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PROMOTING ECONOMIC RECOVERY AND JOB CREATION: THE ROAD FORWARD

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

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PROMOTING ECONOMIC RECOVERY AND JOB CREATION: THE ROAD FORWARD

Wednesday, January 26, 2011

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the committee] presiding.

Members present: Representatives Bachus, Hensarling, Royce, Lucas, Paul, Manzullo, Biggert, Miller of California, Capito, Garrett, Neugebauer, McHenry, Campbell, Bachmann, McCotter, Pearce, Posey, Fitzpatrick, Luetkemeyer, Huizenga, Duffy, Hayworth, Renacci, Hurt, Dold, Schweikert, Grimm, Canseco, Stivers; Waters, Maloney, Velazquez, Watt, Clay, McCarthy of New York, Baca, Miller of North Carolina, Scott, Green, Cleaver, Perlmutter, Donnelly, Carson, Himes, and Peters.

Chairman BACHUS. This hearing of the Financial Services Committee will come to order. Without objection, all members' opening statements will be made a part of the record.

The gentleman from California, Mr. Royce, is recognized for 1 minute.

Mr. ROYCE. Thank you, Mr. Chairman. While the President touted the strength of our economy last night, significant obstacles stand between where we are today and real economic growth. The housing market continues to sputter, small businesses are burdened with a massive new health care law, and there are real questions about addressing our national debt. Firms are bracing for hundreds of new regulations coming from Dodd-Frank.

Despite what some may say, repairing a fundamentally flawed law does not add to the uncertainty in the market. Rather, healthy capital markets require sound regulations. Dodd-Frank failed in this endeavor. It is now up to us to correct the mistakes of the past, truly end "too-big-to-fail," wind down the GSEs, and ensure safety and soundness regulation is the primary focus throughout our regulatory structure.

I yield back, Mr. Chairman.

Chairman BACHUS. Thank you. Ms. Waters is recognized for 4 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman. As you know, Barney Frank, our ranking member, is not here this morning.

I want to thank you for holding this hearing on "Promoting Economic Recovery and Job Creation: The Road Forward." While the economy has shown some signs of recovery, it is clear that more ag-

gressive action is needed from Congress in order to put our country back on the right track. In spite of a slight decrease, unemployment remains unacceptably high. At 9.4 percent, the economy shows no sign of regaining the 8.45 million jobs that have been lost since 2008, and foreclosures will be 20 percent higher in 2011.

The Federal Reserve has acted because Congress failed to provide an adequately large stimulus given the magnitude of this crisis. The Fed's recently implemented qualitative easing policy is consistent with the Fed's dual mandate of fostering maximum unemployment and stabilizing prices. It is clear to me that since interest rates can can't get much lower, buying long-term securities is one of a handful of options left to the Fed to stimulate the economy.

While reasonable people can have differing opinions about the manner in which the Fed has chosen to stimulate the economy, ending the Fed's dual mandate to both reduce unemployment and keep inflation low, as some on the other side of the aisle have suggested, is not the answer.

I think what we must remember and what has been lost on some of my colleagues on the other side of the aisle is that this unemployment is a result of the financial crisis of 2008. This crisis, which represents the biggest challenge to the Nation's economy since the Great Depression, led to less credit for small businesses, prospective home buyers, and other groups who traditionally drive local economies. While they played no role in creating this crisis, they, like everyone else, are now suffering the consequences of the systemic risk caused by the risky behavior of a few reckless institutions, behavior which culminated in a bailout of Wall Street. The logical response to this systemic collapse of the financial market was for Congress to fill in the regulatory gaps so that this never happens again.

The Dodd-Frank Act reforms the derivatives market, establishes a Financial Stability Oversight Council to monitor for systemic risk, bans proprietary trading, and makes other fundamental changes to a financial industry that we can't afford to bail out again.

Unfortunately, instead of focusing on solutions to create jobs, today's hearing seems to be aimed at criticizing the Fed for acting in a manner consistent with this dual mandate and criticizing the legislation that will prevent another bailout. I am interested in working on solutions to create more jobs. However, I believe we must protect the reforms in Dodd-Frank because by preventing another bailout we are preventing another financial collapse that will result in the loss of millions more jobs.

Thank you, Mr. Chairman, and I yield back the balance of my time.

Chairman BACHUS. Thank you, Ms. Waters.

Let me explain to the witnesses and the audience that we are having 10 minutes on each side; we have restricted the time for opening statements because we want to hear from our witnesses. Mrs. Capito and I have both surrendered our time to allow some of our other members to make statements.

At this time, I recognize Mr. Hensarling for 1 minute.

Mr. HENSARLING. Thank you, Mr. Chairman. Last night in the State of the Union Address, the President said, "To reduce barriers to growth in investment, I have ordered a review of government regulations. When we find rules that put an unnecessary burden on business, we will fix them."

Mr. Chairman, we found one. It is called Dodd-Frank. Unfortunately, in the President's announcement he seems to exempt from the ambit of regulatory review both Dodd-Frank and ObamaCare, which if you talk to any job creators in our Nation is about 90 percent of the challenge that they face. Whether it be fiscal policy, monetary policy, or regulatory policy, too many job creators in America feel they are either facing uncertainty or they are facing hostility. It is one of the reasons that, unfortunately, under this President's Administration, with the exception of 2 or 3 months, unemployment has hovered around 10 percent.

I understand that Dodd-Frank is the law of the land. Not all aspects of it are bad. But we were looking at no fewer than 243 new formal rulemakings—and, by the way, there is even uncertainty about how many rulemakings. It will be the job of this committee to ensure that although the rulemaking is approached deliberatively, it is better to get it right than to do it quick.

With that, Mr. Chairman, I yield back.

Chairman BACHUS. Thank you, Mr. Hensarling.

Mr. Baca is recognized for 2 minutes.

Mr. BACA. Thank you very much, Mr. Chairman. We all heard the President last night state that the future is ours to win—and that means that we all need to work together and create jobs. That is why I am looking forward to this session, and I hope that my colleagues in this committee are committed to working in a bipartisan fashion over the next 2 years, and that is important for us if we are to progress and go forward.

We have a lot of work to do. The American people are still not satisfied with the state of our economy. Unemployment is still at an unacceptable level, and in my district it is about 14 percent. We still are one of the highest in foreclosure. Middle-class families are still dealing with the harsh reality of not being able to make their mortgage payments. Over the last 2 years, I believe this body and the Administration has made some progress, but our work is far from being done.

I hope that we will be able to analyze—and I state analyze—the positive actions we took over the last 2 years and see how we can build on it. I think that is important for us in this committee, to find out how we can build on it.

With that, Mr. Chairman, I yield back the balance of my time and I look forward to this hearing.

Chairman BACHUS. Thank you. Mr. Paul is recognized for 1 minute.

Dr. PAUL. Thank you, Mr. Chairman. I appreciate you holding these hearings because the subject of unemployment certainly is one issue on which everybody in the Congress agrees. We are worried about it. We need more jobs. Democrats, Republicans, everybody wants to do something with it. But the big problem seems to be that everybody has a different answer. Some people want to increase the spending. Others want to decrease the spending. Some

people want to increase taxes. Other people want to decrease taxes. Then it comes to some saying there are not enough regulations and some saying there is too much regulation. Some people think we can print our way out of it, and that is where the problem comes from.

But I think the problem really is that we fail to ask the right questions. Why do we have unemployment? It might have to do with the fact that we have a recession. Why do we have a recession? We can't have recessions unless we understand that there has been a boom period and there is a cycle. So it is really dealing with the business cycle, why we have boom times, and what we do about that. Rather than just dealing with the symptom, I think we have to look at the overall cause of why we have these boom periods and then we have the inevitable corrections. And that brings us unemployment.

So by tinkering around the edges and saying that we can change taxes or that regulations will solve our problem, I think we will be missing the boat.

