mark-to-Market Accounting

Mark-to-market accounting, in principle a valuable rule, has become a pro-cyclical measure that exacerbates bubbles and deepens panics because of how it is applied. The biggest financial losses are coming not in loans taken out by household or business borrowers but in the shadow banking system. For example, by mid-December 2008, pure panic had pushed the value of AAA-rated commercial-mortgage-backed securities (CMBS) down to 68 percent of their face value, despite a commercial-mortgage delinquency rate of only one percent. That 32 percent loss has reverberated throughout the financial system due to mark-to-market accounting rules, which require securities to be valued at their current market price, even in markets where there is little trading and prices fluctuate wildly. As a result of these rules, all investors holding CMBS have had to write down their holdings by 32 percent, even if the underlying mortgages are being paid on time. That, in turn, has led prices to decline even more and investors to write off more capital, further tightening the credit crunch. In another case, Merrill Lynch sold some rarely traded securities at 22 cents on the dollar to raise cash to avoid bankruptcy. Others had go mark down their holdings to 22 cents also because the market was so thin. The rules are mark-to-myth when there is no market. In October 2008, the International Monetary Fund predicted that this vicious cycle would cause $1 trillion in mark-to-market losses, as much as 7% of U.S. GDP. The estimate is higher now. As with monetary policy, mark-to-market rules need to be adjusted so that they are anti-cyclical.

Fiscal-Monetary Stimulus Is Absolutely Necessary But Not Sufficient

There is a myth that Japan shows the uselessness of fiscal stimulus. Supposedly, Tokyo used massive stimulus and it accomplished nothing. The reality is that Japan applied fiscal stimulus is a very stop-go fashion. When Tokyo stepped on the fiscal gas, the Japanese economy did better. When it took its foot off the pedal or, worse yet, applied the brakes—such as when it raised taxes in 1997—the economy faltered. Had Japan done nothing, it risked depression.

As for monetary stimulus, initially after the January 1990 beginnings of the stock market crash, the Bank of Japan actually kept raising interest rates because land prices were still rising. The BOJ miscalculated; it was still fighting the last battle: the 1980s bubble. It took until 1995 to bring overnight rates down to 0.5% and then another four years to bring them to 0.0%. A Federal Reserve study says that, had the BOJ acted quickly enough, it could have avoided deflation. But by 1995, it was too late. The problem was a miscalculation of how bad the problem was. The Fed says that, if it had been in charge and used its own forecasts of Japanese growth and inflation during 1991-95, it also would have been too tight.

On the other hand, fiscal-monetary stimulus is not enough. It is hard for them to have their normal potency when the financial system is broken.

Fiscal-monetary stimulus is indispensable for two reasons: it cuts off the vicious cycle of financial crisis leading to economic recession leading to more financial collapse and deeper recession, etc. Secondly, the necessary measures to cure the bad debt problem are inherently depressive in that they wipe out imputed wealth and income. A fiscal-monetary cushion is needed as an offset. Otherwise the recession will be too deep to be tolerable on either economic or political grounds and voters/politicians will choose Japan-style denial and delay. Trying to cure a financial crisis without fiscal-monetary cushion is like doing surgery without an anesthetic. In Japan, all too often, fiscal-monetary stimulus was used, not as anesthesia for surgery, but as heroin to dull the pain and avoid surgery. The notion was to pump up growth and the price of stocks and real estate so as to be able to bail out the zombie borrowers. So, Japan ended up in a false debate between those who wanted to build "bridges to nowhere" to prop up the "zombies," and those who opposed any sort of stimulus because they felt it would only be wasted.

Unconventional Central Banking Needed, Not Just Monetary Ease

Japan tried all sorts of different types of monetary ease, from zero overnight interest rates to "quantitative easing." This put a floor underneath the economy, but did not restore growth. In the US situation, there is a need to go beyond monetary ease, a need recognized by Fed chair Ben Bernanke, who has studied Japan's problems. For example, when panic hit the money market mutual funds, sparking withdrawals that hurt the commercial paper market, Bernanke put in a temporary guarantee and stopped the panic. Other measures have worked on panic-level spreads. Japan never went beyond conventional routes. Bernanke already has.

The primary monetary problem in Japan was not Japan's mild deflation. Deflation merely reflected the output gap; it did not exacerbate it. It did not cause people to spend less (if it had, the savings rate would have risen; in reality, it fell). But deflation did raise the problem of the zero bound for conventional monetary stimulus. Ultimately, the economy recovered before deflation ended and the narrowing of the output gap then lowered deflation.

When a banking system is broken, the normal money multipliers don't work. The key ingredient is not quantitative easing, inflation-targeting, etc. but getting the credit system working again. In Japan, that meant raising aggregate demand and tackling the NPL problem. In the US, it means raising aggregate demand and restoring the functioning of the securitization market.

Regulatory-Institutional Changes

At the root of Japan's banking crisis were a host of regulatory-institutional issues, including a "convoy system" under which no bank could be allowed to fail, the lack of genuine credit screening for loans, reliance on collateral which created a self-feeding spiral of loans and asset prices feeding each other, etc. Beyond that, there are much deeper problems in the capital, labor, and goods markets requiring much more fundamental reforms.

In the US, too, there are regulatory-institutional issues that could be solved much more easily than the more thorough-going flaws in Japan. One was the failure to apply to the nonbank mortgage originators the same prudential rules applied to banks, e.g. requirements for downpayments and documentation. A second was the refusal to regulate the derivatives market. The third is an executive compensation system that gives executives incentives to take outrageous risks with other people's money (heads I win; tails you lose). See the Appendix below for details.

A Story in Charts

Figure 1 shows that bank losses from Japan's NPL problem exploded from a negligible amount in 1993 to nearly 20% of GDP. Not until 2005 did big losses stop accumulating. **Figure 2** shows that, not until 2003, did the ratio of NPLs to total loans start declining—more than ten years after the onset of the crisis.

Figure 3 shows that America's nonfinancial corporations do not suffer from huge amounts of excess debt, as is often stated. In fact, they own twice as much in financial assets as they owe in debt. This decade showed the highest such ratio going back a half-century. **Figure 4** shows that, by one measure (debt to net worth ratio), America's nonfinancial firms today are about five times better able to handle their debt load than were their Japanese counterparts at the beginning of the lost decade.

Figure 5 shows that despite a record 16% drop in the value of household-owned assets since the third quarter of 2007, the average household still has net worth equal to nearly years worth of income. That is close to the average ratio of wealth to income that has prevailed for 50 years. The wealth destruction has been a correction of a bubble-fed high. Just as households adjusted to the dot.com bust, they should be able to adjust to this correction without a collapse of spending—as long as the job destruction is checked.

Figure 6 shows that, while the delinquency rate (loans with interest more than one month late) has risen sharply for mortgages, the delinquency rate for other consumer loans and especially for business loans remains low so far, especially considering the depths of the recession.

In **Figure 7** and **figure 8**, we can see that, unlike in Japan, US are rapidly getting the bad loans off their books. The ratio of loans being charged off as a share of delinquent loans is very high by historical standards.

Figure 9 shows that Japanese bank loans first stopped growing in early years of lost decade and then plunged by 30% of GDP (**Figure 10**). US bank loans in 2008 were 66% of GDP, far below the 105% ratio reached in Japan (**Figure 11**), but ABS issuance exploded to 30% of US GDP.

Contrary to popular belief, the credit crunch in the US does not stem from banks refusing to make normal commercial bank loans. As seen in **Figure 12**, the growth rate of outstanding loans has slowed, as it always does in recession, but at least so far, has slowed less than in the 2001 recession. How do we reconcile this with the widespread experience of so many business and consumer borrowers that loans are hard to get? The answer is the distinction between normal loans and the shadow banking system, as discussed in the following charts.

In **Figure 13**, we look at total private nonfinancial sector debt, deflated by the GDP deflator so as to be able to compare high inflation and low inflation periods. In 2008, debt stopped growing. So, while bank loans are still growing, other forms of debt are not. On the other hand, in some past recessions, e.g. 1975, debt actually fell. **Figure 14** looks just at nonfinancial business debt, so home mortgages are not included. There we see that credit outstanding is still growing; it was up 2.6% from the end of 2007 to the end of 2008.

Figure 15 tells us that bank loans (deflated by GDP deflator) were up 5.3% from the end of 2007 to the end of 2008, not much slower than in recent years. By contrast, we see in **Figure 16** that credit by issuers of ABS (Asset-backed securities) was down 12%. This is a problem since ABS issuers are now a significant (12%) share of the credit market. So, the credit crunch problem lies less in commercial banking than in the shadow banking system. In other words, banks cannot easily issue, say, a car loan, then securitize it and use the money to make yet another loan, so that the same dollar is used over and over again. That, in our view, helps explain the gap between the banking data and people's experience. The Fed's flow of funds gives a better idea of the overall debt situation, but it only comes out quarterly and three months after the fact.

Figure 17 shows that the ratio of bank net worth to assets has fallen in the current recession, as in past recessions, but is still at multi-decade high. US Banks are in better position to write off bad assets than were their Japanese counterparts. How do we reconcile this with the view that US banks are poorly capitalized? We discuss this in the following charts.

Figure 18 shows that Japanese bank operating profits were so low that they were wiped out by credit costs for NPLs and the drop in stock prices. **Figure 19** shows that Japanese banks had a much thinner net worth cushion at the onset of the lost decade than do American banks today: 3-4% of liabilities for the Japanese banks vs. 10%-11% for US banks. Regulatory capital for internationally active Japanese banks was only 8-9% of risk-weighted assets at the onset of the lost decade (**Figure 20**) vs. 10-11% for the US banks. Plus much of the Japanese capital was deferred tax assets, holdings of company shares and other low-quality capital.

Figure 21 and **Figure 22** show US commercial banking institutions (mostly via their holding companies) were massively increasing their equity issues even before TARP in order to cope with write-downs; the Japanese government did not start injecting capital until 1998-99 and private equity issues began in big way a couple years later. So, part of the reason for the US banks' better capital position is the massive TARP injection in 2008-IV. Also, if we compare today's capital position to today's assets, the banks look in good shape. But if we compare today's capital position to the assets and capital after further write-downs, then it is likely that the mega banks will need more capital injections.

Figure 23 shows that, for all US financial intermediaries, not just banks, new capital raised does not equal the losses from credit losses and mark-to-market write-downs. New capital raised, including from private sources, is substantial, but not yet sufficient. However, keep in mind that bank capital adequacy ratios remain considerably above Basle standards.

Figure 1: Japan's Losses on Nonperforming Loans Hit Nearly 20% of GDP

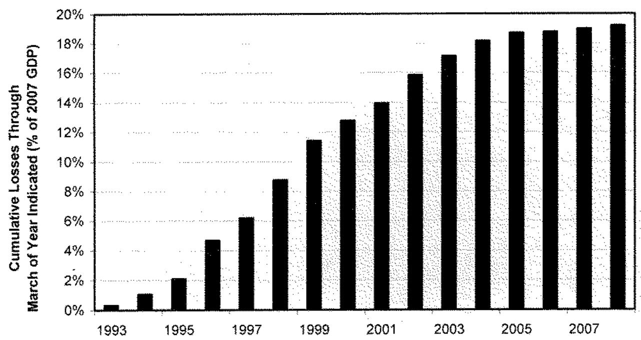
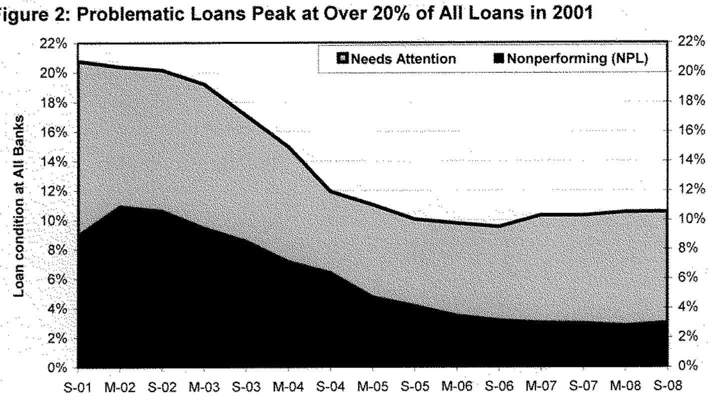


Figure 2: Problematic Loans Peak at Over 20% of All Loans in 2001



Source: Financial Services Agency
Note: Nonperforming loan equals loan three months in arrears (vs. US standard of one month) or loans where concessions have been made on interest and/or principle; "needs attention" loans not yet in arrears but at high risk of falling delinquent

Figure 3:
US Nonfinancial Firms Own Twice as Much in Financial Assets As They Owe

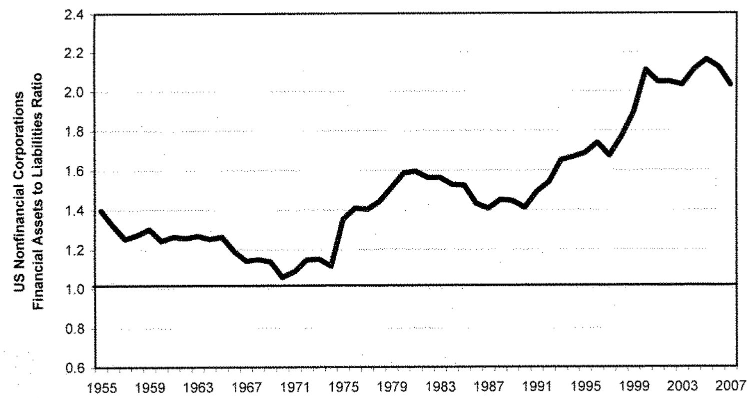
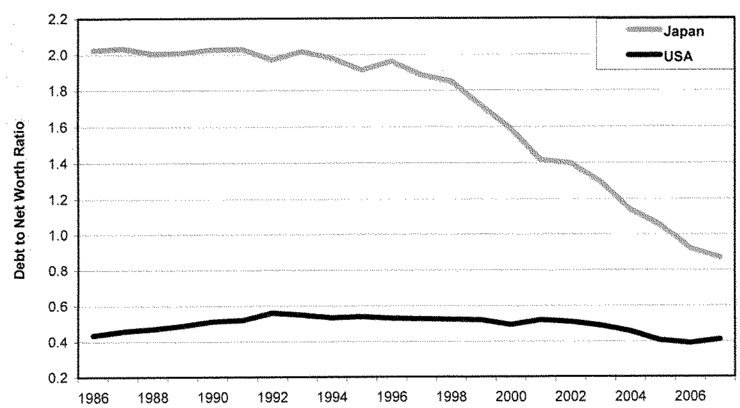


Figure 4: US Firms In Much Better Shape Than Japanese Counterparts on Eve of Lost Decade



Source: US Federal Reserve and Japanese Ministry of Finance

Figure 5: US Household Net Worth Back to Historic Levels: Five Years Worth of Income

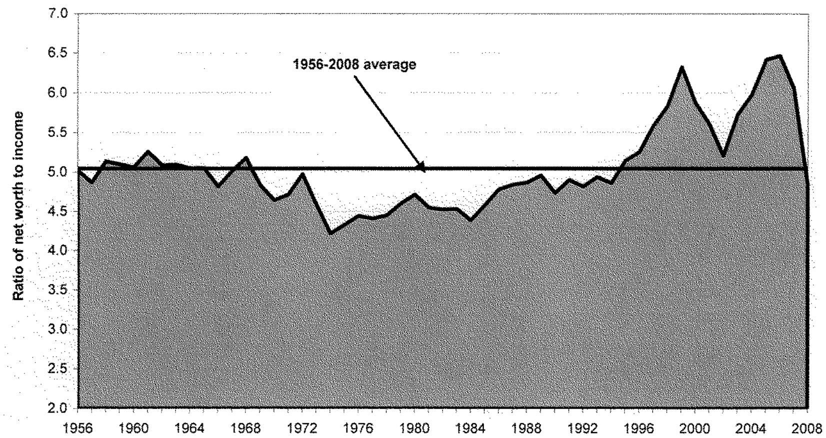
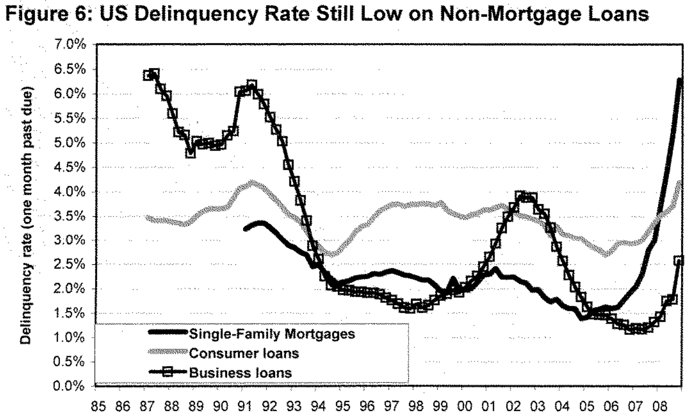


Figure 6: US Delinquency Rate Still Low on Non-Mortgage Loans



Source: US Federal Reserve

Figure 7: US Rapid Charge-Off Of NPLs . . .