I yield back.

Chairman BACHUS. Thank you. Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman. Thank you for holding today's hearing. Nearly 1 year ago in his State of the Union Address, President Obama said jobs must be the number one focus in 2010. Sadly for businesses, for the last 2 years Washington leaders set aside the jobs agenda and instead chose the path of uncertainty. Last night we heard the President again offering a number of encouraging words about the need to focus on job creation, but I have to say I am skeptical of the rhetoric.

The President also called for review and reform of Federal rules and regulations that stifle job growth. Meanwhile, according to the Wall Street Journal last week, "Business leaders say an explosion in new regulations stemming from the President's health care and financial regulatory overhaul has, along with a sluggish economy, made them reluctant to spend on expanding and hiring. Companies are sitting on nearly $2 trillion in cash and liquid assets, the most since World War II."

Authorized by the Dodd-Frank Act, Federal agencies and bureaucrats are lining up to issue to businesses across the country new and costly rules, regulations, and data collecting requests. It is fueling uncertainty; it is stifling job growth; and where are the jobs? To create jobs, the Administration needs to get serious about finalizing trade agreements, reforming the Tax Code, and fostering regulatory certainty for business so they can invest, expand, and grow.

I yield back.

Chairman BACHUS. Thank you.

Mr. Garrett, for 1 minute.

Mr. GARRETT. Thank you, Mr. Chairman. The issue of potential systemic risk has been something that this committee has been looking at now for the last couple of years, and I have said throughout that entire time that if you think about it, the most critical and obvious systemic risk that faces our economy really is our massive national debt that hangs over all of us and our future generations as well. So addressing that risk, we can do so by reduc-

ing the size and scope of the Federal Government is, of course, job one, as has been said. One of the primary benefits of doing so, of course, will be to help the economy start growing again.

But beyond that, beyond addressing the budget and spending crisis facing our country, those of us here in this committee have the opportunity to remove and review regulations, just as the President said, those outdated regulations that stifle job creation and make our economy less effective.

But as Jeb has pointed out, the President tends to exempt some new regulations called for under Dodd-Frank as well as those independent agencies. At least one of those agencies, however, is doing the right thing, and that is the SEC. Under the leadership of Mary Schapiro, she intends to proceed as if they are subject to the President's order. So I look forward to working with her and with the SEC and with other agencies that continue to do what the President has asked for to eliminate those unnecessary regulations of all variety to help incent job creation and get our economy back on the move.

Chairman BACHUS. Thank you, Mr. Garrett.

Mr. Scott, for 2 minutes.

Mr. SCOTT OF GEORGIA. Thank you, Mr. Chairman. Jobs is certainly the priority of our Nation. There are currently 14.5 million Americans out of work. Currently, the national unemployment rate stands at 9.4 percent. And in my home State of Georgia, the unemployment rate is a staggering 10.2 percent, with over 500,000 Georgians unemployed. Our country did see a modest gain in economic recovery in 2010, but unemployment remained high. An estimated 7 million Americans, referred to as "99ers," exhausted all unemployment benefits, and 16.7 percent of workers either could not find a job or have simply given up looking for work.

However, despite these discouraging numbers, our job market is showing some signs of improvements. The progress is, in part, due to the policies guided by this very Financial Services Committee in the last Congress. Economic experts are anticipating faster growth in 2011, with more firms expressing positive hiring plans than in over a decade. A recent survey from the National Association for Business Economics found that 82 percent of the economists expected the Nation's economy to grow by 2 to 4 percent in 2011. These are promising sentiments, and along with my colleagues on this committee, I look forward to taking advantage of every single opportunity to further increase economic growth in the 112th Congress.

We must make sure that the United States has the most competitive and innovative workforce and economy in the world. This is the only way that the American people will be able to face the future with confidence and with boldness the way we need to.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you. Mr. Pearce. Mr. McHenry is not here.

Mr. PEARCE. When we are talking about jobs, we ought to take just a second to ask, what does it take to create a job? Bill Sweatt over in Artesia, New Mexico, said it best: "It takes me $340,000to create a job. I run bulldozers." He said that is what a new bulldozer costs. Any time we tax away his capital, then we take away

his right to create a job; any time we create regulatory uncertainty where he is afraid to invest in that bulldozer, we kill a job. We have systematically killed jobs in the timber industry, we have killed jobs in the oil and gas industry, we have killed jobs in the mining industry, and we wonder why we are at 9.5 employment. It is a specious question that we are asking.

We know what is wrong with the economy. We know where the jobs are. We are not willing to take the steps that are there. I do not think that we can cut spending enough to create the solutions to our economy. We must rebuild our jobs. Let's put the capital to give them certainty and give them tax advantages and they will begin to invest again. That is what it will take to create jobs.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you, Mr. Pearce.

Mr. Watt, for 2 minutes.

Mr. WATT. Thank you, Mr. Chairman. If I thought this hearing was really about jobs and job creation, I wouldn't be so worried. What I am really concerned about is the content of some of these witness statements, which really get us into exactly this issue of the independence of the Federal Reserve and the appropriateness of the Federal Reserve's dual mandate.

So I am kind of like President Reagan. Here we go. We have had this debate. If we are going to have a Fed, we need to allow it to be an independent Fed. If we want to go at whether the Fed should exist or not, then we can have that debate in Mr. Paul's subcommittee. But to do it under the guise of talking about creation of jobs, I think, is just disingenuous.

We are here politicizing the Fed. We are going at their independent status, and that is a debate that we ought to have in a clear-cut, unadulterated manner. If you don't want the Fed, then come on and say you don't want the Fed. But don't come in and try to impact its independence circuitously by going at the mandate it has. We gave them that mandate and we gave them the independence to exercise that mandate. And if we want to take it back, we ought to do it directly rather than trying to do it by chipping away and talking as if we are talking about creating jobs or not creating jobs.

Everybody wants to create jobs. I don't think this hearing is about creating jobs. It is about the independence of the Fed and whether we are going to politicize the decisions that they are making.

I yield back, Mr. Chairman.

Chairman BACHUS. Thank you, Mr. Watt.

Mr. Fitzpatrick for 30 seconds. All the other remaining opening statements will be for 30 seconds.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

It is entirely fitting and appropriate that at our first hearing we discuss job creation and economic recovery, and I appreciate the chairman's leadership on these issues. Americans are hurting, and certainly my constituents in the Eighth District of Pennsylvania are among them.

This committee is in a unique position to assist in our country's economic recovery. It can be said that the financial sector was one source of the great recession, but with responsible rules and safe-

guards and leadership from this committee, our Nation's markets will continue to lead the world and be a source of American prosperity. We all look forward to getting to work and listening to today's testimony.

Thank you, Mr. Chairman. I yield back.

Chairman BACHUS. Thank you.

Mr. Huizenga.

Mr. HUIZENGA. In the interest of time, I have a longer statement for the record that I would like to submit, if that is all right with you. But I want to thank the chairman.

Chairman BACHUS. This won't take away from his time, but anyone who has an opening statement can submit it for the record. We have already had an unanimous consent for that.

So we will start the time again.

Thank you.

Mr. HUIZENGA. Thank you, Mr. Chairman. I appreciate the opportunity, and Ranking Member Frank, for holding this important hearing today. I am a small business owner from Michigan involved in real estate and construction trades, and I can tell you that Michigan has been hit like no other State. I see some heads nodding already.

In recent years, the unemployment rate has been well above the national average. There are areas in my district in the Second District in Michigan that I represent which actually have seen the official unemployment rate double the national average, and that is not including the hundreds of thousands in Michigan who have stopped looking. We need to turn this around.

Last evening, we heard the President declare that the actions of this Administration and Congress had "broken the back of this recession." I am not convinced that we are out of the woods. I can tell you the people on the ground back in Michigan don't believe that. And that is my main concern.

There are some small business principles that I live by and run my businesses by. One, don't spend more than you take in. I think, clearly, we are violating that. Two, do what is necessary to create an atmosphere for success. I am concerned that while well-meaning—as well-meaning as our current law is here under Dodd-Frank, we don't achieve that goal through that.

Chairman BACHUS. I thank the gentleman from Michigan.

Mr. HUIZENGA. Thank you, sir.

Chairman BACHUS. Mr. Dold.

Mr. DOLD. Thank you, Mr. Chairman.

I certainly want to take this opportunity to thank the witnesses for joining us today, and we look forward to your insight. What we are talking about today is jobs and the economy, how do we improve those things. We must improve the climate for business. I am a small business owner. I am a job creator. And one thing that I can tell you is that back in my district, the unemployment rate in certain areas is well above 20 percent.

We need to create an environment that allows businesses—small businesses, medium-sized businesses, and large businesses—to invest back in their businesses. Right now, they are unwilling to do so because there is no certainty. We need to create more of a certainty in terms of the environment and cut down on the onerous

regulations to make them more competitive and even the playing field in a global marketplace.

So I look forward to your comments today, and I yield back.

Chairman BACHUS. I thank the gentleman from Illinois.

At this time, Mr. Schweikert, the gentleman from Arizona.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. I truly appreciate you putting together this hearing. Being from Arizona, we are basically foreclosure central. The devastation that I have seen in my real estate market; the number of families who have been just crushed by home prices, but also banking, Fannie Mae, Freddie Mac, policy. And, Mr. Chairman, I truly hope you have some real talent on this panel. If there is a moment where I can also reach out to each of you because I have some very technical and very specific questions I need some data on. I would really appreciate that opportunity.

So, thank you, Mr. Chairman.

Chairman BACHUS. I thank the gentleman from Arizona.

At this time, the gentleman from New York, Mr. Grimm.

Mr. GRIMM. Thank you, Mr. Chairman. I would like to thank you for calling this hearing on job creation. We all know it is a top concern for America, and in just about every kitchen table in Staten Island and Brooklyn, that is the number one discussion.

What I would like to hear today is a discussion on how this recent legislation is creating uncertainty for small businesses. Specifically, I would like to discuss how Dodd-Frank regulatory reform may affect the flow of credit to small businesses that are looking to expand, create jobs, but they are finding that their ability to do so and their access to funds in a cost-effective way have been restricted.

With that, I yield back.

Chairman BACHUS. I thank the gentleman from New York.

Our final opening statement will be from Mr. Stivers, the gentleman from Ohio.

Mr. STIVERS. Thank you, Mr. Chairman. I appreciate you calling this hearing. Obviously, jobs is the number one issue. In Ohio, where I am from, we have over 10 percent unemployment in some parts. Obviously, jobs is the number one issue in Ohio, and we have small business and business people sitting on capital unwilling to invest in their businesses to create jobs.

And so I would like to hear today from the panel a little information about the unintended consequences of our current regulatory scheme, including Dodd-Frank, and how it is adding to the uncertainty and keeping business from having access to capital.

Thank you, Mr. Chairman. I look forward to hearing that.

I yield back.

Chairman BACHUS. Thank you. I thank the gentleman.

At this time, I would like to introduce our very distinguished first panel for today's hearing, which is entitled, "Promoting Economic Recovery and Job Creation: The Road Forward": Dr. William Poole, Distinguished Scholar in Residence, Alfred Lerner College of Business and Economics at the University of Delaware; Professor John B. Taylor, the Mary and Robert Raymond Professor of Economics at Stanford University; Dr. Donald Kohn, Senior Fellow at

the Brookings Institution; and Professor Hal S. Scott, Nomura Professor of International Financial Systems at Harvard Law School.

We welcome your testimony, gentlemen. We will start with Dr. Poole.

STATEMENT OF DR. WILLIAM POOLE, SENIOR FELLOW, CATO INSTITUTE, AND DISTINGUISHED SCHOLAR IN RESIDENCE, ALFRED LERNER COLLEGE OF BUSINESS AND ECONOMICS, UNIVERSITY OF DELAWARE

Mr. POOLE. Mr. Chairman, and members of the committee, I am very pleased to be here today to discuss issues with regard to promoting economic recovery. The topic is obviously an enormous one. But what aspect of Federal policy deserves to be at the very top of the list of concerns? The Federal deficit is my answer. However well the economy may perform this year, growth over an extended period will require that the Federal budget be put in order. There must be no higher priority.

Before I get to budget issues, a few brief comments on regulation. There are scores of disquieting anecdotes circulating about the depressing effects of regulation. One that I heard recently from a friend concerned a company that had for many years hired summer interns. Not this past summer, however. Following an examination of the effects of the Affordable Care Act and increasing insurance costs and risks, the company decided to forego its usual summer intern program. I find the anecdotes persuasive, but whether regulation adds up to a significant impediment to growth is yet to be determined.

Now let me go to the very most serious issue, the budget.

Chairman BACHUS. Excuse me, Professor.

Let's give respect to the witnesses. I know some of you all are sort of talking and reacting, but let's try to have respect and preserve our decorum.

Thank you.

Mr. POOLE. The general public does not understand the enormity of the budget challenge. The Congressional Budget Office has said clearly that the current budget is not sustainable. It is natural, and often appropriate, to view the task of repairing a budget problem as involving some combination of tax increases and spending cuts. It would be useful if Congress would ask the CBO to clarify this issue by projecting the tax rates that would be necessary to finance spending in current policy projected over the next 30 years. What will be immediately apparent, I believe, is that there are no rates—no tax rates—consistent with the functioning of a market economy that could finance the projected spending. If tax increases cannot fix the budget problem, Congress will have to cut outlays. Above all, Congress will have to scale back entitlement spending. That means Social Security, Medicare, and Medicaid. And I will be blunt: We cannot save Medicare in its current form.

I emphasize that the issue is spending in current policy, not spending in current law. As the CBO states in its important study, long-term budget outlook, released this past August, the Administration and Congress have systematically set current law to understate likely outlays and overstate likely revenues. This is a problem with the current Administration and prior ones and is how the Na-

tion, for example, ended up with the Bush Administration tax cuts that expired at the end of 2010.

And here I will be blunt again: Current law budget projections for future years have become so distorted that they are hardly worth looking at. The problem of inaccurate and distorted budget projections is especially acute with regard to Medicare. The chief actuary said this in the appendix to the Medicare Trustees Report released this past August. And this will be a quote from the appendix: "The financial projections shown in this report for Medicare do not represent a reasonable expectation for actual program operations in either the short range as a result of unsustainable reductions in physician payment rates, or the long range, because of the strong likelihood that the statutory reductions and price updates for most categories of Medicare provider services will not be viable."

Everyone agrees that tough decisions are needed but many say not yet, because of the importance of nurturing the recovery. I doubt that Federal spending is as important to recovery as many believe. But suppose I accept that argument—the argument that Congress should go slow in cutting spending. Many things could and should be done now that would have a minor effect on current spending, but a major long-run effect.

The President's Deficit Commission contains many useful recommendations. Modifying Social Security to place the program on a sound basis need not involve any changes to current benefits or taxes. Following the Commission's recommendations would demonstrate that the Federal Government can get serious about fixing the budget problem.

There are scores of outlays and tax expenditures that ought to be phased out. Along with many others, and probably a clear majority of citizens, unfortunately, I have low expectations. People are losing confidence in the Federal Government. Something must be done to resolve the situation with Fannie Mae and Freddie Mac. They should not be permitted to remain alive on government life support. If Congress sets Fannie and Freddie on a shrinking path, I am confident that private firms could pick up the slack quickly.