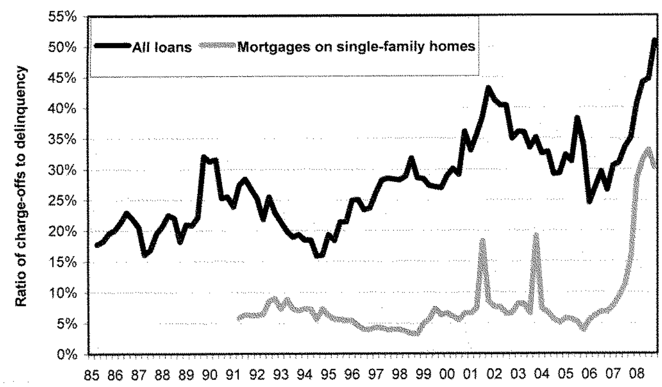
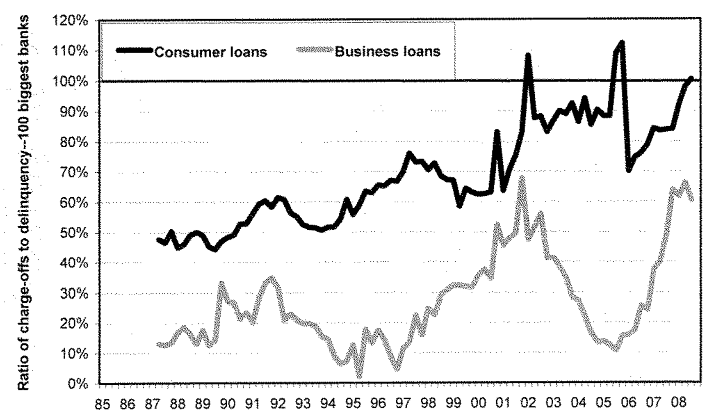


Figure 8: . . . Especially on Business and Consumer Loans



Source: US Federal Reserve

Figure 9: Japanese Bank Loan Growth Stops, Then Goes Deeply Negative

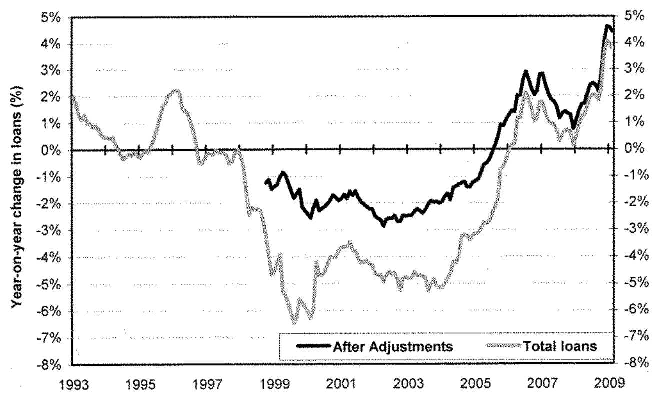


Figure 10: Japanese Bank Loans Drop by 30% of GDP

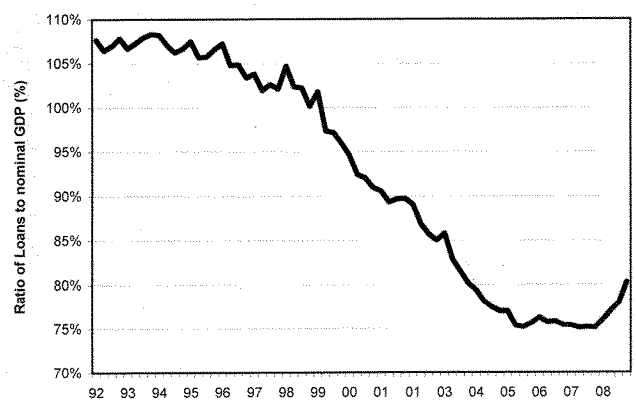


Figure 11: Bank Credit Lower Share of GDP Than in Japan (ABS Issuance Explodes)

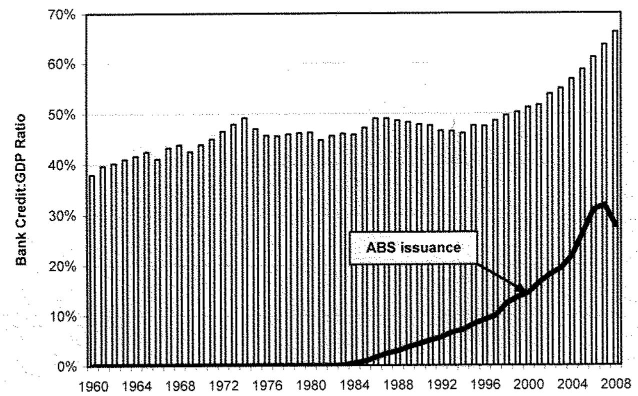
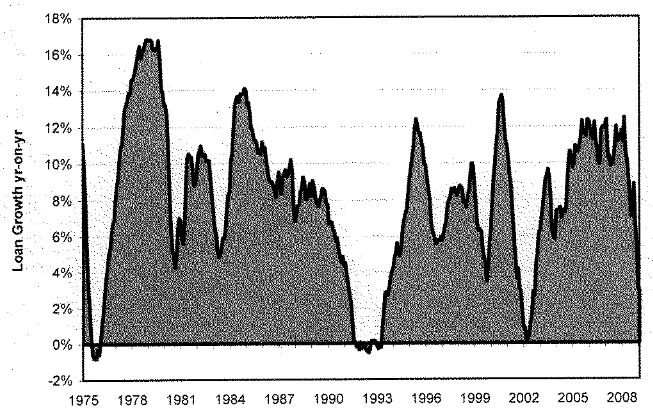
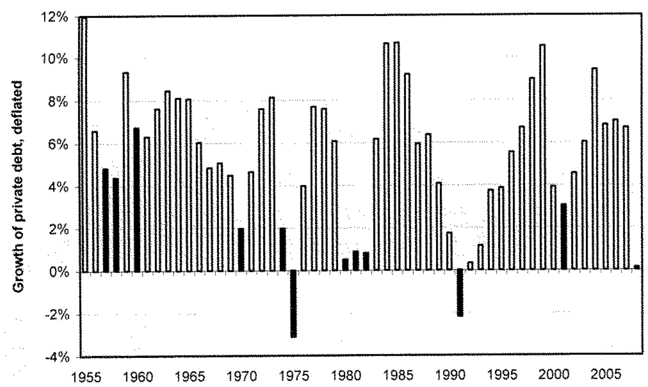


Figure 12: US Bank Loan Year-on-Year Growth Slows No More Than In Typical Recession Fashion



Source: Federal Reserve

Figure 13: US Private Debt Stops Growing in 2008; Fell in 1975 and 1991 (deflated)



Source: Federal Reserve
Note: Deflated by GDP deflator so that inflation doesn't distort comparisons between high inflation and low inflation periods

Figure 14: US Nonfinancial Business Debt Slows, But Doesn't Yet Fall As In Some Past Recessions

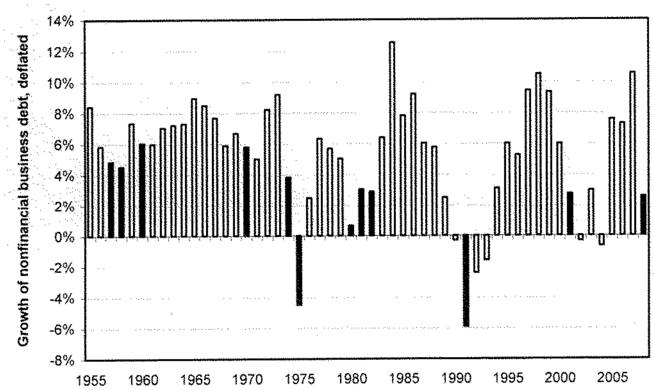
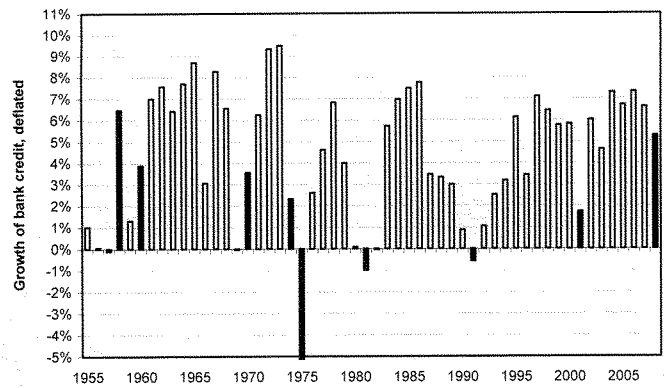
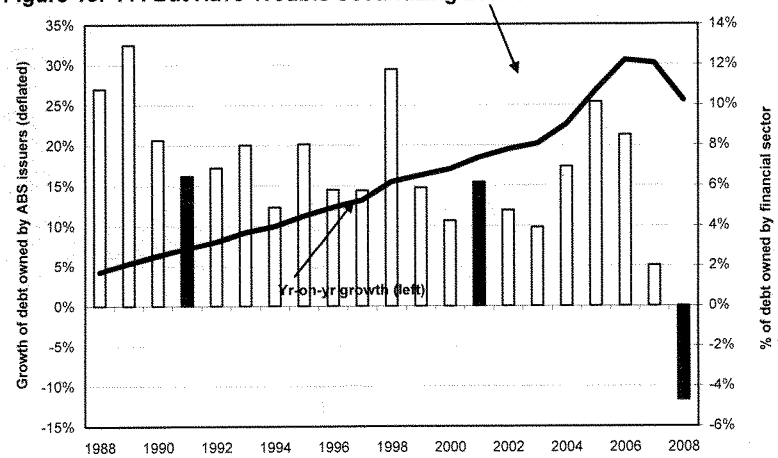


Figure 15: US Banks Expand Credit 5% in 2008 . . .



Source: Federal Reserve
Note: Deflated by GDP deflator so that inflation doesn't distort comparisons

Figure 16: . . . But Have Trouble Securitizing Loans



Source: Federal Reserve
Note: Deflated by GDP deflator so that inflation doesn't distort comparisons

Figure 17: US Bank Net Worth To Assets Falls, But Still At Multi-Decade High

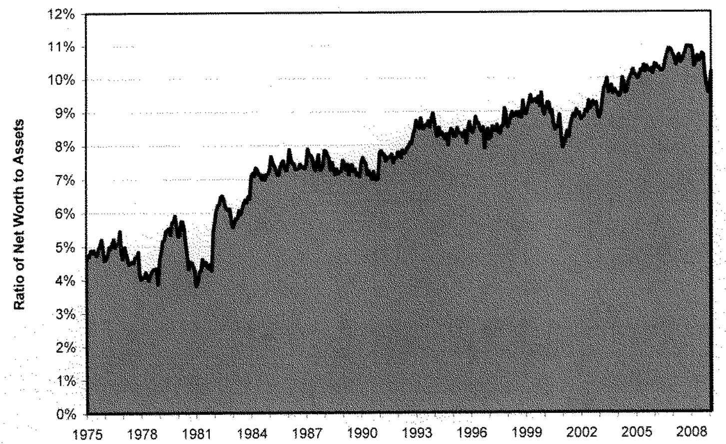


Figure 18: Japanese Bank Profits Wiped Out By NPLs, Stock Losses

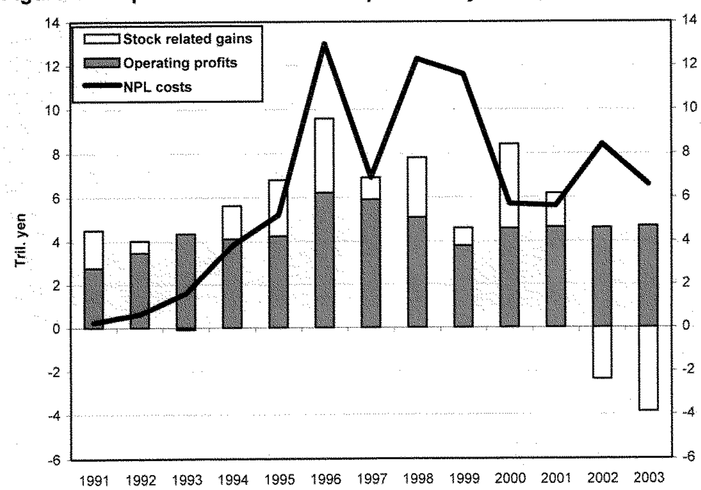
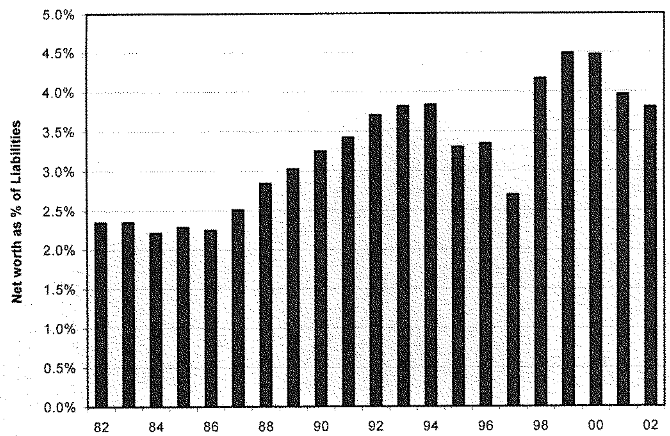


Figure 19: Japanese Banks Thin Net Worth Cushion to Absorb Losses



Source: Bank of Japan

Figure 20: Japanese Bank Regulatory Capital for Int'l Banks

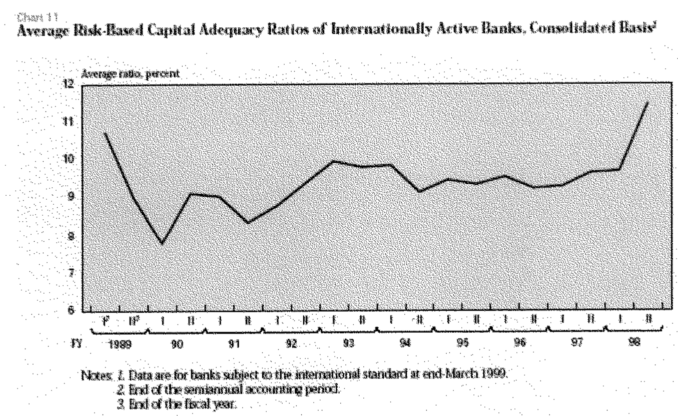


Table 5
Consolidated Financial Statements

Source: Bank of Japan
Note: Only applies to banks active in international markets; domestic banks had much lower ratios. Capital includes holdings of company stock, deferred tax assets and other low-quality capital. This risk-weighted ratio improved as banks moved their asset from company loans to government bonds.

Figure 21: US Banks Up Equity Issuance in 2008 . . .

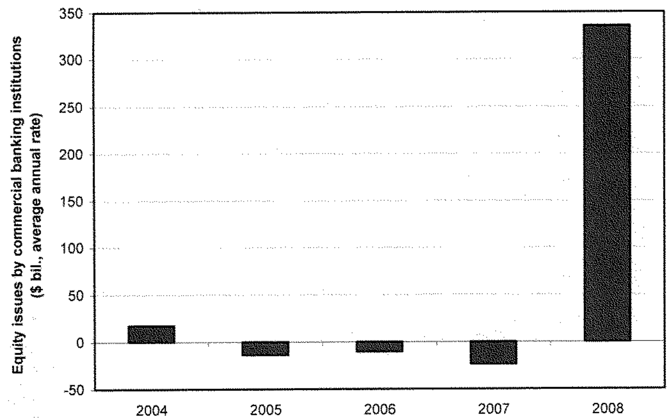
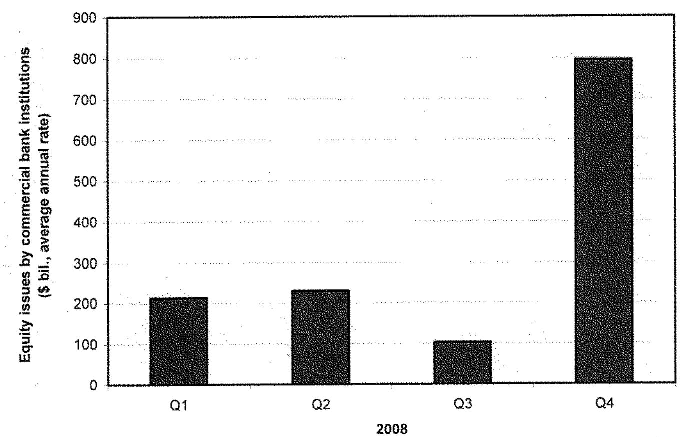


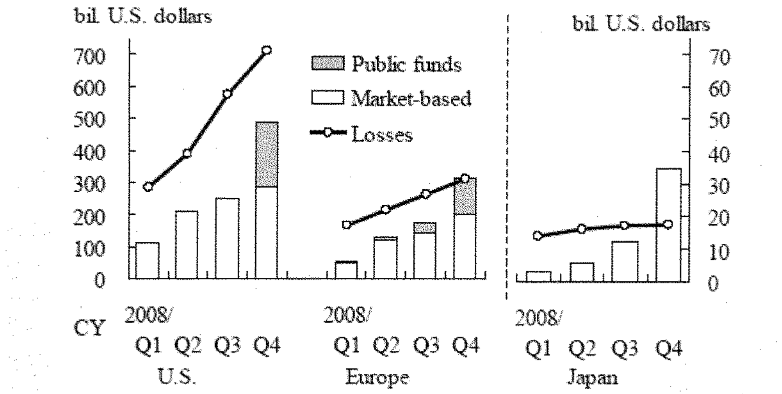
Figure 22: . . . Even in Jan-Sept. Before TARP Injection



Source: Federal Reserve

Figure 23: But Capital-Raising by US Financial Firms Not Yet Equal To Losses

Chart 1-7: Losses vs. Capital Raising by Global Financial Institutions[1,2,3]



Source: Bank of Japan, *Financial System Report*, March 2009

Note: The values are the sum of those of brokerage firms, insurance companies and GSEs, as well as banks. Losses are the value of write-offs and credit losses.

Appendix

The Japan Fallacy:
Today's U.S. Financial Crisis Is Not Like Tokyo's "Lost Decade"

By Richard Katz

From *Foreign Affairs,* March/April 2009 (foreignaffairs.org)

Summary: The financial crisis of 2008 need not usher in a replay of Japan's "lost decade" of the 1990s. The current crisis is the result of correctable policy mistakes rather than deep structural flaws in the economy.

Richard Katz is Editor in Chief of The Oriental Economist Alert and the author of Japanese Phoenix: The Long Road to Economic Revival.

In periods of crisis, pundits and policymakers tend to scramble for historical analogies. This time, many have seized on Japan's notorious "lost decade," the decade of stagnation that followed a mammoth property bubble in the late 1980s. But this comparison is wrong. In Japan, the primary problem was pervasive dysfunction in the economy, which caused a banking crisis. In the United States, pervasive dysfunction in the financial sector has caused a deep recession in the economy as a whole. This financial dysfunction is not the result of structural flaws, as in Japan, but of grave policy mistakes. It is now being compounded by widespread investor panic.

The consequences of the 2008 U.S. financial crisis will be different from Japan's slump in the 1990s for three reasons: the cause of the current crisis is fundamentally different, its scope is far smaller, and the response of policymakers has been quicker and more effective.

Japan's malaise was woven into the very fabric of its political economy. The country has a thin social safety net, and so in order to protect jobs, weak domestic firms and industries were sheltered from competition by a host of regulations and collusion among companies. Ultimately, that system limited productivity and potential growth. The problem was compounded by built-in economic anorexia. Personal consumption lagged, not because people refused to spend but because the same structural flaws caused real household income to keep falling as a share of real GDP. To make up for the shortfall in demand, the government used low interest rates as a steroid to pump up business investment. The result was a mountain of money-losing capital stock and bad debt.

Japan's crisis pervaded virtually its entire corporate world. In sector after sector, debt levels and excess capacity ballooned and profitability remained low. White-elephant projects, from office buildings to auto plants, were built on borrowed money under the assumption that if times got tough, the government and banks would bail out the debtors. But the banks were too poorly capitalized to write off bad loans. And for every bad loan, there was a bad borrower whose products were not worth the cost to make them. The cumulative total of bank losses on bad debt between 1993 and 2005 added up to nearly 20 percent of GDP.

Policy mistakes -- from Japan's mismanaged fiscal and monetary policy to the government's failure to address the loan crisis -- made a bad situation even worse. But even if policymakers had done everything right, Japan's economy still would have stagnated until Tokyo addressed its more fundamental flaws.

DEREGULATION NATION

The United States' subprime mortgage fiasco of 2007-8, in contrast, was primarily the result of discrete, correctable mistakes brought on by ideological excess and the power of financial-industry lobbyists rather than intractable structural problems.

The first mistake was the U.S. government's refusal to regulate subprime mortgages. Traditional banking regulations forbid banks from lending to people with no down payment or proof that they can repay a loan. However, no such rule applied to nonbank lenders, even after they became the country's biggest mortgage originators. That left new mortgage institutions with little incentive to ensure that their loans could be repaid; no sooner had they issued these so-called liar loans than they resold them to investment banks for a profit. The investment banks then sliced and diced the loans into securities embossed with AAA ratings despite the dubious creditworthiness of the original borrowers. A single statistic makes clear how damaging this lack of regulation was: by the third quarter of 2008, 22 percent of subprime, adjustable-rate mortgages were in foreclosure; by contrast, the foreclosure rate for prime, fixed-rate mortgages -- 60 percent of all mortgages -- was still less than one percent.