For those who are less optimistic, a cautious plan is feasible but would do the job. The two companies should stop their purchase of new mortgages and permit their existing mortgage portfolios to run off as homeowners pay down mortgages in the normal course of business. The companies should announce a gradual increase in securitization fees, which would create room for private firms to enter the business over time. How can Congress permit these two firms to survive? After all, with their proven record of failure, costing taxpayers $150 billion and counting, they are not shining success stories.

I began my study of economics using the justly renowned textbook by Paul Samuelson. Early in the text is a subheading: "The Law of Scarcity." Samuelson points out that, "In the world as it is, even children learn in growing up that 'both' is not an admissible answer to a choice of which one." When will American voters and Congress learn that "both" is not an admissible answer when it comes to Federal spending?

Thank you, Mr. Chairman.

[The prepared statement of Dr. Poole can be found on page 95 of the appendix.]

Chairman BACHUS. Thank you, Dr. Poole.

Professor Taylor.

STATEMENT OF PROFESSOR JOHN B. TAYLOR, MARY AND ROBERT RAYMOND PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY

Mr. TAYLOR. Thank you, Mr. Chairman, and other members of the committee. Thank you for inviting me to testify at this important time.

It has been over 3 years since the crisis flared up and the recession began and we still have unemployment well over 9 percent. It has been over 9 percent for 20 consecutive months.

In my view, many discretionary Federal interventions which really deviated from basic economic principles were largely responsible for the crisis with the slow growth and indeed for the current high rate of unemployment. Many of these interventions occurred before the panic in 2008, but they have been doubled down in the last couple of years. When you look at each of them, as I have tried to do, you find that they had very little effect in stimulating the economy or affecting unemployment.

The one-time payments to individuals did not jump start consumption. The sending of grants to the States did not increase infrastructure spending. The Cash-for-Clunkers program merely moved spending a few months up. The purchases of mortgages under Quantitative Easing II did not, in my view, have a material impact on mortgage rates when other risks are taken into account. So, at best, these actions had a small temporary effect, which dissipated quickly with no lasting effect on growth or job creation.

Indeed, the legacy is higher debt, monetary overhang, and uncertainty about new regulations that have likely been a drag on the economy. In my view, none of this should be surprising. Basic economics says this would happen. But we have had this painful experience over the last few years that seems to me point very clearly to the need to restore sound fiscal policy, restore sound monetary policy, in order to reduce unemployment and create jobs.

In the fiscal area, I think it is very important to lay out a plan, a long-term plan, to reduce spending and stop the exploding debt. What I would like to see is a plan put together fast enough that this summer the Congressional Budget Office can make a projection, a long-term projection, that brings debt down rather than exploding. On page 3 of my written testimony, I have included a chart. It has the projections of CBO of the debt to GDP ratio, the forecast they made last summer, the forecast they made the summer before that. A plan should be scored to reverse this disturbing explosion of the debt as soon as possible, and I believe the uncertainty that would generate would directly affect jobs.

Some say we should wait, postpone the reductions in spending that are required. I don't see the evidence for that. In fact, what I see—and I have included a chart in my testimony on this as well on page 4—what I see is the importance of private investment in creating jobs. It is just an amazing correlation between this high unemployment rate and the low level of private investment we

have. There is no such correlation with respect to government purchases or spending. We really need to take that into account and address the real problem.

But just as Congress and the President needs to lay out a plan for reducing the debt, I think the Federal Reserve should lay out a plan for reducing the size of its extraordinarily large balance sheet. In addition, I think in order to generate more predictable, certain policy, bolster the Fed's independence in the monetary policy area, we should amend section 2 of the Federal Reserve Act; amend it in a way that clarifies the objectives of the Fed and restores reporting requirements which were removed in 2000.

It would be better, in my view, for economic growth and job creation if the Fed focused on the goal of long-run price stability within a clear framework of economic stability. Such a reform would not prevent the Fed from providing liquidity, serving as lender of last resort, or cutting interest rates in a financial crisis or a recession.

In addition, it seems to me the reporting requirements could be amended. The Federal Reserve Act, I think, should require the Fed to report its strategy that it plans to use for setting interest rates in order to achieve this goal of price stability. The Fed, of course, should establish its own strategy. It shouldn't be dictated by the Congress. And the Fed should have the discretion to deviate from the strategy in a crisis or other unanticipated circumstances. However, if it does deviate, it should and must report in writing and in a public hearing the reasons for such deviations.

This requirement provides a degree of accountability that I think is needed for an independent agency of government. I think such a reform will reverse the short-term focus of policy and help achieve strong growth and job creation now and in the years ahead.

Thank you very much for the opportunity to testify. I am happy to answer any questions.

[The prepared statement of Professor Taylor can be found on page 117 of the appendix.]

Chairman BACHUS. Thank you.

Dr. Kohn.

STATEMENT OF DR. DONALD KOHN, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. KOHN. Thank you, Mr. Chairman. Mr. Chairman, members of the committee, I appreciate this opportunity to address the topic of promoting recovery and job creation. I can think of no more important economic topic facing the Nation today, as many of you have remarked.

A slow economic recovery is a predictable consequence of a financial crisis that impairs lenders and destroys wealth. The headwinds seem to be abating and many economists, myself included, expect the pace of growth will pick up some this year and the job market will improve somewhat. The natural healing powers of a market economy are being complemented by very accommodative monetary policy and by the boost to spending that will come from the fiscal package the Congress and the President agreed to in late 2010. To a considerable extent, patience may be the most potent weapon we have now to promote economic recovery and job creation. And if the economy follows the expected path, that patience should extend to

withdrawing stimulus in the near term as well as trying to create new jobs through major new initiatives. Patience on both sides is required.

That said, I think there are few broad areas in which policymakers can constructively contribute to faster recovery. The challenge for monetary policy will be to promote expansion without allowing fears of deflationary or inflationary spirals to take hold. Longer-run inflation expectations must continue to be well-anchored for economic performance to improve.

The Federal Reserve should continue to emphasize its willingness to adjust its policy based on the changing outlook for growth and inflation and its determination to return consumer inflation to the range of 2 percent, or a little below, that forms the central tendency of the FOMC members' expectations for inflation over the longer run, and then to keep it there. To keep inflation from rising above 2 percent, the Federal Reserve will need to exit its extraordinary policies in a timely way.

In the end, it will not be technical factors that determine whether the Federal Reserve makes progress toward the objectives it has been given. Rather, it will be judgment and, critically, a continued high degree of independence from short-term political pressures so that it can exercise that judgment, and that will be what determines its success.

In fiscal policy, the lack of a clear and committed path to fiscal and debt sustainability is an important source of uncertainty for households and businesses and a risk to stability in financial markets. As the recovery gathers momentum, the public and private sectors will come increasingly into competition for scarce saving, causing interest rates to rise. The pressures on rates will be greatly intensified if the investors come to doubt the willingness of the Congress and the Administration to confront and make very difficult choices on spending and taxes that are required. You must determine and commit to a path to longer-run fiscal sustainability.

Regulatory policy, including uncertainty about regulations, has probably been one of the factors holding back spending, though in my view it is probably not one of the main factors. To some extent, both greater regulation and uncertainty about that regulation have been byproducts of efforts to achieve important societal goals. That is certainly the case for financial regulation. In the writing and implementation of Dodd-Frank legislation, the near-term costs of greater regulation—and there are costs—are being weighed against the promise of a more stable and resilient financial system that will be able to avoid the types of systemic problems that have proven so disruptive and costly for jobs and incomes over the past several years. Its net effect will depend importantly on how it is implemented.

I believe that, on balance, the new legislation will make our financial system stronger and more resilient to unexpected developments, will reduce the moral hazard effects of "too-big-to-fail," and will increase transparency for better monitoring by both supervisors and the private sector. I hope that implementation of the legislation is not materially slowed. In many cases, putting in place some rules, even if they are adjusted later, will do more to relieve

uncertainty and allow the private sector to adapt and move forward than would a generalized slowing of most implementation.

Of course, the Congress must continue to evaluate whether the benefits of specific requirements of the law, and the law's implementation more generally, are likely to exceed their costs. As our economy recovers from this painful episode, it must be reoriented from excessive dependence on debt, and especially from dependence on foreign saving and capital inflows to finance spending in excess of production.

Fiscal and regulatory policies must be structured to reduce government borrowing over time and to encourage private saving and business capital spending. Monetary policy must contribute to a macroeconomic environment characterized by stable prices and moderate fluctuations in economic activity to facilitate longer term planning by governments, households, and businesses. None of this will come easily or quickly, but it is essential to promoting longer term economic growth and job creation.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Kohn can be found on page 76 of the appendix.]

Chairman BACHUS. Thank you, Dr. Kohn.

Professor Scott.

STATEMENT OF PROFESSOR HAL S. SCOTT, NOMURA PROFESSOR OF INTERNATIONAL FINANCIAL SYSTEMS, HARVARD LAW SCHOOL

Mr. SCOTT. Thank you, Chairman Bachus, and members of the committee for permitting me to testify before you today. I want to make clear I am testifying in my own capacity and do not purport to represent the views of the Committee on Capital Markets Regulation, which I direct, although much of the testimony I am giving to you is based on the committee's reports and statements.

My testimony today is focused on the implementation of the Dodd-Frank Act. The rules that are now being written to implement Dodd-Frank will have a profound impact on our financial system and economy. These rules—the count is questionable—240, 230—of which are being promulgated by the SEC, the FDIC, the CFTC, the Fed, and the Financial Stability Oversight Council, all of these rules will substantially revise how we regulate financial institutions and markets in this country.

President Obama, keenly aware of the danger to economic growth of poorly formulated rules, is now focusing his attention on the general regulatory process and its burden on American competitiveness. But the independent financial regulators are exempt from his new initiatives. As a result, they will not be subject to review by the Office of Information and Regulatory Affairs within OMB of their cost-benefit analysis, nor required to provide 60-day comment periods, as generally applicable in his executive order. Indeed, under current law, only the CFTC has a formal cost-benefit requirement.

Meanwhile, these agencies give on average only 45 days for public comment on the Dodd-Frank rules, down from an average of more than 60 days for rules issued in 2005 and 2006, and these rules are extremely complicated and being issued at a frenetic

pace. In revising our regulatory structure, the most important objective should be to get the rules right, not to act quickly. And let me be clear. I am not urging delay to avoid or unnecessarily defer regulation. I am simply advocating taking the time we need to get it right.

I have four recommendations that may improve this process. First, all the financial regulators, including the independent agencies, should be required by Congress to evaluate their rules, the costs, and benefits. In addition, OIRA should have the obligation to file comments on the adequacy of their analysis. The agencies would not be bound by such comments, but they would be given the comments—not be bound in order to preserve their independence.

I should say that the current head of OIRA, Cass Sunstein, a former colleague of mine, has argued in various law review articles that the independent agencies should be fully subject to OIRA review. My proposal stops short of that.

Second, Congress should encourage the financial regulators to report on their progress toward meeting statutory deadlines. The CFTC has already missed a deadline, and more are likely to follow. But this is understandable, and Congress should let these agencies know that it will give them more time if such time is truly needed.

Third, it can typically take days and sometimes weeks for agencies to make available the full text of proposed and even final rules. Congress should urge the regulators to make the full text of regulations publicly available as soon as possible so people can comment on them and react to them.

Fourth, it would be unwise, in my view, for Congress to cut the budgets of the financial regulatory agencies in an attempt to control or derail the regulatory reforms prompted by Dodd-Frank. Tightening the purse strings will not stop the rulemaking process. It will only make it worse. Agencies should be given the resources they legitimately need to implement this new legislation. If Congress wants to change the legislation, it should do so directly.

I would like to take this opportunity also to highlight two areas where the Dodd-Frank Act could be improved. Others are in my written testimony. First, under Dodd-Frank, the newly created Bureau of Consumer Financial Protection is funded from the profits of the Federal Reserve. It should be funded like other agencies through the ordinary appropriations process. In addition, the Bureau needs a permanent director. Treasury's temporary powers to guide the Bureau will be significantly limited in July when the Bureau becomes a functioning agency. The Congress should call for the President to tender such a nomination as soon as possible.

Second, Dodd-Frank requires Federal agencies to purge credit ratings from their regulations. Yet there is no clear solution as to how to replace them; for instance, capital requirements are heavily dependent now on ratings. In my view, this legislation needs to be relaxed. In the short term, the statute should be revised to prohibit undue reliance on the ratings, not to ban the use of the ratings entirely. And other options should be explored for the longer term.

Thank you, and I look forward to your questions.

[The prepared statement of Professor Scott can be found on page 98 of the appendix.]

Chairman BACHUS. Thank you. We have probably about an hour before the first votes on the Floor. I am going to forego questioning so more of our members can ask questions.

At this time I recognize the gentleman from Texas, Mr. Hensarling, for 5 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

Dr. Poole, in your testimony—not to put words in your mouth—I think you had your greatest angst with respect to the spending trajectory in the future that creates the deficit and the Federal debt that we are contending with now, is that correct?

Mr. POOLE. Yes. I am pointing particularly to the entitlements, the outlays that are on autopilot.

Mr. HENSARLING. I am not sure if you are aware of this, but less than an hour ago you were referencing that the Congressional Budget Office should project, I believe, future tax increases necessary to finance the spending trajectory. The CBO just issued its current baseline this morning, and they project a $1.48 trillion deficit for Fiscal Year 2011, which will be the single largest deficit in American history, following the two previous $1 trillion-plus deficits that occurred under this Administration. That is roughly 10 percent of GDP, according to the Congressional Budget Office. According to the Congressional Budget Office, debt held by the public is estimated over the 10-year budget window to essentially double from roughly $8.8 trillion in Fiscal Year 2011 to $18.2 trillion. I know that is not comforting to either of us.

You reference the President's Fiscal Responsibility Commission. I was one of the House appointees to that Commission. You said it would be useful to ask CBO to clarify the issues of projecting the tax rates necessary to finance spending under current policy. I think we both know the answer to that. We had testimony from a number of different academics from GAO, I think, including CBO. Frankly, to fund current policy, as you know, is going to require a doubling of the tax burden on future generations, crushing economic growth as we know it.

In your testimony you say, "I want to be blunt: Current law projections versus current policy projections for future years have become so distorted they are hardly worth looking at."

Can you expound on that view, please?

Mr. POOLE. Yes. It is a point that is extremely important. Let me just give two examples that everybody has heard of and understands. For quite some time, we have had the annual so-called "doc fix." What the doc fix does is to delay the scheduled, in the law, reductions in payments to physicians under Medicare. Everybody knows that if those scheduled reductions go into force, then many doctors will simply drop out. My own ophthalmologist told me this: "I'm 62 years old. If those payments go in that schedule, I'm just going to retire."

And so what has happened is year by year by year there has been the 1 year at a time doc fix, but the projections forward for the outlays include the assumption that the reimbursements will decline.

Mr. HENSARLING. Dr. Poole, another way of saying that is—and the Congressional Budget Office scores or estimates essentially

what Congress says as opposed to what Congress does. Is that a fair assessment?

Mr. POOLE. The CBO has done a fine job in distinguishing between estimates based on current law, which would include things like the decline in physician payments. Another good example is—-

Mr. HENSARLING. I am sorry, Dr. Poole; I have a limited amount of time here. I am going to have to move on.