There were plenty of warnings. In 1994, a bipartisan coalition in Congress passed the Home Ownership and Equity Protection Act, which enabled the Federal Reserve to force all mortgage lenders to follow traditional banking standards. But Federal Reserve Chair Alan Greenspan refused to use these powers, claiming that the financial markets were self-correcting. When Democrats and Republicans in the next Congress tried to require that the Fed enforce these rules, House Majority Leader Tom DeLay (R-Tex.) quashed the effort.

The second policy blunder was the U.S. government's failure to regulate the compensation of chief executive officers (CEOs) -- a system that in its current form gives executives incentives to take outrageous risks with other people's money. When CEOs are paid primarily in stock options, as is the case today at many firms, they suffer little punishment for failure. If CEOs gamble big with the company's money and succeed, they can gain hundreds of millions of dollars in bonuses; if their gambling fails, they do not suffer losses, just a smaller reward. Even CEOs who have caused their firms to collapse, such as Merrill Lynch's Stan O'Neal, have still walked away with enormous severance packages. This system is a critical factor in the behavior that led to today's crisis. Studies show that extraordinary losses are much more common at firms where the majority of CEO compensation comes from stock options, rather than cash or outright stock.

The third error was the virtual non-regulation of the derivatives market. Derivatives should serve as a kind of insurance to lessen risk. Corn futures, for example, stabilize farmers' incomes, inducing them to plant more, which gives consumers more food at cheaper prices. Today's financial derivatives often turn the insurance principle on its head, causing shocks to be amplified and transforming derivatives into what the investor Warren Buffett has called "financial weapons of mass destruction." If an investor buys a share of General Electric from Merrill Lynch, that share retains its value even if Merrill goes bankrupt. But unlike corn futures or stocks, most financial derivatives are traded not on exchanges but in bilateral deals. If an investor's trading partner (counterparty) fails, the investor takes the loss. The collapse of the investment bank Lehman Brothers caused the insurance company AIG to lose big in so-called credit default swaps, undermining trust in all counterparties and causing a run on the entire derivatives and securitization markets. Rather than frightened depositors banging on bank doors, the result was investors furiously clicking away at their keyboards as their money disappeared. In the end, the impact was the same: perfectly solid companies suddenly found themselves unable to issue commercial paper, and creditworthy homeowners found it hard to get car or student loans. It took an intervention by the Federal Reserve to forestall a more serious meltdown.

This run on the shadow banking system is the real cause of the severe post-September credit crunch that transformed a mild recession into something far worse. Banks have actually increased their extension of credit by six percent since September, but they are having a hard time securitizing those loans in the capital markets. That means that they can no longer use the proceeds to make further loans, which would allow them to use the initial dollar over and over again.

If powerful financial lobbyists waving the banner of faith in markets had not thwarted commonsense regulation, much of this would never have occurred. Democratic and Republican policymakers alike, from Treasury Secretaries Robert Rubin and Lawrence Summers to Federal Reserve Chair Greenspan, blocked attempts at reform in 1998. Then, in 2000, Senator Phil Gramm (R-Tex.) went so far as to virtually outlaw the monitoring and regulation of many types of derivatives by initiating the Commodity Futures Modernization Act. Just as deposit insurance now prevents massive runs on banks, the regulation of derivatives could have made this crisis less severe.

A TALE OF TWO BUBBLES

The scope of the Japanese crisis and the scope of the U.S. crisis are also fundamentally different. From 1981 to 1991, commercial land prices in Japan's six biggest cities rose by 500 percent. The subsequent bust brought prices down to a level well below that of 1981; as of 2007, they were still 83 percent below the 1991 peak. In the United States, the real estate bubble was not as inflated, and the bust has been less severe. From 1996 through the 2006 peak, housing prices in the 20 biggest U.S. cities rose by 200 percent. Most forecasters think prices will drop by 30-40 percent from the peak levels before bottoming out in 2009 or 2010. No one is suggesting that prices will fall below the level of 1996.

Most of the United States' nonfinancial corporations are still healthy. Whereas the debt of Japanese corporations was several times their net worth, in the United States, corporate debt amounts to only half of companies' net worth, the same level that has prevailed for decades. The ratio of nonperforming loans among nonfinancial companies is only 1.6 percent, and productivity growth remains solid.

In October 2008, the International Monetary Fund's Global Financial Stability Report predicted that the losses on all U.S.-originated unsecuritized loans (including home mortgages) would amount to $425 billion, about three percent of U.S. GDP. This estimate will likely rise, but even then it would not come close to the 20 percent ratio that Japan experienced.

The biggest financial losses are coming not in loans taken out by household or business borrowers but in the shadow banking system. Because of the leverage inherent in financial derivatives -- which are designed so that a one percent hike in real estate prices can create a much larger gain in asset-backed securities -- a small loss in the value of the underlying assets can be multiplied several times over. Far more significant is the psychological factor: by mid-December 2008, pure panic had pushed the value of AAA-rated commercial-mortgage-backed securities (CMBS) down to 68 percent of their face value, despite a commercial-mortgage delinquency rate of only one percent.

That 32 percent loss has reverberated throughout the financial system due to mark-to-market accounting rules, which require securities to be valued at their current market price, even in markets where there is little trading and prices fluctuate wildly. As a result of these rules, all investors holding CMBS have had to write down their holdings by 32 percent, even if the underlying mortgages are being paid on time. That, in turn, has led prices to decline even more and investors to write off more capital, further tightening the credit crunch.

The International Monetary Fund predicts that this vicious cycle will cause $1 trillion in mark-to-market losses, as much as seven percent of U.S. GDP. If this is correct, most financial losses suffered since the onset of the crisis will have come not from genuine defaults in the real economy but from problems generated within the shadow banking system. Applying normally beneficial mark-to-market rules in today's abnormal markets without any adjustment is doing more harm than good. By the time the economy recovers and those marked-down securities are marked back up, the credit crunch will have led to a host of corporate bankruptcies, millions of layoffs, and countless families losing their homes.

A PROGRAM OF ACTION

The Japanese and U.S. crises differ in many ways, but the starkest contrast is in the response of policymakers. Denial, dithering, and delay were the hallmarks in Tokyo. It took the Bank of Japan nearly nine years to bring the overnight interest rate from its 1991 peak of eight percent down to zero. The U.S. Federal Reserve did that within 16 months of declaring a financial emergency, which it did in August 2007. It has also applied all sorts of unconventional measures to keep credit from drying up.

It took Tokyo eight years to use public money to recapitalize the banks; Washington began to do so in less than a year. Worse yet, Tokyo used government money to help the banks keep lending to insolvent borrowers; U.S. banks have been rapidly writing off their bad debt. Although Tokyo did eventually apply many fiscal stimulus measures, it did so too late and too erratically to have a sufficient impact. The U.S. government, by contrast, has already applied fiscal stimulus, and the Obama administration is proposing a multiyear program totaling as much as five to six percent of U.S. GDP. When it comes to crisis management, it is far better to do too much than too little.

Policymakers can draw many lessons from this comparison. First, the current U.S. crisis -- like the Asian financial crisis of 1997-98 -- has proved that even an economy with sound fundamentals can be thrashed when financial markets go haywire. However, the Asian crisis provides a more promising message: once financial markets are calmed and policy mistakes are reversed, economies recover.

Second, whereas Japan needed a thorough overhaul of its political and economic institutions and practices, a process that continues today, the United States simply needs aggressive reform of its financial architecture and CEO compensation system. President Barack Obama clearly understands the need for better regulation, and there is reason to hope that his economic advisers, many of whom are alumni of the Clinton administration, have learned from their mistakes. In October, former Treasury Secretary Summers, now director of the National Economic Council, wrote in the Financial Times, "The pendulum will swing -- and should swing -- towards an enhanced role for government in saving the market system from its excesses and inadequacies."

Third, fiscal policy works, but only in connection with other measures. Many commentators believe that Japan's lost decade proves the uselessness of fiscal stimulus. They are wrong. When Tokyo stepped on the fiscal gas, the Japanese economy did better. When it took its foot off the pedal or, worse yet, applied the brakes -- such as when it raised taxes in 1997 -- the economy faltered. Equally important, it is hard for fiscal and monetary stimuli to be effective when the financial system is broken.

Finally, markets only work when undergirded by proper regulatory institutions that enforce genuine checks and balances on corporate executives, corporate boards, financiers, accountants, rating agencies, and regulators. Better rules make it safe to have freer markets.

There is, of course, one way in which the United States' crisis is much worse than Japan's: its global ripple effects. Getting through today's recession will be neither quick nor easy. But there is absolutely no need for fatalism or talk of an upcoming "lost decade" in the United States. The first step is to recognize, as Obama has repeatedly stressed, that this crisis is not a once-in-a-century unforeseeable disaster. Bad policies created this mess. Better policies can fix it.

The CHAIRMAN. Thank you very much. I appreciate it.

So we go from Sweden to Japan to the United States. Mr. Cooke.

STATEMENT OF DAVID COOKE, FORMER EXECUTIVE DIRECTOR, RESOLUTION TRUST CORPORATION

Mr. COOKE. Hello. Thank you very much, Madam Chair and members of the Panel, for letting me be here today to talk a little bit about the RTC experience and what lessons may be relevant.

What I will do pretty quickly is go back. The S&L crisis really started back in the late '70s and early '80s when interest rates were very high, and a lot of S&Ls got into deep trouble because they had made a lot of long-term, fixed-rate loans and depended on deposits. And depositors left, funding costs went up, and so then they started to lose money, and their capital accounts became very jeopardized.

So you are dealing with—as rates are coming down, you are dealing with an industry that has already got weak capital, which is very important. During that time, a lot of the S&Ls that were mutuals converted to private stock ownership. They brought in new investors, and they started to use some of the expanded authority that Congress gave in '80 and '82 to basically allow the S&Ls to do more things so they wouldn't be so dependent on residential mortgages.

The S&Ls, what a lot of them did was they started making risky loans that they didn't really understand, and the regulators really didn't understand either. The S&L regulators at that time really were very good on understanding residential mortgages, but they didn't understand a lot of this other stuff.

So about around '86, credit losses started to surface. Actually, they started to surface even earlier, and then it became pretty clear that a lot of the S&Ls were really in trouble and needed to be resolved. The regulators were really unprepared for what happened, in my view, over on the S&L side, of course.

And already by the time '88 ended, '86 to '88, there were like almost 300 failures and over $100 billion in assets of failed S&Ls that had been resolved either in some kind of assistance transactions, a lot of them were done in 1988. It got very controversial and political, and Congress got very outraged that the FSLIC, the insurer at that time, was bankrupt and it was making all these deals that it really didn't have the authority or the funding to do. And things went pretty sour.

So, at that time, you also had a very strong industry influence that didn't want to acknowledge that the problems really existed. I mean, the S&L industry had a very powerful lobby, and they just disputed. And when the administration at that time did get some money in, back in those days, they didn't get near enough. It had only gotten about 10 percent of what the costs ended up being.

In 1988, in late 1988, the Treasury Department came over to the FDIC and asked if maybe we could provide some help in eventually running a temporary agency, the RTC, as well as taking over some of these failing thrifts that the FSLIC would say were no good. Take them over.'

We agreed. In August of '89, FIRREA was passed, and that law was a fairly comprehensive law. As the executive director, my job was trying to ramp up operations and interact with the other agencies. So maybe I am a little influenced by that too much.

But FIRREA did a major overhaul of the S&L regulatory system. At the same time, it was trying to have that system deal with the crisis, and that involves a certain amount of personal interaction and time that I don't know yet is fully appreciated. FIRRA basically eliminated, abolished the Home Loan Bank Board, FSLIC, created OTS, created the Federal Housing Finance Board and created the RTC, transferred new functions to the FDIC.

That takes time to do, but there was no time allowed to really do that. Maybe it is wrong, but at the FDIC side, we sort of kept an eye on it. But we didn't do much until we knew there was going to be a law passed. And so, there really was not much preparing that I am aware of.

The RTC was set up. I was the deputy to Chairman Bill Seidman at that time. He asked if I would go over to ramp it up, and I didn't expect him to ask. And in hindsight, there were many times when I wish he had never asked.

But in terms of the temporary agency, the RTC, first of all, it would avoid confusion in governance. If you are going to overhaul the regulatory system, don't confuse people as to who is responsible for what.

We had an oversight board that was created for the purpose of policy and had control of the budget. The oversight board consisted of Secretary of the Treasury, chairman of the Federal Reserve, the Secretary of HUD, and two private sector. A very, very high-level board.

And the FDIC was responsible for putting someone in charge, trying to oversee the operations of the FDIC. There was a gap between the operation end and understanding the governance. And so, whatever is done, don't put yourself in that same mess.

On the operating side, we knew what we were supposed to do now. We didn't realize how many there would be, but we knew we were supposed to take over these S&Ls and resolve them. That took a lot of time. Original loss etimates of $50 billion were way low. They were based on, maybe 400 failures and a couple hundred billion in assets. Ended up being like twice that, and that took a lot of time.

I am trying to rush through here. About half of the assets were hard-to-sell assets. We had to come up with new ways to try to sell the assets and to value them. We came up with new valuation policies, and we came up with new disposition methods.

We did not have to negotiate and buy. But we did have to come up with values because there were provisions of FIRREA not to sell any asset for less than 95 percent of fair value and no one really knew what was the fair value. Some of the markets in the Southwest, you know, Arizona, Texas, very hard hit during this, and people were concerned we would dump the assets.

Interestingly, when I was in the chairman's office, we had representatives from Arizona, as I recall, come in and ask that the RTC not dump assets and destroy the values that healthy banks had on their books. A year later, the same group came in and said you have got to start moving these assets because RTC was freezing up the market.

So we started a much more aggressive approach. At the time, we went through a lot of times having to go back to Congress and say we don't have enough money. We needed two types of money. We need money to pay for the losses in these institutions, but more money to get these institutions out of conservatorship. On the day that we opened our doors on August 9th, we had like 270 institutions in conservatorship, which meant that we were supposed to be somehow running them.

There were no real guidelines on what meant. So when you nationalize an institution, at least know what you expect it to do, if that happens.

The CHAIRMAN. Mr. Cooke, let me just stop you there.

Mr. COOKE. Am I running over? I am sorry.

The CHAIRMAN. Yes, that is all right. We are a couple of minutes over, but we will get back to more of this in the questions.

Mr. COOKE. Okay. All right. Thank you.

[The prepared statement of Mr. Cooke follows:]

Testimony of

David C. Cooke

Former Executive Director

Resolution Trust Corporation

Before the

Congressional Oversight Panel

March 19, 2009

Madame Chair and members of the Congressional Oversight Panel: I welcome this opportunity to discuss my experiences and lessons learned as the Executive Director of the Resolution Trust Corporation (RTC). While I recognize the current situation threatens our economy more than the problems we faced with the failing S&Ls – and banks- during the mid-1980s and early 1990s, I also believe some of the lessons learned also apply today.

My views are based primarily on my experience as RTC's Executive Director but also are influenced by my years at the FDIC and work in other countries. It's been a long time since I served as Executive Director but lessons would apply whenever the government intervenes in a market based economy to solve a financial crisis.

I will begin with a brief history of the S&L crisis that led to the creation of the RTC and then, summarize my experience starting up this new agency along with the operational challenges we faced, particularly with regard to toxic assets; how we approached them; and, what lessons would be relevant today

How it Began

The origins of the S&L problems from the mid 1980s to early 1990s date back to the high interest rates of 1979 to 1981. Back then, most thrifts invested in long term mortgages and bonds funded by short-term deposits. As interest rates rose, so did the funding costs of S&Ls as depositors left to earn higher returns. Most S&Ls started losing money rapidly depleting their capital accounts. Fortunately, interest rates started to decline before the industry collapsed. Still, the financial condition of most S&Ls had been seriously weakened. A number of institutions sought new investors by converting from mutual to stock ownership. Many S&Ls encouraged by the government and their new owners to diversify their risk using expanded lending and investment authority granted by congress in the early 1980s. Unfortunately, too many S&Ls were attracted to the upfront fees of commercial real estate loans and had too little experience or too much insider conflicts of interest. Loan losses started to noticeably rise in 1985, especially in Texas and Louisiana that had a high dependency on rising oil costs. .

By 1986, increasing numbers of S&Ls turned to the Federal Home Loan Bank Board (FHLBB) and the Federal Savings & Loan Insurance Corporation (FSLIC) for help. The FHLBB relaxed capital rules and enforcement but the number of troubled S&Ls continued to rise. By the end of 1987, FSLIC had resolved 102 S&Ls holding $28 billion in assets and many more S&Ls on the verge of failing. Industry experts and the media were starting to say FSIC was going bankrupt. The Administration and the Federal Home Loan Bank Board (FHLBB) that oversaw FSLIC requested $15 billion but, after intense lobbying for less by the S&L trade group, Congress only provided $10.8 billion in 1987.

S&L insolvencies continued to mount throughout 1988 and the new FHLBB Chairman along with FSLIC started an aggressive initiative to encouraged healthier S&Ls and other investors to buy failing S&Ls. The assistance packages typically involved providing S&L buyers loss guarantees or a note that offered attractive tax benefits and favorable accounting rules, particularly with regard to capitalizing "Goodwill" – a practice that soon became very controversial and litigious.

How FDIC Got Involved

Critics started to clamor loudly that FSLIC was rushing into transactions without sufficient competition, financial resources or authority. The FHLBB maintained it had the necessary authority. FDIC Chairman L. William Seidman, in response to a congressional request, provided an estimated S&L cost of $50 billion but cautioned that the estimates were based on S&L regulatory reports and failed bank loss experience and may not prove reliable or applicable. Nonetheless, the Chairman's estimate received a lot of attention as it was far greater than other government estimates. Meanwhile, FSLIC continued on an aggressive pace completing nearly 200 resolutions (often called the 88 Deals) while public confidence in the S&L industry and their regulators continued to decline.

During the fall of 1988, U.S. Treasury officials met with Chairman Seidman to discuss the FDIC taking over S&L deposit insurance and managing the RTC, a new temporary agency that would be responsible for resolving problem S&Ls. At that time, the FDIC was also experiencing an increase in failures but the banking industry was fundamentally sound and the insurance fund was considered sufficient to handle failure costs. Chairman Seidman was well respected for his leadership and forthrightness and the FDIC had valuable bank failure experience. Bank failures continued to rise over the next several years putting a strain on resources but the banking industry funded all losses. During the following months, Treasury drafted legislation that was presented to Congress in early 1989. The draft provided for $50 billion in funds to resolve failures, of which$20 billion would come from taxpayers and $30 billion from the S&L industry. While the legislation was going through congress, the Treasury requested the FDIC to begin managing S&Ls placed in conservatorship by FSLIC. By the time the law was enacted on August 9th, the FDIC was overseeing 271 S&Ls in conservatorship with $110 billion in assets.