Dr. Taylor, in your testimony you speak about rules-based monetary policy. I know there was some angst on the other side of the aisle that I share about having Members of Congress interfere with conducting monetary policy. But when we look at the actions the Fed has taken under 13-3, when we look at what is happening to the Feds' balance sheet under QE II, when we look at a Federal Reserve setting interchange fees, when we look at a Federal Reserve setting credit card terms, this isn't exactly your father's Federal Reserve.

So what is it—with Chairman Bernanke essentially seeming to move us towards inflation targeting, does that seem to be moving towards a rules-based monetary policy? Could you expound on your views and what you see the Fed doing?

Mr. TAYLOR. I think the kinds of things you mentioned the Fed doing are moving away from what I would call classic traditional monetary policy, focusing on inflation and price stability and overall stability, getting involved in fiscal policy issues, getting involved in credit allocation. I don't think you need to have an independent agency of government for that. Professor Scott just mentioned the idea of the Fed seigniorage paying for the new Consumer Financial Protection Bureau. That is an example of this.

So I think with respect to the Fed, we need an independent Fed to conduct monetary policy. And the more that can be more rule-like, more predictable, as it was for many years in the 1980s and 1990s when we had long expansions and short recessions, the better we will be. The more it becomes erratic, more discretionary, more interventionist—you gave many examples—the less desirable the policy is and the worse the outcomes. I think we saw that in the 1970s, and we are seeing that in last 3 or 4 years as well.

Mr. HENSARLING. Thank you, my time has expired.

Chairman BACHUS. For the record, would you clarify what was the budget projection, the deficit for this fiscal year?

Mr. HENSARLING. This is from news reports on my Blackberry, so I certainly—members may have a differing opinion, but the Congressional Budget Office estimates a $1.48 trillion deficit for Fiscal Year 2011 at roughly 10 percent of GDP.

Chairman BACHUS. That is approximately $1.5 trillion, but of course, the President proposed $10 billion worth of savings in 2014. So that would bring it down to $15 or $14.9 billion from $1.5 trillion. He would bring that down a few billion dollars.

Ms. Waters.

Ms. WATERS. Thank you very much, Mr. Chairman. Mr. Kohn, there seems to be some consternation among your colleagues on this panel as to whether or not the Federal Reserve's dual mandate makes it difficult to do its job. And we all heard what Mr. Watt said when he came in about some of the attacks on the Fed. So I

ask you, given your background as a former Vice Chair of the Federal Reserve, do you think that the dual mandate presents a conflict for the Fed in carrying out its mission?

Mr. KOHN. I don't think the dual mandate has presented such a conflict nor does it right now. I think right now we see both inflation running below the long-run objective of 2 percent or a little below, and unemployment running well above, as all the members have said, well above where it ought to be over the long run. So there is no conflict right now.

I think this is a discussion that the Congress should have. Is there a reason to clarify the Federal Reserve Act? I do think the last three Chairmen—Volcker, Greenspan, and Bernanke—have all said that they recognize that price stability is uniquely the responsibility of the Central Bank, and really the first responsibility of the Central Bank. And establishing a stable price environment is the way the Federal Reserve, over long periods of time, helps to encourage maximum employment.

I think it is also the case that not only variations in inflation, but also variations in output interfere with the ability of businesses—small and large—to plan, create uncertainty, and are inimical to economic growth. So I do think the Federal Reserve can do both. It can seek price stability as it has and it can lean against business cycles in a perfectly consistent way.

I would urge the Congress that if you decide to clarify the objective, that you make sure there are two things: First, considerable flexibility in pursuing these objectives over the longer run; and second, that you do nothing to impair the independence of the Federal Reserve in carrying out the objectives you give it.

Ms. WATERS. Thank you very much. I am going to move to Mr. Poole. This hearing is not about Fannie and Freddie, but you interjected your thoughts about Fannie and Freddie in your testimony. As you know, it emerges as a huge issue in this Congress. And as a ranking member of the Capital Markets Subcommitte, it is one of those issues that I am going to be very much involved in. While I have always supported the mission of Fannie and Freddie, we recognize that they failed us. They got into trouble, and we have to straighten it out. And one of the things that I want to do is I want to work very closely with the opposite side of the aisle and take the politics out of dealing with this issue so that we can reform, we do what we have to do to make sure that we don't have to get in the kind of situation we were in before.

You talked about how easy it is going to be for private firms to pick up the slack quickly. What private firms are you talking about? Are you talking about Bank of America? Are you talking about JPMorgan? Are you talking about Citi? Are you talking about Goldman Sachs? Are these the firms that have no problems? That didn't need a bailout? That could pick up the slack quickly? Who are you talking about?

Mr. POOLE. Yes, those it would be among the private firms.

Ms. WATERS. I can't hear you. Speak right into your microphone.

Mr. POOLE. Do you want me to expand at all?

Ms. WATERS. No, I want you to speak into your microphone so I can learn which of the private firms can take up the slack quickly.

Mr. POOLE. I didn't say for sure that they would pick up the slack quickly. I happen to believe that they would. Other countries, high-income countries operate mortgage markets without intermediaries of this kind and they work just fine. There is no evidence that those intermediaries are necessary for the mortgage market to operate satisfactorily. And if you are worried about how quickly private competitors could come in, if you think I am too optimistic, then there is a plan. I have outlined it to phase it out slowly and allow time for the private competitors to build their business plans and to come into the market.

Ms. WATERS. Did some of the private firms that you are thinking about like Bank of America, whom we are working with now dealing with serious problems with robo-signing in this loan modification effort we are trying to do, or JPMorgan or Citi or Goldman Sachs, all of whom we bailed out, having the same kinds of problems, or potentially having those problems, do you think these are the kinds of firms that can pick up the slack?

Mr. POOLE. There is no question that those firms have created some problems for—

Ms. WATERS. Just like Fannie and Freddie, wouldn't you say?

Mr. POOLE. I would like to emphasize that some years ago, both Fannie Mae and Freddie Mac had serious internal problems with their accounting systems. They did not file reports as required for the New York Stock Exchange, for example, for a couple of years. So the issue here is not whether the private firms sometimes make mistakes, and indeed, very serious mistakes. It is a question of the relative effectiveness of the government firms and the private firms and their cost and risk to the taxpayer.

Chairman BACHUS. Thank you. Mr. Royce.

Mr. ROYCE. Yes. Mr. Poole, you were president of the Federal Reserve Bank of St. Louis for 10 years. I happen to agree with Dr. Paul's thesis here, and many economists, including the Economist Magazine laid out the case that the Federal Reserve, from 2002 to 2006, had set a negative real interest rate in the United States. And as a consequence of that, we were going to create a boom bust cycle in housing because we were flooding the housing market with credit, and that was a mistake of the Fed. That was one of our errors.

But the second error, I think, was the government guarantee implied that we had over with Fannie and Freddie, in a situation at which Congress intervened in the market in a very big way, in 1992, with the GSE Act in which we allowed them to go into arbitrage; we allowed them to overleverage 100 to 1; run up a mortgage portfolio of $1.7 trillion. A lot of it junk, countrywide. And a lot of this was under a mandate from Congress because we were muscling, Congress here was muscling the market. The market wanted 20 percent down, we got that down to 3 percent and then down to 0 percent. So what did we think was going to happen?

Economists at the time—I remember John Taylor here, Professor Taylor had a solution to both problems; he wanted the Taylor rule first of all applied so that we would have a stable monetary policy, we wouldn't have the boom bust that would come about as a result of the flood of credit because we would keep the monetary units stable. We wouldn't have a negative real interest rate. And at the

same time he and others, Dr. Poole, yourself included, I think, warned about some of the consequences with respect to this government guarantee.

We did not have a higher homeownership rate in the United States than other developed nations. What we had instead was a higher profit to the shareholders of Fannie and Freddie. Study after study showed they were the beneficiary, and management was the beneficiary. So you had managed earnings, you had all the problems we went through.