The Financial Institutions Reform, Recovery and Enforcement Act (FIRREA)

FIRREA became law on August 9, 1989 and included provisions that significantly impacted the financial sector. The existing S&L regulatory authorities, the Federal Home Loan Bank Board (FHLBB) and the Federal Savings and Loan Insurance Corporation (FSLIC) were abolished and their duties transferred to the FDIC and three new agencies, the Office of Thrift Supervision (OTS), the Federal Housing Finance Board (FHFB) and the Resolution Trust Corporation (RTC). OTS was created as a bureau of the Treasury Department charged with chartering and supervising thrift institutions; FHFB was created as an independent agency to oversee the 12 federal home loan banks; and, the RTC was created as a temporary agency primarily to resolve all failing S&Ls already in conservatorship or failing over the three following years.[1] The RTC was to terminate by December 31, 1996[2] and transfer assets and activities to the FDIC. FIRREA also transferred to FDIC the responsibility for administering a thrift deposit insurance fund and serving as a contract agency responsible for operating the RTC.

[1] As it turned out, RTC continued to takeover such S&Ls through 1995 to help preserve the industry's insurance fund.

[2] Later shortened to December 1995.

In addition to overhauling the S&L regulatory framework, FIRREA provided for more stringent thrift capital standards. It dramatically shortened the period for amortizing "goodwill" counted as regulatory capital which contributed to increased S&L failures and extensive lawsuits. The law also made other provisions relevant today. Notably, it authorized FDIC to establish "Bridge Bank" and impose cross guarantees on insured institutions affiliated with a failing one.

Regarding RTC governance, FIRREA created a structure that clouded responsibilities. It established a high level Oversight Board to oversee and be accountable for RTC and to develop a strategic plan for conducting its activities. Oversight Board members included the Secretary of the Treasury, the Chairman of the Federal Reserve, the Secretary of Housing and Urban Development and two private sector experts. Essentially, the Oversight Board had responsibility for RTC's operating policies and budget while the FDIC Board of Directors served as RTC's operating board. A new agency with such a complex task requires strong lines of communication between policy and operations. This was not practical given the very high level of the Oversight Board and the fast need for operational challenges. The Oversight Board recruited a sizeable staff structure to help communications and understanding. This helped somewhat although it required a lot of time and effort to bring the staff up to speed with operations. Still, the Oversight Board seemed to more driven by political than operational concerns.

FIRREA's primary mandate for the RTC was to manage and resolve S&Ls designated as failed or failing by OTS but, also called for RTC to dissolve the Federal Asset Disposition Association (FADA) the existing asset management company established by FSLIC and to review all the so called 88 Deals for competitiveness and cost savings and renegotiate accordingly. FIRREA also had a number of other provisions that had to be "operationalized". It required RTC to establish a Real Estate Asset Division and quickly publish an inventory of real property assets; to establish guidelines and provide opportunities for lower income families when selling rental properties; to develop methods for increasing minority ownership of financial institutions; to work with regulators to establish and use new real estate appraisal criteria.

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RTC Funding.

Original cost estimates of $50 billion quickly proved inadequate. Treasury's estimates reportedly were based on 400 failures with roughly $200 billion is assets occurring over a three year period after the law was enacted. Over 500 S&Ls and $260 billion in assets were taken over by the end of 1990 and many more were expected. In addition to not having enough funding to cover losses, no provisions were made for "working capital", the money needed to pay financial institutions for taking over deposits. Usually, healthy institutions are very reluctant to buy questionable assets even at steep discounts. While we had the authority to provide loss guarantees or provide a note for the balance, the activity was discouraged because of its resemblance to the widely criticized 88 deals. (Refer to Figures below and Tables on page 7.)

As the number of failures kept growing, the RTC repeatedly found itself in the unpopular position of having to request more funding. (See Figures 1 & 2). Cost estimates changed several times through the first few years. Additional funding was requested and approved in early 1991, then again at the end of the year and again in December of 1993. The total funds requested by RTC totaled $105 million. Fortunately, most of the final appropriations was not lost as discussed below.

Figure 1

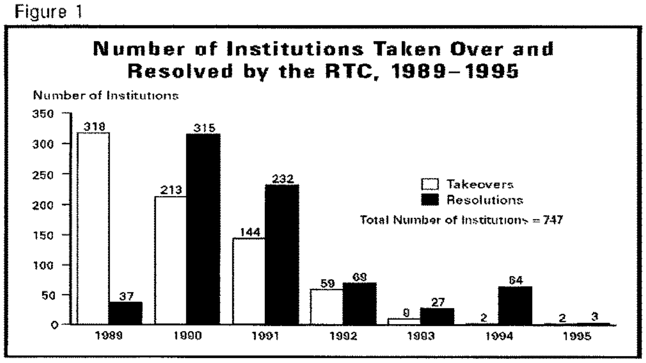
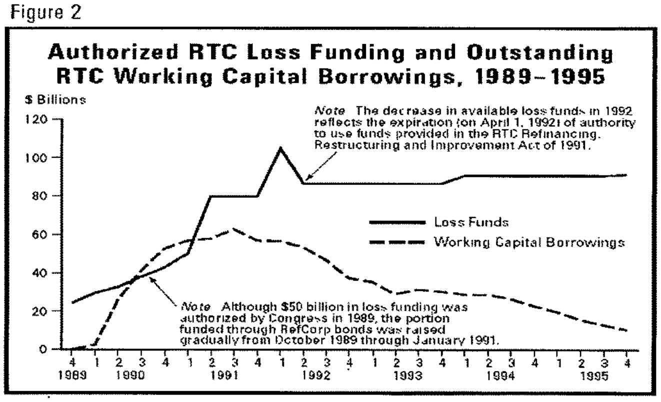


Figure 2



Source: 2006, VOLUME 18, NO. 2 38 FDIC BANKING REVIEW

As of year end 1999 when the S&L resolution was nearly complete[3], the FDIC completed a study entitled "The Cost of the Savings and Loan Crisis: Truth and Consequences" that estimated the costs of all S&L failures from the beginning of 1986 through the sunset of the RTC in 1995. (See Tables 1 to 4 on following pages) Direct and indirect costs were estimated at $153 billion, of which taxpayers paid $124 billion or 81% and the S&L industry paid the rest.

Direct costs of resolving S&Ls were estimated at $146 billion and indirect costs at $7 billion. These indirect cost estimates included $6 billion in tax benefits given to buyers of failing S&Ls prior to RTC and $1 billion in higher interest costs from using REFCORP rather than Treasury appropriations to fund RTC.

Of the $146 billion in direct resolution costs, FSLIC resolved failures accounted for $63 billion and RTC $83 billion. Taxpayers funded 65% of FSLIC resolved failures and 91 percent of RTC resolved failures.

Certainly, these FDIC estimates are much higher than early estimates given the public. Estimates mentioned in 1986 were about one tenth as big. Even estimates given in 1989 to pass FIRREA were only about 60% of the Treasury estimate. The good news is the FDIC's estimate for RTC is much lower than later government estimates. The bad news is no one really knew and the obvious question is why?

Several factors likely influenced early low cost estimates by FHLBB and FSLIC. Strong industry pressures to keep estimates low and/or an overly optimistic outlook probably played a role. Another likely factor was a lack of sufficient regulatory expertise to identify problems. The ownership and lending practices of many S&Ls changed rapidly but it wasn't until around 1985 that FHLBB recognized the need to recruit experienced examiners to better understand their exposure.

The FDIC might have been able to provide revised estimates based on S&Ls in conservatorships but lacked the resources and mandate to do so. The FDIC had to recruit and borrow staff to takeover this function. All estimates were based primarily on S&L records with little time for due diligence. Putting any reliance of such records eventually proved problematic. When FIRREA became law, the RTC quickly began to build staff and hire experts to understand just how bad the S&Ls in conservatorship were. .

While many early forecasts underestimated the size of the problem, later ones tended to be too high. They did not fully recognize the impact of lower interest rates and an improving economy. The number of failing S&Ls began to decline and the value of their assets and franchise improved. In addition, the RTC adopted very conservative asset recovery estimates resulting in realized gains as the economy improved.

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[3] Remaining assets of both the FSLIC and the RTC were about $7 billion, mostly cash and low-risk securities. Goodwill litigation cost estimates were largely unknown and excluded but may change final estimates.

Table 1
Thrift Failures, 1986–1995
($Millions)

Year	FSLIC		RTC	
	Number	Assets	Number	Assets
1986	54	$ 16,264		
1987	48	11,270		
1988	185	96,760		
1989	9	725	318	$134,520
1990			213	129,662
1991			144	78,899
1992			59	44,197
1993			9	6,148
1994			2	137
1995			2	435
Total	296	$125,019	747	$393,998

Table 2
Chronology of Thrift Crisis Events

December 31, 1986	FSLIC insolvent
August 10, 1987	FICO created to fund FSLIC
August 9, 1989	Enactment of FIRREA
	– FSLIC abolished
	– FRF created (succeeds to FSLIC's assets, liabilities, and operations)
	– SAIF created to handle thrift failures starting August 9, 1992
	– RTC created to resolve thrifts placed into conservatorships or receiverships between January 1, 1989 and August 8, 1992[a] (RTC to cease operations December 31, 1996)[b]
	– REFCORP created to fund RTC

Table 3
RTC Funding Legislation
($Billions)

Legislation	Loss Funds	Date of Enactment
FIRREA, 1989	$ 50.1	August 9, 1989
RTC Funding Act of 1991	30.0	March 23, 1991
RTC Refinancing, Restructuring and Improvement Act of 1991	6.7	December 12, 1991
RTC Completion Act of 1993	18.3	December 17, 1993
Total Funds Appropriated	$105.1	
Total Funds Provided to RTC	$ 91.3	

Table 4

Estimated Savings and Loan Resolution Cost, 1986–1995

($Billions)

	Private Sector	Public Sector	Total
Direct Cost			
FSLIC/FSLIC Resolution Fund, 1986–95			
FSLIC year-end equity and reserves, 1985	$6.1		$6.1
FSLIC insurance premiums, 1986–89	5.8		5.8
SAIF assessments diverted to FRF, 1989–92	2.0		2.0
FICO bond proceeds, 1987–89	8.2		8.2
FRF appropriations, 1989–95		$43.5	43.5
Less: FRF equity at 12/31/99[a]		(2.5)	(2.5)
Estimated Direct FSLIC/FRF Cost	$22.0	$41.0	$63.0
RTC, 1989–95			
Raised through REFCORP bond proceeds:[b]			
FHLB payments to defease REFCORP debt, 1989–91	1.3		1.3
SAIF assessments paid to defease REFCORP debt, 1990	1.1		1.1
Net present value of FHLB-paid interest on REFCORP bonds[c]	3.5		3.5
Net present value of REFCORP interest paid by U.S. Treasury[d]		24.2	24.2
Total REFCORP bond proceeds	5.9	24.2	30.1
Appropriations from U.S. Treasury[e]		55.9	55.9
Initial contribution from FHLB system	1.2		1.2
Less: RTC equity at 12/31/99[a]		(4.5)	(4.5)
Estimated Direct RTC Cost	7.1	75.6	82.7
Estimated Total Direct Cost	$29.1	$116.5	$145.7
Indirect Cost			
Estimated cost of tax benefits to acquirers from FSLIC assistance		6.3	6.3
Increased interest expense from higher interest rates on REFCORP bonds compared with U.S. Treasury borrowings[f]		1.0	1.0
Estimated Indirect Cost		7.3	7.3
Estimated Total Cost	$29.1	$123.8	$152.9
Memo: goodwill litigation cost through 12/31/99[g]		0.4	0.4

Source: FDIC - The Cost of the Savings and Loan Crisis: Truth and Consequences

RTC Governance

Establishing clear governance and an optimal organizational structure and staffing model are a critical first step to any organization. Originally, the RTC governance structure included a high-level Oversight Board to dictate policy and budget and the FDIC Board serving as the RTC Board responsible for all operations. Those of us involved with operations soon found this approach limited our operational clarity and line of sight and contributed to confusion in the public about RTC's mission and operations. It also impacted RTC's operational independence, which is important given the specialized expertise of staff and accelerated pace of their workload.

Having someone clearly in charge improves both accountability and program implementation. After about a year operating under its original governance, the RTC argued that its governance needed to be restructured and consolidated and proposed changes that were eventually passed into law a year later. These changes as well as international experiences demonstrate the benefits of consolidated governance that clearly designates accountability, reduces the potential of conflicting programs, and relieves the Department of Treasury and the Federal Reserve Board (FRB) from detailed program operations. Such a consolidated approach also leads to better consistency in information and system needs, performance metrics as well as stakeholder coordination.

Another organizational lesson learned by the RTC was the importance of having adequate staffing and the risks of depending on others for support. Originally, the RTC planned to draw heavily on FDIC and other regulatory agencies for skilled personnel to help in closing S&Ls and managing conservatorships. However, the mounting demands on these agencies significantly reduced their ability to support RTC operations. Importantly, the RTC also relied heavily on FDIC for operational support in key areas such as systems, accounting, legal, media, and public relations. As demands increased on everybody, the RTC concluded it needed to develop its own support staff operations.

We also learned the importance of *reliable* information systems for almost every part of operations – not only for measuring performance but also to establish baselines when setting goals and managing expectations. We learned early on the unreliability of troubled thrift prepared regulatory reports and the problems created when estimates were based on them. The reports were too often overly optimistic and did not reconcile with their own records. Estimates of conservatorship assets and losses based on these reports had to be revised causing lost confidence in RTC. The lack of good data also resulted in problems securing government funding that delayed the resolution of larger institutions resulting in even larger losses.

Good data and information systems are critical to identify, prioritize, and mitigate high-risk areas. For RTC, the biggest risk areas were managing S&L conservatorships, managing and disposing institution assets—including asset due diligence and valuation processes, and quality of asset information systems—as well as selecting and overseeing contractors. Congress tied future funding to faster improvements in these areas. Without good information systems, confidence in everything you do suffers. Case in point: The RTC's 1990 "qualified" GAO Opinion became "unqualified" in 1991 after improvements in initial systems and processes proved inadequate for: Inventorying assets acquired, reconciling general and detailed asset records, analyzing and reporting on assets sales, and estimating asset recovery values

RTC Resolution Operations

Essentially insolvent S&Ls involved three phases: Conservatorship; Resolution; and, Receivership.

The conservatorship phase involves placing an S&L under RTC control upon designation by OTS (or the appropriate state authority) that it has failed due or in imminent danger of failing. The RTC typically replaces executive management; limits operations and downsizes the institution. During this phase the RTC begins due diligence, cataloging and selling assets and preparing the institution for final resolution.

The resolution phase usually involved transferring insured deposits and as many high quality assets as possible to a healthy institution. In some cases, where fraud was prevalent or the S&L offered no deposit franchise value, the RTC would arrange for direct payoff of insured depositors. In all cases, the RTC would have to provide cash in excess of expected asset losses. Initially, this caused a rapid depletion of funds that slowed resolution. Eventually, RTC obtained authority to borrow from the Federal Financing Bank based on expected asset recoveries. Due to very conservative asset valuations all these borrowings were eventually repaid with interest. (See Figure 2 on page 5)

The receivership or final phase involves the recovery of any remaining assets (usually the most toxic ones) pursuing and defending claims and distributing proceeds to RTC and other general creditors. The difference between RTC's cash outlays and cash dividends received determines the cost of the failure.

RTC Asset Management and Disposition

The RTC was charged with managing and disposing of $400 billion of loans, real estate and other assets located throughout the country. The RTC did not have to deal with the complex securities of today backed by subprime home mortgages. Most of the home mortgages taken over were performing and marketable. About half of the assets taken over were marketable home mortgages and securities and most were sold with less than 5% loss. The other half was a much different story. They were mostly illiquid and hard to value assets such commercial real estate construction and development loans, undeveloped land and other assets where losses were much higher. (See Chart Below for sample losses) Still, no valuations or negotiations were required to obtain them since they came from failed S&Ls. We did establish approaches to value these assets for selling them however. Essentially, we relied on conservative real estate appraisals and present value analysis using market based discount rates.

RTC's strategy for selling S&L assets rapidly evolved. Early influences included provisions in FIRREA not to sell real estate assets less than 95% of fair value in distressed markets where most such assets were located. RTC's Governance also played a role. The Oversight Board was initially resistant to such strategies as providing seller financing, providing reps and warrants or bulk sales. The political environment was also a factor. There was considerable concern that the RTC would sell assets rapidly at fire sale prices bring down values of similar holdings by other institutions. After about a year however, attitudes began to change. Concerns went from selling too slow to the uncertain impact when the RTC started to sell its large holdings. One banker group that originally encourage a go slow approach later said the overhang of RTC assets was freezing the market. Funding or the lack of it was also a factor. Slow sales increased our need for working capital. The RTC gradually developed a strategy that prioritized disposition strategies by type. These strategies ranged from negotiating loan modifications to securitization or bulk sales, to auctions to seller financing to equity partnerships.

Sample of RTC Sales ($ Millions)

Asset Type		Number of Pools	Book Value	Net Sales Proceeds	% of Book Value Recovered
REO Land		5,880	$3,574	$828	23%
REO Commercial/Multifamily		2,940	$2,902	$1,609	55%
REO 1-4 Residential		3,542	$441	$356	81%
Mixed Commercial/Consumer	Non-Performing	40	$168	$31	18%
Land/ Construction	Non-Performing	288	$3,035	$946	31%
Consumer	Performing	82	$1,055	$1,061	101%
Consumer	Non-Performing	233	$355	$132	37%
Commercial/Multifamily	Performing/Sub-Performing	74	$6,177	$5,217	84%
Commercial/Multifamily	Sub-Performing	52	$30	$22	73%
Commercial/Multifamily	Non-Performing	646	$33,339	$22,607	68%
Commercial	Non-Performing	5	$134	$39	29%
1-4 Family Mortgages	Performing	179	$30,854	$30,726	100%
1-4 Family Mortgages	Performing/Sub-Performing	665	$1,157	$768	66%
			$83,221	$64,342	77%

Source: FDIC study of RTC Rep and Warranty Claims

The RTC also worked closely with the private in the management and sale of assets including:

- Asset management contractors: The ability to use the expertise and resources of private sector contractors was essential given the volume and complexity of assets under RTC management.
- Seller financing: In a number of cases, including equity partnerships, the RTC successfully provided the financing investors needed that the financial system was unwilling or unable to provide during a period of economic uncertainty. The losses suffered on such loans were very small.
- Equity partnerships: One of the more innovative methods that RTC used for asset disposition was the equity partnership, created to capture the expertise and efficiencies of the private sector and reserve some upside potential from the recovery of depressed markets. More recently, the FDIC has used a similar approach.

RTC Interventions

As previously noted, the OTS was the agency deciding whether or not an S&L should be taken over and the RTC had limited flexibility in structuring the intervention. Assistance transactions similar to those of the prior FSLIC were strongly discouraged. The FDIC intervention experience is more relevant. While most FDIC resolutions are similar to those used by RTC, it has a broader array of options when resolving large or complex failures. The FDIC has assisted and taken effective ownership of the nation's seventh largest bank in the early 1980s it has since provided loss guarantees on assets sold and used its Bridge Bank authority on a number of occasions.

Lessons learned from RTC and FDIC:

Listed below are highlights of important lessons learned that I will be happy to discuss in greater detail.

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Financial Institution Interventions

1. Prompt intervention is essential to curtail losses in institutions plagued with toxic assets who, otherwise, will either curtail lending or take even bigger risks to increase earnings;
2. Base intervention decisions on established guidelines supported by understandable and sound cost – benefit analysis and proper due diligence;
3. Isolate toxic asset risk to attract new investor capital;
4. Intervention strategy should be transparent, cost effective, and fair.
    a. Establish clear guidelines regarding selection criteria;
    b. Quickly stabilize systemically important banks or remove them with as little disruption as possible.
    c. Minimize perceptions of a banker bailout or that failing bankers are being rewarded.
    d. Do not rely on the accuracy of an institution's own assessment of problems;
    e. Manage "toxic assets" separately by qualified and properly incented professionals.
    f. Use independent experts to identify high risk assets;
    g. Preserve market discipline principles by ensuring executive management and shareholders accept responsibility and consequence of intervention...
    h. Do not place healthy banks at a competitive disadvantage against assisted banks.
    i. Establish limits on time and scope of assistance supported by approved repayment plans;
5. Modify FDIC Bridge Bank authority as necessary to better accommodate large complex bank interventions - especially to address unrealistic timeframes for decisions and/or if key functions are located in affiliated companies outside the bank.

6. Establish rules and guidelines and responsibilities should the temporary nationalization of a Bank Holding Company become necessary.
7. Place time limits on government ownership supported by approved exit plans to minimize conflicts or loss of franchise value.

Toxic Assets Acquired

8. Minimize time for assets in government ownership or control;
9. Avoid holding large inventories of assets that can adversely impact market functioning;
10. Selling illiquid assets requires initially establishing low price reserves to attract investors and competition to drive prices up.
11. Buying toxic assets will require a standardized valuation and sales approach to promote seller competition; and. avoid perceptions of unfairness, protracted negotiations and conflicts between assisting a bank today and minimizing future losses;

Strategy Governance & Organization

12. Provide for clear governance and Isolate operations from political influences as much as possible
13. Avoid or prioritize conflicting objectives.
14. Give maintaining public trust and operational transparency a high priority;
15. Make every effort to minimize taxpayer losses by operating effectively and pursuing those who caused the loss.
    a. Establish high ethics standards and internal controls
    b. Develop and disclose meaningful performance metrics as soon as possible.
    c. Focus on eliminating waste, fraud and abuse.
    d. Vigorously pursue claims against bankers and other professionals who contributed to losses.
16. Base funding decisions and cost estimates on *reliable* information and conservative assumptions.
17. Provide for adequate and well qualified staff and encourage use of private sector expertise;
18. Develop reliable and inter-connected information systems for every part of operations.
19. Minimize time and effort required creating and organizing new government entities when dealing with a crisis.

The CHAIRMAN. Okay, thank you very much.

And Dr. White. You will take us to the U.S., but further back. Please.

STATEMENT OF EUGENE WHITE, PROFESSOR OF ECONOMICS, RUTGERS UNIVERSITY, AND RESEARCH ASSOCIATE, NATIONAL BUREAU OF ECONOMIC RESEARCH

Dr. WHITE. Yes. I would like first to thank the Panel for the invitation to provide testimony on the actions of the U.S. Government to stabilize the financial and housing sectors during the Great Depression. Although I devote equal time to these two questions in my written testimony, I understand the committee has requested that I focus on the operations of the Reconstruction Finance Corporation.

At the beginning, I would like to point out that the financial system then was very different than today, and it is those differences which are instructive—principally, the absence of deposit insurance and the very high levels of capitalization.

The Great Depression, as you know, we all know, was the most severe recession the U.S. has ever experienced. There is a general scholarly consensus that the primary driving force that transformed a relatively ordinary recession into the Depression was the failure of the Federal Reserve to pursue correct policies at several critical moments.

The first question must always be why didn't the Fed respond to the rising number of bank failures? That answer is fairly straightforward. Bank failures were a common feature of the financial landscape because of a structural weakness in the banking system. State and Federal regulations had a nearly universal prohibition on branching that created a system dominated by small, single office banks.

Thus, in the 1920s, there were well over 20,000 banks. Failures of a few hundred a year were regarded by policymakers and most of the public as a normal winnowing of weak institutions with poor management. Shareholders lost their investment—in fact, more because there was double liability—and depositors faced a haircut. While this may sound severe, aggregate losses of the entire system were relatively modest.

In the absence of Federal deposit insurance, bankers were aware that the public was attentive, withdrawing deposits if the banks appeared to be in trouble. Consequently, they maintained high levels of capital. For national banks of the 1920s, the capital asset ratio was about 12 percent, or approximately double what it is today.

These bank failures did not present a systemic risk to the economy because they were relatively random and not part of a general economic decline. That changed in 1930, when the first panic began.

The first major response to the massive bank failures was the creation of the Reconstruction Finance Corporation (RFC) in 1932. The Federal Reserve's reluctance to provide additional liquidity to financial markets presented the Government with an unusual problem. The classic policy remedy in a banking crisis was for the central bank to lend freely from its discount window. This policy would enable banks that were illiquid but otherwise solvent to survive the crisis.

The task of the RFC was to provide sterilized lending without a change in the monetary policy of the Fed to banks that were weak. In other words, a second-best policy. The RFC was an agency of the executive branch of the Government and granted extraordinary discretionary authority. The agency aimed to follow sound banking practices with advances being fully secured. Lending was through its field offices, and these had full authority to grant loans up to what are the equivalent today of $1.5 million.

The management philosophy was to pick a man to be completely responsible for the operations in an office and let him succeed or fail on the basis of whether or not his office showed a profit. Loan evaluation was simple. Once an application was received, the agency evaluated whether an asset value was sufficient.

There were three phases of the RFC's operations—the first from February 1932 to July 1932, second from July 1932 to March 1933, and third after March 1933. The first program in 1932 was where the RFC made loans to banks and railroads. During this period, Eugene Meyer, chairman of the Federal Reserve Board, was also chairman of the RFC.

Meyer kept the terms and collateral on loans at the RFC the same as those at the Federal Reserve. Consequently, what happened was that the Fed could only lend to member banks. So he essentially extended the policy to nonmember banks; and it is during this period that the RFC loans are generally seen to be ineffective in improving bank survivability.

I should add parenthetically that the RFC also made loans, substantial loans to railroads. However, various studies have shown that these did not actually solve the problems of the railroads. In fact, they prolonged their distress.

The second phase of the RFC began in July 1932, when lending rules were liberalized. However, at almost the same moment, the list of banks that had received aid had been kept secret, just as the Fed had kept the names of banks who came to the discount window secret were made public. Making these loans known to the public, banks became hesitant to go to the RFC to get loans, and the number of loans offered by the RFC rapidly dwindled.

The last phase began in March of 1933, when the RFC began to offer its preferred stock purchase program. Unfortunately, this program occurred at just the same time as the banking system was collapsing and the bank holiday occurred.

When the RFC failed to prevent bank failures and runs, the state turned to a widely used 19th century method, which was to restrict payments, and they began to announce bank holidays, which snowballed eventually into the bank holiday of March 1933.

The bank holiday was a drastic remedy. Before the holiday, the public was prone to run on a bank because it had no means to assess its solvency. This information asymmetry had always been present, but it was heightened during the financial crisis.

The Government now stepped in and erred on the side of caution. After examination, only those banks that were clearly solvent were reopened. Those banks whose condition was dubious would remain closed until the Government could ascertain their true condition.

Thus, at the end of 1932, there were over 17,000 banks, but after the holiday, only about 11,000. The remaining 2,000 were either liquidated or merged. This had the effect of restoring public confidence in those banks which were open; and for those which were closed, depositors were not bailed out. Instead, all stakeholders in the failed institutions absorbed losses of $2.5 billion, or roughly equivalent today of $39 billion, about 2.4 percent of GDP. This burden was shared roughly between shareholders and depositors.

To wind up, I will just offer you a rough comparison. If we compare the 1930s to the 1980s, the rough loss from the S&L and commercial banks was about $126 billion, about 3.4 percent of GDP. And if you believe that today's crisis has losses of $1.7 trillion, that is 11.6 percent of GDP. So the cost of our crises seem to be spiraling upwards.

[The prepared statement of Dr. White follows:]

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Testimony Before the Congressional Oversight Panel Hearing to Examine Government Responses to Major Banking Crises of the 20th Century March 19, 2009

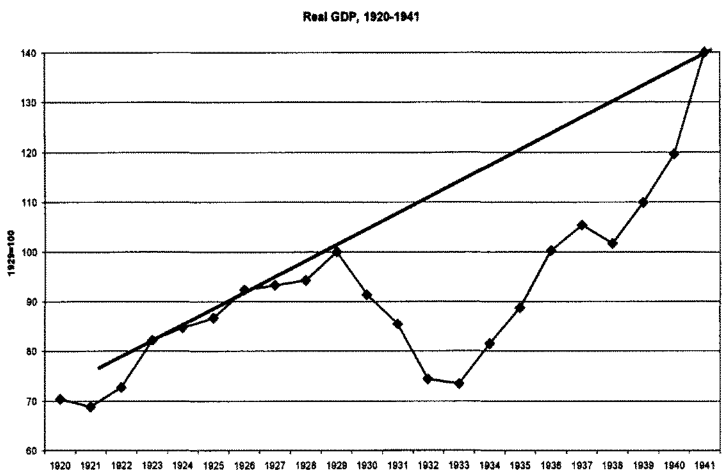
The Great Depression of 1929-1933 was the most severe recession that the U.S. has ever experienced. The federal government was faced with the failure of thousands of financial institutions and a collapse of the housing market as a result of this contraction. Dramatic action was required to halt the decline, resolve the failures and foreclosures, and provide new institutions for the future. My testimony today examines both the banking industry and the residential housing market in this period after first providing a chronology of the Great Depression.

Bank failures had been a common part of the economic landscape before the Great Depression, as there were many small weak institutions. But, the number of bank failures soared after 1929. The establishment of the Reconstruction Finance Corporation was the first attempt to stabilize the banking industry by providing capital and loans. In spite of its substantial resources, the RFC failed to halt the collapse of the industry. In the face of a nationwide panic, a Bank Holiday was declared. All banks were temporarily closed while the government determined which were solvent and could be reopened. The insolvent institutions were closed and neither depositors nor shareholders were bailed out. For the future, the Federal Deposit Insurance Corporation was established.

As unemployment rose and prices of all assets tumbled, the Great Depression compounded the problems of the housing market, already suffering from a boom that had collapsed in 1926. States responded to the rising number of foreclosures with moratoria that reduced the number of foreclosures but also lowered the supply of credit while raising interest rates. The first response of the federal government, the creation of the Federal Home Loan Bank System helped to reduce the number of savings and loan association failures but not the problem of foreclosures. To refinance home mortgages, Congress created the Home Owners Loan Corporation in 1933. Although the HOLC refinanced approximately 20% of the nation's mortgages, preventing many foreclosures, its success was qualified. The agency rejected half of the applications and set relatively stringent terms for borrowers. Nevertheless, 20% of its loans ended in default. Its small reported profit should be reduced by subsidies from the federal government. For the future, Congress created new institutions, the Federal Home Loan Bank System, the Federal Housing Administration, and Fannie Mae that transformed the mortgage market.

I. An Outline of the Great Depression

From the peak of the business cycle in August 1929 to the trough in May 1933, the real Gross Domestic Product of the U.S. fell 39%, prices declined 23% and unemployment rose from 3.2% in 1929 to 25% in 1933. From the low point in 1933, recovery was slow and unemployment still remained well above 10% for the rest of the decade.



The figure above shows the real GDP for the United States from 1920 to 1941 with a trend line to indicate what GDP would have looked like if there had been steady growth. The peak year is 1929 followed by the extraordinary four years of decline. By 1937, the economy had recovered to the 1929 level, but this was well below the economy's potential, which was only reclaimed in 1941. The general consensus among scholars of the Great Depression is that the Federal Reserve has the great share of responsibility for the large decline and halting recovery because of its mistakes in monetary policy.

The basic chronology and key events of the Great Depression are:

1. The Roaring Twenties. The 1920s was an exceptional period with no inflation and high productivity growth. After the brief but sharp post-World War I recession, GDP grew at a rate of 4.7% a year and unemployment averaged 3.7%. There were two exceptions to this rosy economic picture. The agricultural was weak, especially in the early part of the decade, because of overexpansion during the war and a collapse of prices. Residential housing boomed in the middle of the decade, with a crash in 1926 followed by a collapse of construction and rising foreclosures.
2. Beginning Shocks, 1929. A stock market boom/bubble began in March 1928, drawing in capital from across the country and around the world. The Federal

Reserve tried to talk down the market but finally, in July 1929, it raised the discount rate from 5% to 6%. The Fed's timing was extraordinarily poor as the business cycle had just peaked and a decline was beginning. The stock market crash of October 1929 reduced household wealth, leading to reductions in consumption and investment. Although the economy was clearly moving into a recession, the Fed maintained a tight monetary policy.

3. Aggravating Shocks, 1930-1933. After 1929, the collapsing economy weakened banks and bank runs snowballed into full-scale nationwide panics. There were panics in 1930 and 1933 and two in 1931. The failure of the Fed to effectively offset these panics allowed a rapid contraction of the money supply and credit. High real rates of interest produced by tight Fed policy and deflation, reduced consumption and investment. The deteriorating economy created a fear that the U.S. would not be able to remain on the gold standard. Capital flight reduced gold reserves and prompted the Fed to keep interest rates relatively high, further damaging the domestic economy.
4. Rock Bottom to Recovery, 1933-1936. The panic of early 1933 and the cascading state bank holidays led the U.S. to impose a bank holiday on March 6, 1933. The new Roosevelt administration responded to the collapse of the financial industry with the New Deal banking and securities legislation. The U.S. was lifted out of the depression by the abandonment of the Gold Standard in 1933 that allowed the U.S. to devalue the dollar and pursue an expansionary monetary policy. Fiscal policy was minimal.
5. The 1937-1938 Recession. The Fed's attempt to stimulate bank lending by doubling their reserve requirements backfired, as banks curtailed lending to replenish their reserves. The decline in credit produced a sharp contraction.
6. Second Recovery, 1939-1941. The economy began to recover with a new monetary expansion and spending in preparation for war.

II. Bank Failures: Resolution and Reforms

II. A. Bank Failures Before the Great Depression

The general prohibition of branch banking in the United States produced a banking system dominated by thousands of small single office (unit) banks. This development stood in stark contrast to the branching systems of Canada and much of Europe. In 1920, there were 28,435 commercial banks in the United States. Many banks were small, if not tiny, single office operations that were heavily dependent on the economic health of one town or county. Deposits average $1.2 million ($2008 = $13 million), but many had as little as $100,000 on deposit.

In this fragile banking environment, failures were a common feature. In the 1920s, bank suspensions averaged 588 per year. The average annual deposits in these suspended banks $180 million ($2008 = $2.2 billion). Shareholders lost their investment and more because federal and most state law imposed double liability, which made them additionally liable for the face value of their investment. Depositors were faced with a "haircut." For national banks, the historic record for payouts is preserved. Between 1907 (a major banking panic) and the end of World War I, depositors in failed banks were paid approximately 70 cents on the dollar. The collapse of agriculture with the fall in agricultural prices following World War I, briefly led to payout of less than 30 cents, until they recovered to about 60 cents in the 1920s.

A comparison with Canada is instructive during the last great banking crisis before the Great Depression—1907. In the United States, there were 16,389 banks, with fewer than 500 branches. In Canada there were only 28 banks, yet they had 2,367 branches. Both countries experienced a recession and a collapse of the stock market, but the U.S. endured a severe banking panic then ended in a temporary suspension of payments and produced 231 bank failures during 1907-1908. In contrast, there was no panic in Canada and weak banks typically did not fail but were absorbed by one or more sounder banks.

II B. Bank Failures During the Great Depression

Bank failures during the Great Depression were on a far greater scale than previously experienced. The policy mistakes by the Fed hit a fragile banking system hard. The fact that bank failures were regarded as a normal culling of bad institutions clouded the judgment of many policy makers as the downturn in 1929 began to gather speed.

From 498 failures with $142 million in deposits in 1928, the numbers rose dramatically. In 1929 there were 659 failures with $230 millions in deposits; in 1930, 1,350 failures with $837 million; in 1931, 2,293 failures with $1,690 million; in 1932, 1,453 with $706 million, and finally in 1933, 4,000 failures with $3,596 million in deposits. The demise of so many banks was unparalleled in the history of the United States. In addition to the loss of banks, there was a steady contraction of the banking system and collapse of bank credit, weakening the economy.

In "ordinary" years, banks had failed because they were insolvent, but the banking panics of 1930, 1931, and 1933 created a liquidity crisis. If bank were unable to meet its customers' demands because it could not sell enough assets fast enough without realizing large losses, it too could fail. Banks were thus subject to both solvency and liquidity pressures.

II C. The Response to Bank Failures---the RFC

The rising number of bank failures and the apparent lack of response by the Federal Reserve concerned both Congress and the White House. However, after the 1930 mid-term elections, the Democrats gained control of the House; control of Congress was now split and the legislative response stalled. President Herbert Hoover persuaded bankers and businessmen to form a private National Credit Corporation (NCC). The NCC pooled together $500 million of funds ($2008 = $6.4 billion) to lend to weak banks on assets that were not eligible for discount at the Federal Reserve banks. But given the increasingly dire condition of the banks only $155 million was lent by the end of the year. Congress did respond in 1931 by liberalizing the Federal Reserve's discounting rules, permitting the acceptance of more types of collateral on loans to member banks. But, this action did not help the thousands of banks that were not members of the Fed.

More importantly, on January 22, 1932, Congress created the Reconstruction Finance Corporation (RFC) to provide additional liquidity. The RFC was authorized to make collateralized loans to financial institutions for up to three years. The agency was largely financed by the Treasury, which subscribed to $50 million of its capital and bought $3.3 billion ($2008 = $52 billion) of its bonds. By the end of 1932, it had provided 7,880 loans for a total of $810 million dollars, improving bank liquidity. The RFC was also charged with making loans to closed banks to speed up the process of the liquidation and repayment of depositors.

However, the effectiveness of the RFC was compromised in July 1932 when Congress required the names of banks receiving RFC funds to be revealed. Although distribution of the list of banks was limited to the president and Congress, the Speaker of the House, John Nance Garner ordered the reports to be made public to control any favoritism. Fearing damage to their reputation or a run if news broke that they had borrowed from the RFC, requests for new loans rapidly declined. Although the RFC certainly provided banks with additional liquidity, its effectiveness was also limited by the Federal Reserve's unexpected deflationary policy that continued to weaken the banking sector and raise the demand for liquidity. Furthermore, while the RFC could assist with the liquidity problems of banks, it could not address problems of solvency as more and more banks' assets deteriorated with the declining economy.

II D. The Response to Bank Failures---the Bank Holiday

As bank failures continued, an old response began to reappear, some cities and states began to grant banks the right to restrict payments to their deposits. The hope was that the banks were solvent and restricting payments would permit them a chance to improve their liquidity while a panicking public calmed down. Banking runs would be checked before they brought down any banks.

The deterioration of the banking situation led Nevada to declare the first statewide banking holiday in October 1932 when faced with numerous runs on state institutions. Several states followed suit, but the February 14, 1933 Michigan bank holiday began a cascade of state holiday declarations. Pressure on New York City banks grew as their regional correspondents withdrew funds in the city to satisfy their customers. In this crisis, President Roosevelt declared a national bank holiday on March 6, 1933, suspending all banking transactions. Following the Emergency Bank Act, Roosevelt announced a schedule for licensing the reopening of the banks on March 11, ensuring that only solvent institutions returned to operation.