Okay, going forward, what you argued for today was we slowly bring the private market back in as we reduce the conforming loan limits, as I understand basically your argument there and we phase out.

Now this is the thing I want to ask you: Others are saying well, we had that problem with the government guarantee with Fannie and Freddie, but now why don't we bring back a government guarantee. Do you think that brings back the same problems with regard to moral hazard, the same problems with regard to risk pricing that we had with Fannie and Freddie if we bring in a government guarantee? Yes or no, Dr. Poole?

Mr. POOLE. I would not have government guarantees for mortgages at all. We don't have government guarantees for auto loans, or for all sorts of loans in the marketplace. Why do we need government guarantees for mortgages? It doesn't make any sense to me.

Mr. ROYCE. I appreciate your response to that question. I am also going to just ask—give Professor Taylor a chance for a minute of explaining a little bit of foresight in terms of keeping the monetary policies stable might help offset the boom bust cycle that we experienced more in the United States than anywhere else in terms of the way it hit our real estate.

Mr. TAYLOR. I think you need to just go back and look at what happened in the 1980s and 1990s. We got that inflation down, created price stability, kept to a reasonably predictable rules-based approach, and we had two long expansions. And certainly compared to what has happened recently, a small recession. So it is clearly in the history. I also think it is clearly in the—

Mr. ROYCE. Let me ask Mr. Scott a question, because this goes to the Bureau of Consumer Financial Protection. For the first time, safety and soundness regulation takes a back seat to consumer protection. We saw this with the GSEs. We had bifurcated regulation. And for those of us who carried the legislation as I did some years ago to try to regulate the GSEs for systemic risk, to try to bring down that risk, we had the support of the regulatory community. What we didn't have was HUD, right? And we didn't have Fannie and Freddie because they were on the other side of that argument. Fannie had the biggest lobby up here, they did not want to be regulated for safety and soundness. They were going to carry out their mission because it led to more profits for the shareholders, and especially for management.

What do we do now to rein in the BCFP and ensure our regulatory structure focuses on solvency regulation so we don't run back into the type of situation we had with bifurcated regulation we had before?

Mr. SCOTT. Do you want me to comment on that?

Mr. ROYCE. Yes.

Mr. SCOTT. I think the balance struck between safety and soundness and consumer regulation is a question here because FSOC, as you know, can override the new bureau by a two-thirds vote. How practical is that? Even if you look at the composition of FSOC, there's not really a true majority of bank regulators on that group because it includes the CFTC, the SEC, etc. So I think we need to look at that balance. I think it is a question of different voting rules.

Mr. ROYCE. I think you should have to have a sign-off with a prudential regulator in advance and that is what my amendment was. I yield back, Mr. Chairman.

Chairman BACHUS. Thank you. What we are going to do—there is a vote on the Floor, so we will entertain questions from Ms. Velazquez and Dr. Paul, then we well recess for 15 minutes. Can the panelists all come back? So we will recess at the end of Dr. Paul's questions. Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. If I may, I would like to ask each of the panelists the following question, and I just need a yes or no answer. Do you believe that passage of the Dodd-Frank Act is responsible for lenders constricting their small business lending?

Mr. POOLE. I don't think that is the major reason that small business lending is restricted at this time.

Ms. VELAZQUEZ. Okay.

Mr. TAYLOR. I think the uncertainty caused by the additional regulations is causing people to be more cautious in businesses in general to stop doing what they would do.

Ms. VELAZQUEZ. I am asking because when I was listening to the opening remarks made by our colleagues here, they were basically saying that small businesses who are the ones creating jobs in this country are not—they are limited by access to credit. And that limitation is created by the fact that financial institutions are constricting their lending due to regulations.

Mr. TAYLOR. I think the uncertainty caused by all the new regulations is making lenders more cautious, absolutely. So I would agree with—

Mr. KOHN. No, I don't think Dodd-Frank is the major reason for the reluctance to make loans to small business. I think the reluctance to make loans to small business preceded Dodd-Frank by quite some time and reflected uncertainty in the—

Ms. VELAZQUEZ. Will you say, if you excuse me, by the collapse of the capital markets created by the lack of regulation or lack of oversight?

Mr. KOHN. I am not sure "created by," but I would say the collapse of the financial systems and the deep recession certainly made lenders very much more cautious, as is understandable.

Ms. VELAZQUEZ. Yes.

Mr. SCOTT. Congresswoman, I think that actually the Basel capital rules have much more of an impact on lending decisions of banks than anything, particularly in Dodd-Frank. I think that Congress should take a look at these rules in more depth. So in a

sense, Dodd-Frank permits this Basel process to continue, but I think Congress should look at it.

Ms. VELAZQUEZ. And I would like for the record to reflect that the last Federal Reserve survey that they conducted with senior loan officers this past January showed how small business lending is going up.

Today, in one of the news articles, we have here that the equipment listing and finance association said business originated $9 billion in loans, December. They doubled compared to November. So they are accessing credit. I don't think that the role of this committee is to rewrite history because the Federal Reserve survey shows otherwise, and lending is going up and small businesses are expanding.

Mr. Kohn, thus far, most of the efforts to splurge up creation, particularly among small businesses, have centered around providing credit for established businesses through banks. Should more be done to support the growth of new businesses, particularly since this is where the greater job creation occurs?

Mr. KOHN. That was addressed to me?

Ms. VELAZQUEZ. Mr. Kohn.

Mr. KOHN. I think the Congress last year passed a law trying to encourage banks to make loans to small businesses, I think that was a constructive step. I think the regulators, supervisors need to continue to make sure that they are not discouraging loans to creditworthy businesses. I don't know of any new steps that need to be taken, but I think the steps that already have been taken need to be reinforced and that encouragement given.

Ms. VELAZQUEZ. Thank you. Thank you, Mr. Chairman.

Chairman BACHUS. Dr. Paul.

Dr. PAUL. Thank you, Mr. Chairman.

I would like to, first, say that I was very pleased with Congressman Royce's remarks. I do want to follow up with Dr. Poole, especially because you had a lot of emphasis on the debt and the deficit that we are running up, and of course, many people have been talking about that lately. But I became fascinated with that subject as far back as the early 1970s with a significant change in our monetary policy, because it was very clear to me and many others that this is what it would lead to. It would lead to massive spending, massive deficits, and a massive increase in the size of government and that is where we are. We are at a point of no return and no solutions. So I am not a bit surprised that this has happened.

I don't like to separate the two, have the deficit problem here and the monetary problem over here because I think they are connected, and this is what I want to ask you about. Now if—I know this is not on the horizon, it is not likely to happen, I know some of the downside arguments from this, but just dealing with the question I am going to ask, dealing with the deficit: What if the Fed couldn't buy government debt, what kind of pressure would that put on the Congress to act differently?

Mr. POOLE. Congressman, let me address it in two pieces. It has been known since the late 1970s that the demographics were moving in a direction, and starting in 2010, there would be the beginning of the retirement of the Baby Boom generation, and that the entitlements, in effect, would become untenable with the very large

change in the demographic structure of the labor force. That was known in the late 1970s, and economists and others have been preaching about that without any effect.

When we talk about a monetary policy adjustment, whatever you want to call it, of the type that you have in mind, it is critical to know what the alternative is. My teacher and mentor, Milton Friedman, always used to say, you can't enter a horse race without a horse. So you may not like the horses that are in the horse race, but you have to have a horse to enter that race.

Dr. PAUL. But Milton Friedman also suggested very strongly that he would replace the Fed with a computer, and that is the way he would regulate the money supply. But my suggestion here is that if the Fed didn't buy the debt, interest rates would go up, and the burden would fall on the Congress because they would have to cut back because they were consuming all the savings. Of course now today we don't say, we just create our so-called capital out of thin air.