The Bank Holiday was a drastic and dramatic remedy. Before March 1933, the public was prone to run on a bank because it had no means to determine its solvency in the collapsing economy. This "information asymmetry" had always been present but it was heightened during financial crises. The government now stepped in and erred on the side of caution. After examination, only the banks that were clearly solvent would be reopened Those banks whose condition was dubious would remain closed until the government could ascertain their true condition. Before the onset of the depression, there had been 24,504 commercial banks with $49 billion of deposits in July 1929. By December 1932, the industry had contracted to 17,802 banks with $36 billion in deposits. When the holiday was terminated on March 15, only 11,878 banks reopened immediately. More than half the remainder eventually reopened but 2,132 banks were liquidated or merged. Public confidence in banks as safe harbors for their deposits was thus restored.

The RFC played no role in this part of the drama. After the Bank Holiday, the RFC was sidestepped and had only a limited job in the reopening of banks. It loans to open banks shrank from $677 to $462 million by the end of 1933. The RFC then shifted to providing capital for the reopening of weak banks and making loans to assist with the liquidation of insolvent banks.

II E. The Response to Bank Failures---No Bailout of Depositors

What happened to the depositors of the failed banks? As happened before the Great Depression, they suffered some loss. One option that was firmly rejected by the Roosevelt administration was a bailout.

In April 1933, a bill was proposed in Congress that would have ordered the government to purchase all the assets of closed national banks at a price sufficient to pay all depositors in full and liquidate the banks. The Secretary of the Treasury estimated that the cost of paying off all deposits up to $2,500 (2008 $ = $40,000) would cost the Treasury $ 1 billion (2008$ = $16 billion) or about 2 percent GDP. Roosevelt was opposed and the act was defeated overwhelmingly in Congress.

Instead of a bailout, all stakeholders in the failed banks absorbed the losses. A substantial fraction of the banking system was permanently closed, presenting depositors and shareholders with large losses. Losses totaled $2.5 billion (2008$ = $39 billion) or about 2.4% of GDP in 1933, which were roughly shared equally by shareholders and depositors. For comparison, in the financial collapse of the 1980s, savings and loans cost the FSLIC and the government $74 billion and commercial banks yielded losses of $52 billion. The total of $126 billion was equal to 3.4% of GDP. In today's crisis, one estimate of losses to banks is $1.7 trillion or $11.6% of GDP.

II F. The Response to Bank Failures---FDIC Insurance

Federal deposit insurance did not play a role in the ending the crisis, it was instead part of the New Deal reform package. Today, deposit insurance enjoys broad public support, but before the Great Depression, proposals for federal insurance were viewed as special interest legislation that had little chance of passage in Congress.

States had experimented with insurance of bank liabilities before the Civil War and after the panic of 1907. These state systems had a best mixed results and at worst, disastrous consequences. This experience increased policy prejudice against federal insurance. However the lobby of rural, unit bankers continued to press for a federal guarantee system. They hoped to increase depositor confidence and retain the laws that prevented branching and competition from city banks. Yet, repeal of these regulations would have produced a more stable banking system of larger, diversified institutions.

Studies of the origins of deposit insurance emphasize that it would have had scant chance of being adopted if the banking collapse of 1931-1933 had not frightened the public. The problems of the earlier state systems with moral hazard and adverse selection were well known and debated in Congress. Aware of that deposit insurance would increase risk-taking by banks, the Roosevelt administration, key Senate leaders, the bank regulatory agencies, and larger banks opposed any deposit insurance. In the face of such opposition, credit for the adoption of deposit insurance belongs largely to Representative Steagall who effectively blocked the passage of any banking legislation unless it included deposit insurance at the critical moment in early 1933.

Far from being a high-minded policy aimed at protecting the depositor, the design of the Federal Deposit Insurance Corporation (FDIC) was the product of a lengthy struggle between small, often marginal banks in rural areas, against larger more diversified and efficient banks. The Banking Act of 1935, which created the FDIC set a flat annual assessment rate of one-twelfth of one percent of a bank's total deposits. Banks contributed premiums as a fraction of all their deposits but only received protection on deposits up to a maximum of $5,000 per account ($2008= $78,000) for the permanent fund. This low level reflected the concern that all deposits not be insured and that larger depositors should be at risk. They would provide market discipline by withdrawing their funds if they perceived the bank to be taking excessive risk.

Small banks and lower-income individuals with small deposit accounts benefited, while bigger banks with larger deposits effectively provided a subsidy. By the end of 1935 91% of all commercial banks with 86% of deposits had joined the FDIC. Yet, FDIC insurance only covered 45% of all deposits in 1935. By any measure the vast majority of small depositors were well protected by this level of insurance and there was no public demand for an increase. Even after the inflation of World War II had eroded the value of $5,000 of deposit insurance, only 4.4 million accounts out of a total of 104 million accounts were not protected.

III. The Housing Market and the Great Depression

III. A. The Nature of the Traditional American Mortgage Market

Traditionally, developers, local investors, and family had provided most mortgages. In 1920 only half of real estate lending was provided by intermediaries. The market was characterized by loans for one-third to one-half of the purchase price, with maturities of a few years. During the housing boom of the 1920s, institutional lenders led by savings and loans, commercial banks and insurance companies expanded rapidly. By the end of the decade they accounted for 60% of mortgage finance. Except for savings and loans which primarily gave fixed payment amortized loans, most lenders, including insurance companies and commercial banks, offered three to five year mortgages that typically did not amortize the principal, making the balance due and the end of the life of the loan.

A key feature of these relatively short maturity non-amortized loans was the need for renewal at maturity. The price stability of the late nineteenth century and the 1920s (with the exception of World War I) ensured that these types of loans did not present homeowners or lenders with the risk of rapid price changes that could raise or reduce the real value of the principal. The rapid deflation of 1929-1933 where the general price level fell approximately 30 percent dramatically raised the real value of repayment of the principal. Coupled with the staggering loss of jobs and income during the depression, payment and repayment of loans became much more difficult.

III B. The Housing Market Boom and Crash in the 1920s

Like the current boom and bust, the housing bubble that peaked in the mid-1920s was focused on residential housing. Part of the housing boom is attributable to a recovery of the market after World War I when new construction collapsed, but the number of new homes and the value of construction far exceeded the wartime deficit. The boom occurred during a period of stable prices, low interest rates, and rapid economic growth. There was a construction surge, with a rapid increase in the number of new housing starts. The terms of mortgage finance gradually eased and mortgage borrowing helped to fuel the boom. Securitization of commercial and residential mortgages also grew. Title and mortgage guarantee companies issued certificates of participation against pools of loans they originated and serviced with default risk absorbed by insurance policies they wrote. However, these were all private development without the government institutions that have been so important a role in the current era. Although there is no national data on housing prices, they appear to have increased approximately 30% between 1921 and the peak in 1926, before declining.

III C. State Mortgage Foreclosure Moratoria

The rapid decline in income and real estate wealth during the depression caused many households to fall behind in their mortgage payments. It is thought that perhaps half of urban mortgages were delinquent at the end of 1933. Consequently, both farm and nonfarm foreclosure rates rose to new historic highs in the early 1930s. The foreclosure rate for nonfarm mortgages rose from 0.36% in 1926 to 1.3% in 1933, although it should be noted that these are below current foreclosure rates. Twenty-seven states responded by imposing mortgage foreclosure moratoria. These moratoria varied considerably, from blanket moratoria on most farm and nonfarm foreclosures to specific and limited moratoria. In some states, for example, only borrowers who were current in the payment of interest and taxes but were delinquent in the principal could be granted a moratorium on foreclosure. The result of these moratoria was a reduction in foreclosures by altering the rights and transferring wealth between borrowers and lenders.

These actions immediate reduced foreclosures but contemporary critics argued that moratoria would cause lenders to withdraw, reducing the supply of loans and raising interest rates to compensate for the probability they could not collect on delinquent loans. These objections were countered by arguments that widespread evictions were imminent. If neighborhoods had numerous evictions, the value of property might collapse for all residents, and the social costs might exceed the private costs. Several studies of the Great Depression state foreclosure moratoria have show that private lenders made fewer loans in states that imposed moratoria and charged higher interest

III D. The Federal Home Loan Bank System

Even before the commercial banks were overwhelmed, the decline in real estate prices and delinquent mortgage payments produced a deterioration in the assets of savings and loan associations (S&Ls). Fearful depositors withdrew funds at S&Ls even faster than they did at commercial banks. Deposits fell 17% at commercial banks but 28% at S&Ls. S&Ls responded by building up their cash reserves and slashing new mortgage loans by 76%, compared to a 50% reduction by commercial banks. The gravity of the S&L crisis led Congress to pass the Federal Home Loan Bank Act in 1932. Modeled on the Federal Reserve System, there were twelve regional Home Loan Banks, owned by member thrifts, under the oversight and supervision of the Federal Home Loan Bank Board (FHLBB). The Federal Home Loan Banks served as wholesale lenders to the thrift industry, borrowing at favorable rates and re-lending to member thrifts. Although promoted as a means to aid distressed homeowners, very little refinancing occurred, and the new system primarily benefited the S&Ls. The legal right of S&Ls to limit withdrawals by their depositors and the aid from the Federal Home Loan banks helped to reduce the number of failures. In contrast to the banks, the S&Ls experienced smaller contraction, with the number of S&Ls declining from 12,342 in 1929 to 10,596 in 1933.

III E. The Home Owners' Loan Corporation (HOLC)

The HOLC was established by the Home Owners Loan Act of 1933 and was charged with helping families to avoid foreclosure on their mortgaged homes. Initially, the Corporation received $200 million (2008 $ = $3.2 billion) from the U.S. Treasury and was authorized to obtain the rest of its funding by issuing $ 2 billion (2008$ = $32 billion) in federally guaranteed bonds. With these funds, the HOLC made mortgage loans for taxes and mortgage refinancing. Loans were restricted to mortgages that were in default or held by financial institutions that were in distress. They could be made for one to four-family nonfarm homes. The maximum appraised value of a property was $20,000 (2008 $ = $332, 257). The 15 year amortized loans could not exceed 80 percent of the appraised value and carried a maximum interest of 5 percent.

The HOLC was a massive program. It set up over 400 offices with 20,000 employees to accept applications, make appraisals of property and offer loans. Once the HOLC agreed to refinance a borrower's loan, it offered to purchase the defaulted loan with its securities from the original lender. At the beginning, many lenders balked until the government changed policy and guaranteed both the interest and principal of the HOLC's bonds.

During the initial lending period, the HOLC received 1.8 million applications for $6.2 billion (2008 $ = $100 billion) for refinancing where the average loan was $3,272 (2008 $ = $59,927). This sum was equal to 40 percent of all mortgaged properties in the U.S. that might qualify in terms of their value or about 20 percent of owner-occupied homes.

The program was a qualified success because of its strict standards for refinancing. Approximately one half of the applications were withdrawn or rejected, and one million loans were made worth $3.1 billion (2008 $ = $50 billion). The loans were received by 10 percent of all homeowners and 20 percent all mortgagors. Most of the loans were well below the maximum of $14,000, and 75 percent were for $4,000 ($2008 = $64,317) or less.

In spite of the strict conditions for obtaining HOLC refinancing---an 80 percent maximum loan to value ratio and credit reports on the applicant that had to show an ability to repay---the HOLC foreclosed or received a voluntary transfer 200,000 homes, representing 20 percent of the loans. It should be noted that these foreclosures occurred in spite of economic recovery that began in late 1933. Managing and selling these homes was a major challenge for the HOLC, producing at loss of $310 million ($2008 = $4.8 billion). Continuing problems led Congress to pass the Mead-Barry Act in 1939 that permitted up to 10 year extensions of the original 15 year loans. In 1948, Congress permitted the sale of the HOLC's loans to private institutions.

Total revenue for the HOLC when it wound up its operations in 1951 was $1,417 million while expenses totaled $1,065 million. This profit of $352 million was offset by losses on foreclosures of $338 million, yielding a small profit on its operations of $14 million. Profits had been boosted by the decline in the Corporation's cost of funds to 2.2 percent, giving it a substantial spread relative to its lending rate. However this profit is misleading. In its calculation of profit, the HOLC did not account for the cost of the $200 million cash advance from the Treasury. Harriss (1951) estimated the cost of this advance was $35 million, which would imply a small loss instead of a small profit. The HOLC also had special treatment because it did not have to pay for the use of the post office and it was exempted from Social Security taxes. Together these would have added another $ 8 million, or a true loss of $29 million ($2008 = $466 million).

III F. The FHA, Fannie Mae, and the FSLIC

While the HOLC was intended to address the immediate crisis, Congress created additional institutions to assist the housing industry. In 1934, the National Housing Act was passed to provide mortgage insurance. A new agency, the Federal Housing Administration (FHA) was created to handle the insurance. For a borrower paying a half percent premium, FHA insurance covered the entire principal outstanding, providing the lender with protection from default in the form of compensatory twenty year debentures. The 1934 Act helped to reshape the mortgage market by stimulating the use of long-term, fully amortized, fixed payment mortgages in the residential market, as loans that conformed to the agency's underwriting standards and rules could receive insurance. To encourage participation in the FHA program, the Act sought to create a market for these mortgages through the establishment of private National Mortgage Associations. However, none of these was ever chartered.

To solve this problem and thereby increase the supply of funds for housing finance, the Federal National Mortgage Association (FNMA or "Fannie Mae") was created in 1938 to borrow funds and use them to buy mortgages from lenders and originators. It was authorized to buy FHA mortgages outright from private lenders and even to issue commitments to purchase loans before they had been originated. Thus, Fannie Mae created a secondary market for FHA loans.

Lastly, concerned that the establishment of the FDIC would put S&Ls at a disadvantage in attracting deposits, the National Housing Act also created the Federal

Savings and Loans Insurance Corporation (FSLIC), under the FHLBB. Accounts were insured up to $5,000, while members paid premiums and were subject to periodic examination.

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The CHAIRMAN. Thank you, I think. Thank you very much. Thank all of you.

What we will do now is we just want to engage in some questions, if we can here. We limit ourselves as we ask questions to 5 minutes, but I think we will have enough time that we can go more than one round here. So we do want a chance to explore this while we have got everyone together.

I get the privilege of asking the first. So let me tell you where I would like to start this. There has been much debate around the question of nationalization, and the argument back and forth about nothing is an appropriate analogy. Everything was different at every other point in time or every other place.

And what I have tried to do as I have listened to this is I try to think, so what is it that people are concerned about with nationalization, other than it sounds like a scary word? And as best I can figure out, there are three things that seem to emerge each time, that sort of circle through this.

One is that if we nationalize, there will be politics involved in lending. The notion that there will be folks from Congress who will call the local financial institution and lean on them to finance a constituent's business or to—at a much larger level, to get involved in lending activities that they have no business getting involved in.

The second is that it is simply too complicated. All well and good for those charming little banks of yesteryear, but that today we have mega institutions that are far too complex to be nationalized because, surely, no one in the public sector could run them. It takes the expertise of the private sector.

And the third, and I think related to this, the argument runs there will be too many people who will have to be replaced. It is a sort of variation on the expertise argument. We will have to fire all the bank employees and put to work government employees who would then have to be retrained, who wouldn't understand.

That is the best I can figure it out from what I hear. And if I have left some out, you should feel free to add. But what I would like to do is I would like to start with you, Mr. Lundgren, if you could talk to us particularly about the political influence question. How did you deal with this problem in Sweden? How did you deal with the question of expertise, whether or not government officials could be expected to run these complex institutions?

Mr. LUNDGREN. It has been fascinating to follow the debate in the U.S. regarding nationalization, which we didn't use as a tool. That is not a tool. That is something that can come out of you handling a crisis.

We had one bank that was partly nationalized, which we fully nationalized. And we had another one, which we nationalized because it was just a black hole and nothing else.

What you have to do then is you replace top management because, obviously, those who led the bank into the black hole shouldn't be there, and you have got to replace boards. And you don't replace ordinary people in the banks. You don't try to convince yourself that you are an expert in running banks because you are not.

On the other hand, as I said, I mean, obviously, those people that have run the banks now and the shareholders that have been responsible for them haven't been very successful, to put it mildly. So government, could they do it worse? I don't think so, to be honest. It is a crisis management question, and nothing else.

Regarding political influence, it is not a tradition in Sweden. I wouldn't see how local politicians here would be able to do that, but I couldn't answer that question, of course. We didn't have that problem at all. It wasn't discussed at all.

When it comes to the expertise, as I said, it can be solved. You have a lot of good people that were not responsible for what happened in the banks, and they could take over.

So we took the one nationalized bank, put the viable parts into what was the government-owned, fully nationalized then, and now it is partly privatized. Only 19 percent is still in government, and that is Nordea, which is a very good bank today. The new management managed to restore the bank, per se.

So I don't really see there are any dangers because what you really need to do is if government goes in with capital, market economists say that if you take the responsibility of being an owner and you also take the advantages of being an owner, you should do it fully. You shouldn't abstain from voting power. You shouldn't be afraid of taking ownership. But you should, as soon as possible, try to get rid of it.

The CHAIRMAN. That is very helpful.

Mr. Cooke, was this an issue in the '80s with the RTC?

Mr. COOKE. Well, at the RTC, we had a lot of institutions in conservatorship, and we had to run them. The law that was passed creating the RTC, as I remember it, basically said to Congress, don't get involved.

But your three points—you know, politics, complication, and you need too many expert people—of those, politics was not as big an issue with us. But there was always a little bit. You can't get away from it totally.

As far as being complicated, I think that is the worst excuse to give because that is basically saying, as back in my examiner days, "It is too big to analyze. Pass it and watch it." That is just going to be a problem. So you can't—if it is too complicated to do something with, you have got to do something about that.

And so, we had institutions that were complex, that were larger. But nothing like what people are talking about today. And as far as too many people to replace, you do have to get rid of the top management. You have got to do that. And you have got to get rid of probably the next line down before you start getting any objective analysis. Depending too heavily on the work of the guys in charge now, at least from my view, is a mistake that you will come to realize slowly.

The CHAIRMAN. If my co-Panelists will indulge me, I just would like to follow by asking the question, in effect, in the reverse point. Mr. Katz, does the failure to nationalize take politics out of the relationship between the financial institutions and the government?

Mr. KATZ. In Japan, it worked the other way around. There were some banks, about four, who were effectively nationalized. A couple actually had just simply gone bankrupt. Two were bailed out.

In the first couple of cases, the stockholders were totally wiped out. In the last case, the stockholders were bailed out, and the stock market had a rally.

S&P is about to come out with a study about the banks which were nationalized in Japan. Let me just preface this by saying I am not sure if nationalization is the right solution here or not, but let me discuss the track record in Japan. Those banks that were nationalized in Japan got rid of toxic assets much more thoroughly and much more quickly than those which were not nationalized.

On the other hand, the ones that were nationalized got a much bigger capital injection from the government. So they could afford to do the writedown. And on the third hand, if you will allow me a third hand, the ones that were taken over were smaller. They weren't the mega banks in Japan.

On the politics. Politics actually really worked the other way around. In Japan, your social safety net is your job. So you can't allow companies to fail, and you can't allow banks to fail. They called it the convoy system. So the Diet members would actually call up banks and say, you are not making enough loans to Mr. Tanaka down the street, to mom-and-pop stores.

So the political pressure on banks to lend was actually very, very great, having nothing to do with nationalization. It is just the way the system worked.

Now what happened was the crisis was so bad that the Diet took the whole power over running the banks away from the finance ministry, which had been in cahoots with the bankers for mutual cover-up, and created an entirely new agency called the Financial Services Agency. One of my favorite bureaucrats there actually spent some time working in the National Police Agency, and had spent some time in London and in New York, and so seeing other things.

So the politics actually worked fine, despite an awful lot of political pressure on the nationalized banks, one bought up by a U.S. hedge fund, to make these loans to weak zombie companies. That came out in public. It was a big brouhaha. But, in fact, the politics worked the other way.

On the complexities of nationalization, I basically agree with the other people's comments. Lop off the top management. But you are the shareholder. So you are the boss. You hire people, but you don't get rid of everybody.

The CHAIRMAN. Good. Thank you, Mr. Katz.

And if I could just have a final comment from Dr. White. Just keep it short.

Dr. WHITE. There is good news from the Great Depression——

The CHAIRMAN. Turn your—good news from the Great Depression. We are ready.

Dr. WHITE [continuing]. On the issue of favoritism. The New Deal programs have been extensively studied, and almost all of them find extraordinary political favoritism, with the exception of the RTC. And the reason for that is there was a great deal of insulation by granting extraordinary executive authority to the President.

So even though we know there are cases of congressmen and governors calling up the RTC, overall, it looks like a fairly clean program. It was easy to find plenty of people to staff both the RTC and the HLC, which had 20,000 people on its staff.

The issue about the complexity of valuing a failed banks' assets is kind of misleading because what happens is that at this point, the economy is in a terrible downturn. Markets have become very thin. Assets are harder to evaluate. And so, it is natural that it seems more complicated, but it is just requiring that people, the bank examiners and those others, to exercise a little more discretion.

The CHAIRMAN. Good. Thank you all very much, and thank you, Panelists, for your indulgence on the time.

Mr. SILVERS. Yes, first, just one quick thing. Mr. Lundgren, in your opening comments, you referred to yourself as a market liberal. That is a term that is not current in U.S. parlance. Am I right to assume that you represent the more conservative of the major Swedish parties and that you believe in free markets?

Mr. LUNDGREN. Yes, we call it market liberal because liberal is something that is freedom. It is not the American way of political liberalism. I am a conservative in that respect. Market conservative you could say.

Mr. SILVERS. Yes, just one of those things where we are separated by a common language.

Secondly—first, Mr. Lundgren and then Mr. Cooke—could you talk about the treatment first of stockholders and elaborate on the reasons for the treatment of stockholders in the respective programs you ran. And then secondly, bondholders and how they were treated and why? And then I will have a follow-up question.

Mr. LUNDGREN. If I would start out with the bondholders, I mean, they were creditors. They were investors, and you could argue that they should, of course, be evaluating their investment and suffer if they did wrong in their analysis.

On the other hand, if you come to a systemic crisis, I think that you have a situation where nobody, depositor or creditor, can lose on a bank. You saw that after Lehman. Lehman was a mistake, obviously. So, first of all, all creditors were covered by this blanket guarantee.

Secondly, if you have the blanket guarantee, then you have to, of course, handle the situation within the banks, and all banks except one applied for government support. We then told them that if you want capital injection from government, it is not soft money. We even had to change legislation one more time in order to try to convince them that we were superior when it comes to negotiations. It was not so much negotiations as it was an offer that you couldn't refuse if you needed capital injection from the government.

And that meant that you diluted the shareholders' value, of course. And if we got majority in the government, so be it, then we took the majority in the banks. This helped us getting private equity because the owner families of the SEB, SE Banken, the Wallenberg family, of course, understood that it wasn't very nice to have the bank taken over by government. So they found private equity.

Of course, we were helped by the appreciation of the currency by the economy reviving and so forth. But still, it was a very tough handling. So it was an explicit message that there are no negotiations. If you need capital injection from government, we will take the same stakeholding in the bank as the amount of capital we put into the bank.

Mr. SILVERS. Voting power?

Mr. LUNDGREN. Voting power, of course. I mean, without voting power, you don't have the influence.

Mr. COOKE. With regard to RTC, it was all the deals, all the transactions were closed bank transactions, which basically meant the shareholders ended up being left behind in receivership. And if there were any collections when the day was done, they might get something. But they were pretty much removed from the picture as we removed senior management and all that.

As far as bondholders, depending on the terms of the agreement, they may have been left behind in receivership, which is like the bankrupt estate. We would sell off the deposit franchise. If we can get money to sell it off before it evaporated. And we would sell off the assets, and they would just wait for the collections, their pro rata share of collections in the proceeds. So they would be a general creditor, most bondholders, unless they had some kind of security, they were secured.

What may be more interesting, in the mid '80s before they changed the law, a lot of big banks, not a lot, but big banks were coming to the FDIC, looking for what we called open bank assistance, which is where you are not closing the bank. You are not putting it through a receivership. You are going to provide assistance.

And at that time, Chairman Seidman—there were getting to be a lot of people coming in, looking for money, saying, "Why don't we get this?" And he established some ground rules that basically said to shareholders if you get Federal assistance, your interest, number one, is going to be substantially diluted. And if you want us to bring in new capital, we better have a situation where somebody else puts their money on the hook so we know that you are not the—someone else has said this is a viable assessment and also that top management prepare your travel plans.

And as far as shareholders, one of the things that we did was go aggressively after management at the RTC, and if there are any shareholders, controlling shareholders for any issues that we felt contributed to because every time we had to go up for money, which we had to keep doing, it was good to have something good to tell Congress. And we would say, well, we didn't do perp walks, but we would say this many people went to jail in the regular update.

Mr. SILVERS. Second question. There has been a lot of debate in the United States about valuation issues, particularly about mark-to-market accounting. What is the experience—and any of you could answer. What is your view about the effectiveness of essentially an administrative valuation, which I think is a common theme across a number of your testimonies? And how does one understand it in relation to debates about mark-to-market accounting?

Mr. LUNDGREN. If you start with Sweden, we had a simple situation. We had ordinary bank loans, plain vanilla, which was coupled with mainly real estate as collateral. So what we had to do, in effect, was to try to get right values out of the collateral, which was real estate, commercial real estate mainly.

What we did was opt for the mark-to-market valuation. Even if it could exaggerate in the long run the situation, I think that that gave us, due to the transparency it gave, gave us more credibility, restored confidence much easier. Because even if it seemed that the losses and the total losses in the bank would be greater than otherwise, it was mark-to-market is mark-to-market. Whatever other method you use, it is not a clean method. There is always an argument to what, how do you valuate? How do you really put a value on it?

Of course, this situation with all these securitized instruments is much more difficult. On the other hand, what you need to do, I mean, you need to be able to show that all of the banks' stress testing or whatever, you can have a real picture of what is the black hole and what is the losses on the asset side and how much capital do you need to inject?

Not only because Congress needs it to try to estimate what more funding might be needed, because probably more funding will be needed to handle the situation here, but also to convince investors that, okay, now you have a sizable—you have a picture of how big the size of losses are as well. So I would go for the mark to market, even if it is procyclical. I can see that there are those problems, but that is the one we would choose, and it helped us coming out quite good.

Mr. KATZ. Could I make a very just quick comment on that? In Japan, there was, as far as the loans themselves, mark-to-market was less of an issue because they had preset sort of loan loss reserve ratios depending upon how much in arrears it was, how much loss. They began to develop an actual market in distress assets, both a government organization to create it and private markets.

The real problem with their mark to market was that the banks were allowed to hold stocks as part of their capital. The stock market went down. That hurt them. The government tried what they call price-keeping operations, basically buying stocks. It didn't work. This is the case where the patient has got a fever, so let us bribe the thermometer.

But I would say the situation in the U.S. is different in the sense that mark to market is being used in cases where there is no market. So, for example, when Merrill Lynch has its fire sale of assets and 22 cents on the dollar to avoid bankruptcy, but there were so few actual deals in that particular instrument that everybody else had to mark it down to 22 cents to the dollar even though the underlying asset was actually good.

Mr. SILVERS. Mr. Katz, I don't mean to cut you off there. Keeping that in mind, I am curious about the effectiveness in the U.S. context in the past of essentially trying to get at real values through administrative processes rather than either through a frozen market or through pretending that they are worth more than they are.

How good has that type of process been, and is it something that could be replicated in this situation?

Mr. COOKE. In the case of the RTC, we had a lot of that. We had a lot of junk loans and construction development loans where there was no market for those assets. Now we were in the sell mode, not the buy mode, because we got it when the institution took them over, and that made a difference.

And we were also required not to sell anything initially less than 95 percent of fair value in certain markets, which really created a problem. We updated appraisals, and appraisals were all revised, too, at that time because they were all—the practice was very flawed. We just couldn't get a price we could sell the assets.

So there was no market, but we worked with the private sector advisors as to what kind of reasonable returns would markets be looking for. Then we would take our assessment of the cash flows, and we would use that to establish what we called a derived investment value. We used that to sell the first pools of these structured assets, and we met what we thought was the fair market. And it definitely increased competition.

Very quickly, everybody was in there because the market returns. All it takes is someone making on it to get somebody else to want to come in and do it. And the prices and the values went up. So it worked fairly well.

But again, we were selling, not buying, and that is a little trickier. I would just say I agree. But I don't know how you mark to market when there is no market. I just don't know how you do that, and there has to be somewhat of a different model.

Maybe the Government can come in and really assess cash flows, do something similar. I just don't think you can price it.

Dr. WHITE. Yes, just a bit of an historical comment on this. Given that commercial banks oftentimes specialize in lending to individuals who don't have access to markets, it is hard to say that you mark to market a loan, particularly to small business or something like that.

That being said, the bank examiners used to, before the Great Depression, basically mark to market, and it is only after the Depression comes when they gain the right to—because the markets, the values affecting it have tumbled so far—to make some judgments. And that is when we get forbearance at that point and that sticks, and we drift away from mark to market.

The CHAIRMAN. Very helpful, thank you.

Mr. Neiman.

Mr. NEIMAN. Thank you.

I would like a follow-on to Elizabeth's first question, where she outlined three arguments against nationalization that are often used. I would like to add another one to the extent that nationalization could result in inhibiting factor for the attractiveness, attracting private capital into other institutions, particularly due to the risk of traders pushing down the price of the stock, shorting the stock in anticipation of which is the next bank to fall.

This, I assume, is a relatively unique circumstance in our current events, but I would like your perspectives from whether it was a factor in your prior experiences and how it was significant. Is it a factor in the debate around nationalization?

Mr. KATZ. In the case of Japan, it actually worked the opposite way. So the first couple of nationalizations, the companies actually went bankrupt.

The government bought them and then fairly quickly sold them off to hedge funds, U.S.-based hedge funds actually in both cases. In the third case, which is the most interesting, the bank had not yet failed. It wasn't a de jure nationalization, but de facto it was. They bought up controlling shares. They fired the top management. They injected lots of capital. They did not wipe out shareholders.

And what happened was the stock market, which was at ridiculously low levels, suddenly recovered because other people felt, okay, they are not going to wipe out the shareholders in rescuing the bank, but they are going to fire top management and they are going to say you either get those loans off your books, or we are going to get them off for you.

And what happened was then it concentrated minds in the other banks, which had not been getting the bad loans off the books. They started getting off the loans very quickly so they would not be taken over. And then they began to do all kinds of stock issuance. Some of it was pressuring their customers to send in stock. But the fact is that stocks, including bank stocks, did rally, and from that point on, it was about 2 to 3 years before the problem was really solved.

It ended up attracting capital because it induced the management to finally step up and do the right thing.

Mr. COOKE. Well, I just want to comment. In terms of the institutions—you are not going to attract investors until they are comfortable with the asset problems. I realize short sellers and hedge funds can try to drive prices down, but if you have a bank and you have isolated the problems and take it out, there are plenty of investors looking to buy banks.

One comment about nationalization in terms of political interference. Some may disagree with me. Back when we had Continental Illinois, at the time it was the seventh largest bank. There is a tendency for regulators, when they are running a bank, to be overly risk averse, and that is probably not the right thing to say now. But, there is such a tendency to not be unfairly competing with other banks that are healthy or to take risks.

And, I don't think you can do that very long. So if the government nationalizes, it is best not to stay long. Get it out of government hands.

Mr. LUNDGREN. Well, I have no further comment. I don't think—I don't see that as a problem. We didn't experience it either. But a good thing, if you encounter a situation where you have to, due to crisis management, nationalize, not because you wish to nationalize, you get a better tool in order to get taxpayer money back.

One of the reasons our 4 percent of GDP that the total outlays were in '92 and '93, of that, most of it came back. A lot of it due to value increase and later privatization of the bank or the banks, rather, that were nationalized. So that is a way also of getting back to having an upside for the taxpayer as well, I would say.

Mr. NEIMAN. To include Dr. White in this discussion, am I correct that FDR imposed two rules in this respect? One eliminating mark-to-market for bank valuations and also under his first chairman of the SEC imposing the uptick rule to address the concerns around short selling?

Dr. WHITE. Yes, that is correct.

The CHAIRMAN. I think that you have all hit on this. I was really struck when I read the testimony that you all submitted in advance, which I appreciate. And it is certainly been a part of what we have been talking about today. But I want to give you an opportunity to draw a tighter line on the issue of honesty that I keep hearing in different incarnations.

And if you can, I just want you to draw this line, if you can, as tightly as possible between what you learned from your experiences, what honesty meant in the context that you studied it or lived it and to how that affects or should be affecting what we are talking about today? Why this seems to be a live issue, if that would be appropriate?

Could I start with you, Mr. Lundgren?

Mr. LUNDGREN. It is a question of what you really mean with honesty.

The CHAIRMAN. That is why I asked.

Mr. LUNDGREN. It is vital that government is perceived as honest by the people. I mean, obviously, we had to be very, very straightforward, very open, very transparent. I went to Swedish parliament three or four times in order to be open about what we were doing and so forth. That is one thing.

The second thing is that, obviously, a lot of bonuses we had at that time as well, or golden parachutes, you have to handle that. And you will be very strict in trying to reduce, get rid of, and so forth. And we also had—we sued boards of the two banks that were nationalized for compensation, since they obviously were not up to their responsibilities. There were breaking of bank rules and so forth. And we got some compensation out of that as well.

So from a political point of view, you have to be very, very straight and very honest, and you have to try to see to it that people also understand that you shouldn't be given gratification, bonuses or whatever, if you run something badly. And that is also a necessity to handle.

The CHAIRMAN. I wonder if you had imagined that you would come here to testify to such points any time before the most recent past.

Mr. Katz, you speak about this, and you speak about reluctance to acknowledge problems in Japan.

Mr. KATZ. I think honesty is two levels. One is there was a theory in Japan that you would shatter confidence if you admitted the truth. So there was, on the instructions of the finance ministry, deliberate cooking of books. The problem is it destroys confidence because ultimately reality does come out.

And certainly, if we don't even know how big the derivative market is—we didn't even know the size of the AIG exposure and all the links—then we cannot prepare for a crisis. So that is one level of honesty.

The other level of honesty is what got us in the crisis in the first place. My belief is at the heart of the American crisis was a corrupt corporate governance system where CEOs were compensated in a way that they had to hit homeruns. If they hit homeruns, they got huge, huge bonuses. And if they struck out, there was no penalty.

And should they actually get kicked out of the game, which is to say drive their company underground, they got $140 million severance pay. So, naturally, you get people who should be hitting for singles and would be .300 batters who are instead always hitting for homeruns and striking out.

And there is a huge difference between the performance of CEOs paid by stock options and those who were not. We also stopped applying rules that say when you lend to someone, they have to have a downpayment. When you lend to somebody, they have to be able to pay back. Also it would be preferable if they were alive. We have cases of banks lending to people who were dead.

And so, these nonbanks originated these dubious mortgages and the nonbank portions of commercial banks could then unload these dubious loans, loans they knew to be probably fraudulent, on to other people through securitization. But executives made tons of money and faced no penalty.

So we had an incentive system, which actually incentivized executives to do the wrong thing. That is a whole level of dishonesty that was not the case in Japan. It was much worse here.

The CHAIRMAN. Thank you. Mr. Cooke.

Mr. COOKE. I would just say, really, transparency is key. If you want honesty, the Government has to be honest. And I am pretty sure that the Government was not totally honest back in the S&L days. Everybody thought those problems were going to be more expensive, and they turned out to be so. So I think there was influences there.

But honesty is important. You know, the Government has to be honest with the people, and they have to be—I mean, what is the situation right now? To me, the honest answer is the Government really doesn't know. And what is worse, I don't think the bankers know. I don't think the heads of the major companies know any more than the regulators know about where the risks are. It is all over the place.

So it is first try to feel, just tell the people that and say I am going to try to solve it. Maybe the stress test is the answer that they are doing. But it would be interesting to see exactly how that works, considering how global and complex these things are. Myself, I have great reservations.

The CHAIRMAN. Thank you. Dr. White.

Dr. WHITE. I would agree that it is transparency which is very important because if you have forbearance, then many things can happen.

On the point actually of corporate governance, the reason why financial institutions are able to take these extraordinary risks is the fact that you have insured many of these institutions. That is the other side of the balance sheet, so to speak, so that that is one of the underlying, I think, problems is that there is such an extraordinary ability to take risks. And there is no risk essentially that a run will materialize or any sort of penalty will be imposed except from the oversight of the agencies.

The CHAIRMAN. Thank you very much.

Mr. Silvers, last question. We are going to—no, I mean down the line. [Laughter.]

Mr. SILVERS. First, in preparing for this hearing, I had a look at a report done by the Norwegian bank authorities, looking comparatively at the Scandinavian experience during what you described, Mr. Lundgren, as the regional crisis. Could you comment on the role played in terms of the net cost to the public in each country that faced this crisis? The role played by how aggressive they were in terms of taking upside?

Mr. LUNDGREN. To be honest, I haven't studied that. We studied, before taking to work with our crisis, the savings and loan crisis. We went back to 1933. We studied what happened in Norway some years before Sweden. They were nationalizing quite a lot, and we didn't really like to do that, if we could.

I haven't followed up to what extent their initial outlays have been repaid. What I know about is our own, which was, as I said, 4 percent of GDP, of which most is back, due to bad banks' handling of the bad assets and so forth as well. But I have no comparison with Norway.

Mr. SILVERS. They concluded that—and again, I don't wish to spark any sort of rivalries here. But they concluded that essentially in those circumstances in which very aggressive positions were taken in terms of taking equity upside that it was directly correlated to the net final cost to the taxpayer.

Mr. LUNDGREN. I mean, obviously, if you go in as owner, you get the upside, the whole upside in the bank. So, obviously, then it is a question, if you want to do it or use it as a tool, the first tool if you want to do it otherwise. It would be better if banks managed to get equity on their own, but still we managed to get most of the money we spent back.

Otherwise, the main problem for us with Norway is all their gold medals. [Laughter.]

Mr. SILVERS. You know, Mr. Lundgren and other witnesses have been very kind to be with us. And obviously, these issues are front and center not just for the United States, but on a global basis, as my colleague Mr. Neiman stated in his opening remarks.

I would like to use the rest of my time to give Mr. Lundgren in particular, but any of you, the opportunity to comment further about the particular situation of today, and what, in your view, would be helpful policy for the United States to pursue in relation to what is obviously a global crisis.

Mr. LUNDGREN. I mean, being a small country representative, I shouldn't say so much. But on the other hand, what obviously is needed is some kind of—I mean, you have to restore confidence. And if stress tests will do that or not, it is difficult.

But you have to have a way of getting people, investors, ordinary people understanding that you have—you are comfortable with handling the situation. You can tell about the size of the problems and so forth.

We did a blanket guarantee for creditors and depositors. That restored confidence immediately. I see the problems with that. On the other hand, I mean, some kind of guarantee can help out, especially if it is difficult to value assets without having to buy them or try to make as you said an administrative pricing of that, which is very difficult to do that.

In 1933, the Roosevelt administration did close the banks and restored confidence by that way. It is not very recommendable to do it, of course, in modern times.

But to find the size of the problems in one way or another also guarantees that you can restore both confidence by showing the size of the problems, by guaranteeing or whatever, and then also being able to do the capital injections, having the frame, the economic frame to be able to convince people that the capital base will be restored. So lending will take place in the same amount as before the crisis as well.

Mr. SILVERS. Can I just stop for just one second on capital base? It seems to me that we have shifted from a moment in which sort of systemic confidence was the main issue, which was clearly the case in October, to a situation in which we have large, a handful of very large, systemically significant institutions with no capital base or an unknown capital base, I think, to Mr. Cooke's comment.

Does that strike you as the right—and I would welcome anyone, but since Mr. Lundgren was talking, does that strike you as the right description of where we sit today?

Mr. LUNDGREN. I mean, obviously, there is a lot of uncertainty. I mean, exactly how certain it is for different institutions. But all around for the banking sector as a whole in the U.S., both in the U.S. and abroad, obviously nobody knows how the situation is. And that is something that you have to make clear.

Restore confidence and restore capital base. That is a necessity, either by Government or by private capital, if possible.

Mr. SILVERS. Now you can't have a living bank without an adequate capital base, can you?

Mr. LUNDGREN. No, no. I agree with you, and then perhaps government has to inject that capital, and then as I said, I think that for the taxpayers' sake—and being a market conservative—working with market economy, you should also have the ownership.

Mr. SILVERS. Radical notion.

The CHAIRMAN. Thank you.

Superintendent Neiman.

Mr. NEIMAN. I am interested in your views, based on lessons learned as well as your current thinking, on how to structure these asset purchases by the Government of these toxic assets in a way to best protect the taxpayers. Are there other means, both in terms of valuing the assets or structuring, so that government is not paying all cash up front, giving it a right to recover a part of the losses suffered based on a later disposition of those assets?

I would be interested in your thoughts, starting with David Cooke.

Mr. COOKE. If you are providing assistance to a bank, then, yes, I think you should have some protection. If you are going to basically help them out with the assets and it turns out things turn out better, the Government should have something.

That potential drain, though, it is going to discourage investors. If you want to bring new capital into the institution, depending on what you want. That doesn't make sense if you ended up effectively paying too much for the asset, then, sure, it would make sense that the Government would share, would get something because the bank is better off than it would have been. But if it gets too much, the bank is back where it was.

So it is a difficult thing to structure, but you probably can create some kind of reverse sale or something, as long as you have competition. And you can certainly price any asset. These are complex assets, but you can price them because underneath them somewhere there is an asset. There is a loan. There is a house. So you can do it. It is not going to be easy.

So you can figure out a standardized approach to set your price, and then just get yourself some upside if you end up paying effectively too much.

Mr. KATZ. Could I add here? In the private market, basically, you have an awful lot of debt-for-equity swaps. I don't see why, if the Government wants to inject the money, it cannot do a similar thing. So there is an upside there.

I look at the situation a little bit differently than Mr. Silvers. If you look at the figures, the banks, despite much more aggressive writing off of bad assets than in Japan, have an asset-to-liability ratio that is fairly high relative to current assets. It is just low relative to the future because they are going to have still more to write off.

But I don't see the problem in terms of the actual normal, plain vanilla lending. The problem is that the securitization market is so frozen that a bank which makes a car loan can't then securitize it today, use the proceeds to make yet another loan, yet another loan. So even though the bank portfolio is going up, the actual net credit in the economy is going down.

I think Bernanke's measures of guaranteeing certain things, backstopping certain things is immensely helpful. Whether you use a good bank/bad bank technique or nationalization, you have to find some way to separate the good assets from the bad. I think pricing is difficult because in the shadow banking system, so much is obscure and unknown. It is not like pricing a loan for a house, where there is a relationship between the value of the instrument and the value of the underlying asset.

The shadow banking system is so obscure, and that is why markets are frozen. That is what makes this difficult, in my view.

The CHAIRMAN. Do you want to say something else?

Mr. NEIMAN. No, go ahead.

Mr. SILVERS. I read this part of your testimony, Mr. Katz, in relationship to this question. And it seems—and I was trying to reconcile your data with what we know about conditions in credit markets right now in the United States and what everyone tells us in field hearings and so forth. And I want to test something by you on this.

If you look, we have four very large institutions now. Two of those institutions come back, have been coming back on a repeated basis to the Government for more capital. And it appears to me as though their capital ratios in some sort of real sense—although again there is a real question of what reality is here at all—are significantly lower than the averages you have, all right?

You have a third, Wells Fargo, where I would say it is a little thin, although they haven't come back for more money. These are sort of keystone institutions with a major presence in secondary markets, and it strikes me that that may explain this kind of paradox of the data you have versus people's experience in the credit markets today.

And it also, again, focuses the problem that we face on what to do about these very large institutions, not the banking sector as a whole. And I wondered if does that make sense to you, or do you have another explanation?

Mr. KATZ. Well, you know what? It puzzles me also because of these things. Here is my sense of it.

First of all, some of the capital the banks raised, was raised in the first three quarters of the year before TARP. But there was this huge jump in the fourth quarter, so part of what we are calling the capital is, in fact, the result of the injection that has already occurred.

And there will need to be further injections. I said you have to look at the capital ratio not only to their existing assets, but since we don't really know the value of those assets, they are going to lose more capital going forward, certainly in the next few quarters. So in relationship to that, they are going to need more capital.

But the fact is they have been aggressive about writing down. The real problem here is that I think you have to distinguish the writedowns of actual loans on real homes, cars, whatever, and the default rate there versus this mark-to-market writedown on securities, some of which is justified and some of which is not. And just the level of uncertainty is causing derivative levels to be lower than perhaps they ought to be.

And that is why I think you need to separate the shadow stuff and dubious assets as well as outright toxic assets from the good assets. You have to do some sort of separation. In all of the examples that worked, there was a separation.

In terms of the experience of borrowers, it is the fact that the bank cannot use the same dollar four or five or six times by securitizing the loan. So that is how I reconcile the fact that the outstanding loans on the books of the banks are going up, but people are not getting the money because the asset-backed securities market is going down.

Mr. SILVERS. Our metrics for understanding credit markets don't take into account how important the shadow credit markets have become and are not capturing the reality of what constitutes bank activity in this area anymore.

Mr. KATZ. Because laws were passed that prevented us from knowing that under the theory of deregulation.

Mr. NEIMAN. Yes, and I have confirmed that through conversations with the Fed economists. And, it is very revealing because they, in looking back at past recessions over the last 30 years, where bank lending has declined over that period of recession. This is a period when you look at that bank lending and it has actually increased from the start.

Mr. SILVERS. It is misleading.

Mr. NEIMAN. But it goes to the exact point I think that Mr. Katz is making about being able to securitize those loans and not making up for the difference in the lack of a securitization market.

Any other follow-ups on the pricing of toxic assets if we were to create a bad bank or in the Treasury's implementation of its private-public fund?

Mr. COOKE. I would just make the comment that I agree that what the Fed is doing now to try to restore some liquidity to the more easily quantifiable assets, the loans, makes a lot of sense. But I am pretty familiar with how securitization works and you can value those assets based on the underlying cash flows. It is not easy. You have got to get a lot of information you may not have access to. You need to get that information. But there is a way to approach it, and then to establish, if you are going to be on the buy mode, on the buy side, some value. But some of this, some of these derivatives and all are very, very complex. But they are solvable.

Mr. KATZ. The Government may have to go in and create a market by buying some toxic assets. When somebody actually goes and create a market, that is a price. If it is the wrong price, the market will either push it up or push it down. But at least you started something as opposed to when there is no activity, then nobody else can make a decision.

So make a market. And if you have made a mistake, it is a lot better than doing nothing and having the whole thing frozen. It will adjust.

The government needs to create a debt-for-equity situation. So even if taxpayers lose on the downside, when the upside does occur, the taxpayer will get some of that back. And then you have created a market. You can begin unfreezing things.

The CHAIRMAN. Let me ask on the question about markets because this is the one that puzzles me. So if the Government comes in, let us just say, hypothetically, and it buys at a highly inflated price because its ultimate goal is to make the banks look better, to make the financial institutions look better, how does that start a market?

It says, hey, any time the Government will come in and pin $20 to it and sell it, someone will buy it. But why does that start a market by itself if you use a highly inflated price? How does it produce the next purchase once the Government is not in it?

Mr. COOKE. No, I think if the Government pays too high, it is going to be stuck with the assets, unless it turns out to be right, sometimes, a miracle happens. If it pays too low, it will be a difficult problem for the Government. But it has to have a rational basis for establishing those prices. If it pays too low, it is going to bring down other banks.

The CHAIRMAN. So your real point about it is not just that someone will come in and make a purchase, it is that someone will come in and make a purchase that at least starts close enough that you are talking about markets. You are not talking about subsidization——

Mr. KATZ. No, no, no. I am not talking about going crazy.

The CHAIRMAN [continuing]. Through the back door?

Mr. KATZ. I am saying do your best possible estimate.

The CHAIRMAN. Fair enough.

Mr. KATZ. In a market that is just so crazy, if you are 10 or 20 percent too high or 10 or 20 percent too low, that is something you can adjust to. If you are paying twice as much, well, then your markets can't clear.

The CHAIRMAN. But then what you are really saying is the only thing you can be driven by is trying to get an accurate market price because that is the only thing that runs at least the opportunity for starting a market, as you put it.

Of course, go ahead. Mr. Silvers.

Mr. SILVERS. Yes, I am struck in this conversation by what I think was a model more or less in common of the RTC and the Swedish experience, which was to—and you all tell me if I have this wrong—which was, in the case of the RTC, you simply took the assets in a receivership mode, and I think, Mr. Cooke, your testimony was that you sold low in many cases?

Mr. COOKE. We had to start to gin the market up, get it motivated in some areas. Yes.

Mr. SILVERS. Right, and then, effectively, the Government only insured depositors. Whatever the hit was as a result of that was eaten by bondholders, effectively. Is that right?

Mr. COOKE. Right. But let me just qualify that. We ended up with very conservative valuation assumptions that we were pretty convinced, advised by the advisors, if we could show the cash flow and we use the market discount rate, we would be able to move these assets. We didn't sell them lower than what we thought was a fair price, but at what we thought was a market based, more realistic price. So we weren't trying to sell low.

Mr. SILVERS. No, I understand that.

Mr. COOKE. Market competition came in, and prices went up.

Mr. SILVERS. Right, but the key feature of what you did was is that you looked, and the process of doing that, which obviously did create markets for real estate in some places. In the course of doing that, your basic receivership was structured so that the losses that were going to happen versus the books at these banks was in the first instance absorbed by bondholders, right? And in the second instance absorbed by the taxpayer?

Mr. COOKE. Yes, anybody that had any claim against the receivership, they suffered the loss first. I mean, shareholders would take the first——

Mr. SILVERS. Shareholders took first. Bondholders took second.

Mr. COOKE. Well, it depends. Bondholders may share—at that time, and I think it is still the case, pro rata with general creditors. We didn't have a preference. Then later, somewhere in there, I forget when, they give a depositor preference. Congress passed that.

Before then, we were just like any other general creditor. So if the bondholder lost, we lost. The Government lost. Its agency lost.

Mr. SILVERS. So the depositors were made whole in a context in which the Government as deposit insurer was pari passu. It was on par with the bondholder in the losses. Is that right?

Mr. COOKE. At that time, yes.

Mr. SILVERS. Right. Now, in the Swedish case, you all, as you said, Mr. Lundgren, you marked down very aggressively the assets when you took control of banks. That is correct?

Mr. LUNDGREN. Only a couple of banks marked down, and we tried to find a mark-to-market valuation with a valuation board with a lot of experts on. We did, I think, 30,000 valuations or something like that for different real estate.

But aggressive or not, we tried to find the right at that time mark to market, but only for the assets in the banks that we took over. So we only formed bad banks for those. We didn't have one bad bank and bought other assets as well because—and that is why we didn't have a no valuation problem. If we were wrong, in a way, it was just in our own bank.

And bad banks were formed also by the private banks that survived. They also did, and they formed their own bad banks.

Mr. SILVERS. Let me just clarify also one thing while the chair is kind enough to give me the floor. Some people have asserted in U.S. debates that should the Government impose a receivership on one bank, it would have to do so on all, particularly in relationship to major institutions. That was not your experience, I gather?

Mr. LUNDGREN. No, it was not. I mean, it depended on if the bank needed huge capital injections, which made government forced to take over the bank or get the majority anyhow. And that was only for these two banks. The others had a threat of having it coming into that situation, but they managed on their own.

But what we are talking about here is, of course—I mean, we had, as the RTC, rather plain vanilla situation. Today, it is much more complicated, and I have all respect for that, and that is why I am thinking from my experience some kind of guarantee. Without buying assets, finding a situation where you really can't find the right price, where you have a possible upside, you need to have it for the taxpayer.

I mean, to use some kind of guarantees instead to restore confidence might be a possibility instead of a long, drawn-out process of trying to value unvaluable assets.

Mr. KATZ. Could I make a comment from the Japanese experience? You know, if you had all these bad debts in Japanese banks, and again, there really is a difference between if it was an underlying asset, you would need to have a market-clearing price. But if there is no market, then there is no market-clearing price.

Okay, so you had these assets the banks didn't want to get rid of, couldn't get rid of, whatever. And Lehman, of all people went out to the banks and started buying their bad loans. The banks couldn't get rid of them because foreclosure laws in Japan are so cumbersome, they really couldn't foreclose. And Lehman and others started buying them on, say, 20 cents, 30 cents to the dollar.

And then they would sell the loans back to the borrower for 40 cents, 50 cents on the dollar. So the bank got rid of some stuff at a very low price. Lehman made oodles of money. And the borrower had their debt cut in half. Now which price was right? The 20 percent that Lehman paid or the 40 percent that the borrower paid back to Lehman?

Well, the point is a market was created. And over time, things began to coalesce. Once you have a market, then you could have a market-clearing price.

My concern is in this area of these derivatives where the market is frozen, and there is no market—and I think Ben Bernanke is doing a superb job at trying to unfreeze that. That is why I am saying if you have a rational estimate of the right neighborhood, then you go about doing things to de-stress asset markets, resell them to other people. Prices will begin to be created, and they will go up or down, and we will find a price.

Mr. SILVERS. Can I just comment on this that it seems to me that it is not possible to have that sort of effect if your primary objective in setting the price that you sell assets or that you buy assets because I think that is what we are talking about—buying, not selling—what Mr. Cooke was doing.

If the Government's primary purpose in buying assets is to prop up stockholders in the banks, then the prices that the Government will put out there to buy will always be prices that are not—they don't have any credibility in the marketplace because any price that comes anywhere near where shall we say self-protective actors in the market are willing to operate at will be one that will reveal the capital inadequacy of the banks.

Mr. COOKE. Could I just make a comment on one thing? Just on one bank's failure bringing down other banks. That may be a reference to the cross-guarantee provision. Are you familiar with that?

Mr. SILVERS. No, it was a reference to the argument, Mr. Cooke, that—and I think Richard alluded to it a moment ago—that once you start, that in modern market conditions, once you start stepping forward and forcing dramatic dilution of equity holders, that you will set off some sort of dynamic of lack of confidence in the equity markets that otherwise healthy banks would have be taken over through a bear raid or panic of some sort in the equity markets. That was, I think, the position certainly held by Paulson's team.

Mr. COOKE. I don't know. I don't know if that would happen or not. As far as guarantees, one thing, some of the solutions the FDIC did when we were at the RTC, they found sometimes they would package up a failing bank. They would turn it over to another healthy bank, and they would have them isolate the bad assets, and they would get a stop-loss protection, but it wasn't to the same owners and the same people. It was outside that.

The CHAIRMAN. Thank you.

Mr. Neiman, I want to make sure you complete your questions. I am afraid Mr. Silvers and I——

Mr. NEIMAN. No, this is a very good discussion. If I had a little time, I would go back to Mr. Lundgren and spend a little time on the disposition side.

From what I read in your Swedish resolution process, there is an indication that had you had more time to sell those assets, you may have been able to increase your return. And, I know that there are issues around the RTC selling too quickly and the impact it has on the market. So I would be curious about the disposition period of assets.

The CHAIRMAN. Please, go ahead, Mr. Lundgren.

Mr. LUNDGREN. Thank you.

The law in Sweden said that banks had to disperse of these kind of assets within 3 years. That was, of course, a short period of time. So we wanted to increase that time. They could hold somewhat longer.

And when we formed these two bad banks for the two nationalized banks, my belief at that time was that we should give them about 10 to 15 years at least, but it was upon what they themselves experienced, that they found that after 5 years, in 1997, they could wind up the operations. They have been quite successful.

You can always argue that they could have recovered even more if they stayed on for 5 more years. But I think myself that it was a good decision to wind up at that time. Altogether, as I said, with the shares increasing in value and privatizations, we recovered most of the money anyhow. So you can always discuss the length of it.

The CHAIRMAN. Good. I want to thank everyone. Thank you, Your Excellency, Ambassador Hafstrom, for being with us today. Director General Lundgren, we really appreciate your coming. And Mr. Katz, Mr. Cooke, Dr. White, this is what it should be about.

I have to say I was very much struck by your comment before and that you alluded to in your testimony that as Sweden worked through its difficulties, that you had turned to the experiences of the RTC and our efforts during the Great Depression in part to help inform the next iteration of how to deal with these problems, and that makes me doubly grateful that you would travel to the United States and bring us your experiences that we might bring them together here.

I want to say that this Panel reminds me of the importance of our having an overall strategy to deal with this problem. It is enormously valuable to hear from four different sets of experiences and to hear common themes that run through them, some of which we have already begun to heed, some of which we clearly have not.

It is also very interesting to hear the much more shall I say muscular approach taken toward management and investors and on behalf of the taxpayers whose money is being used to try to rescue these organizations and to put the economy back on a sound footing. But ultimately, the idea of developing and executing a plan in order to be able to preserve the financial institutions and restart the economy is deeply underscored by the testimony of all four of you.

I very much appreciate your taking the time to be with us today. The record will be held open if anyone wishes to add additional questions.

I am sorry that our colleagues were not able to be with us. I know the press of other business has kept them elsewhere. We may have additional questions that we would like to send to you and ask for your remarks in writing so that they might be made part of the formal record.

With that, this stands adjourned. Thank you.

[Whereupon, at 11:40 a.m., the hearing was adjourned.]