But another question to follow up on this is, with an individual, when they get into trouble, if they have too many credit cards, and too much debt, and they get new credit cards and on and on, but finally it has to come to an end, and they have to make a decision, they declare bankruptcy and liquidate that debt and maybe get a chance to start over again, or they might decide, I have to pay my debt down, I have to work harder, get an extra job, my wife has to work, but cut spending. And they do that, and they can get their house in order again and then their standard of living might grow again. I don't know why those rules can't apply to government as well.

But isn't it true that in recent decades, we don't do anything to allow liquidation of debt, as a matter of fact, that is the greatest sin of all, is to allow the liquidation of debt. And it is the liquidation of debt that allows the growth to come back. So how do we get growth if we don't liquidate debt? All we do is transfer the debt. The people who make a lot of money on Wall Street and the Fannie Maes and Freddie Macs, and then they get in trouble and we buy out this illiquid debt, the worthless debt and put it into the hands of the taxpayer, and the problem still exists.

How in the world can we get growth again if we don't liquidate the debt? Or do you buy into the school that says that is not important, we don't need to, we can just build debt and debt and keep it going forever. How would you rationalize and how would you solve this dilemma?

Mr. POOLE. I tried to be very clear that we will have a crisis ahead of us if the Federal budget is not fixed in very significant ways, and that the fix has to focus on spending. I thought I was very clear about that. We will follow the course of Greece, of Ireland, and of the other countries in Europe, Portugal, that are under the greatest pressure right now. We will get there if this problem is not fixed.

We won't get there quite that way—because the "solution" that results will be a rip-roaring inflation. See every inflation in the history of the world has come about because of—great inflation because of fiscal imbalance.

Dr. PAUL. I agree with that, but I think there is a much closer connection. I think the Federal Reserve allows Congress to be irresponsible. And if they didn't facilitate the debt, the Fed is the great facilitator of big government and debt. If they weren't there to buy up this debt, believe me, we would be much more responsible about how we manage our affairs. I yield back.

Chairman BACHUS. I thank you. At this time, the committee is going to recess for approximately 15 minutes. We understand the second vote may actually be by voice, so we will be back in approximately 15 minutes.

[recess]

Chairman BACHUS. This hearing of the Committee on Financial Services will come to order.

At this time, I recognize the gentleman from North Carolina, Mr. Watt, for 5 minutes.

Mr. WATT. Thank you, Mr. Chairman. Perhaps it is an indication that you have been around an institution too long when you look at the title to a hearing, and you instinctively sense that the hearing is probably going to be about something other than what the title is about. And then you look at the testimony and you find that it probably is about something other than the title, what the title indicates the hearing is going to be about.

And then you predict in your opening statement that the hearing is going to be about something different than what the title indicates that the hearing was going to be about. And then you find that your prediction was correct.

Everybody's talking about bashing the Fed and the decisions it has made in the past. I suspect the second panel will be bashing Fannie and Freddie and the decisions that they have made rather than about promoting economic recovery and job creation, which we have had little discussion about.

I do want to thank my colleagues on both sides of the aisle for at least getting this topic on the table, on top of the table, rather than trying to hide it under the subterfuge of promoting job creation. And I want to thank, particularly Dr. Taylor, for putting it front and center in his paper. I am looking at the—clarify the objectives of the Fed and it says, in order to achieve a more predictable rules-based policy and bolster the Fed's independence.

I guess everybody says we believe in the independence of the Fed. Section 2 of the Federal Reserve Act, which lays out the objectives and reporting requirements for the Fed should be amended. That is very transparent. And it is quite apparent that he disagrees with Mr. Kohn that price stability and inflation control and job creation should be equal pillars of our dual mandate here. One should be subordinated to the other, although I am sure he will make a case to the contrary.

I think we have to deal with this. We have to deal with it forthrightly if we don't think the Fed ought to exist or if we think the Fed's mandate should be changed, we should change it, not have scholars come and tell us that they believe that it ought to be something else, which is your right to do, Dr. Taylor. You are at least forthright about it. You say, I think the Fed's mandate ought to be changed, it ought to be amended. Congress ought to be forthright enough to deal with that, if we believe that. And we ought

to be forthright enough to know, which I may argue a little bit with Dr. Taylor about, that if we don't do one or the other, you can't have it both independent and be constantly second-guessing and first-guessing and making it cater to you all the time.

So anyway, back to the subject at hand, that is my little prediction; I made the prediction in my opening statement. Unfortunately my prediction came true that this is more about the Fed and its policies.

But the hearing title says promoting economic recovery and job creation. Nobody on this panel has really told us what they think we should do to create jobs and promote economic recovery. So Mr. Poole, if you could direct yourself to that specific thing and then go right down the line, I would appreciate it. We got a lot from you about how some intern didn't get hired because of health care reform, which I thought was an insult to us, but you didn't tell us how you how you think we ought to be creating jobs and promoting economic recovery which is the subject of this hearing, I thought.

Mr. POOLE. I am eager to talk about that subject. I want to emphasize that every business decision is based on some sort of calculation as to whether the investments, the costs that you put into it can be recovered by the revenue that you get out of the market.

Mr. WATT. That is economic theory. I want to know what you would have us do to create jobs.

Mr. POOLE. What that means is that the government needs to do everything it can to make sure that the conditions under which businesses have to make those decisions are as predictable and stable as possible. Now we have extreme examples of—okay.

Mr. WATT. Dr. Taylor?

Mr. POOLE. Would you let me finish?

Mr. WATT. Dr. Taylor, would you give us your estimate of—I just want one sentence from each one of you on the subject of the hearing.

Mr. POOLE. That is the subject.

Chairman BACHUS. The gentleman's time has expired, so if you will just—

Mr. WATT. And I was trying to expedite getting a response from each one of these gentleman rather than a lecture from Mr. Poole.

Chairman BACHUS. That was a 4½ minute question. So, the question was 4½ minutes long.

Mr. TAYLOR. I believe my testimony, both written and oral, did address the job issue. I think the most important thing to do now, based on experience and economics, is to create a stable fiscal policy, a sound fiscal policy which people can rely on, remove all that uncertainty about the debt, and the same goes for monetary policy. I sincerely believe that is the most constructive thing you can do. Thank you.

Mr. KOHN. In my testimony, I noted that there may not be a lot of things we can do; patience may be one of the things that is required here. But I do think policy, on several fronts, can reduce uncertainty, both the monetary policy needs to be—monetary authorities need to be clear what their objectives are for inflation and the fiscal authorities need to get their arms around tax and spending policy so the people know what to plan for tax rates and government support. The regulatory authorities need to weigh the costs

and benefits of their regulations carefully. And the last thing I would say, that is not in my testimony, is we need to educate our workforce so that when the jobs are created, they can take them. That is critical.

Mr. SCOTT. Congressman, I think we need a strong and well-functioning financial system to create jobs, because the financial system is sort of the life blood of our economy. If loans are not made to small businesses, that affects jobs. So we have to be, overall, concerned that we are not doing things that lead the financial institutions not to do what they otherwise might do by making loans.

Now that can be as clear as capital requirements which might be too onerous so that the banks will not make loans. We have to be careful with safety and soundness, but at the same time, we should not overdo it. It can be as indirect as derivatives regulation. So a very big issue in derivative regulation has been, how are end users going to be treated? Are they going to be exempt from a lot of these margin requirements in central clearing? That was an issue in the consideration of Dodd-Frank. If they aren't, and they are burdened by regulation, they may not be able to hedge as well, their business may suffer, and they might hire, therefore, fewer people.

So I think all of these regulations have a way of ultimately affecting jobs. If they are too burdensome on the financial system, they will produce less jobs.

Mr. WATT. Thank you, Mr. Chairman.

Chairman BACHUS. Let me say this: The question and answers were almost 9 minutes. So what we will do at the end of the 5 minutes, is we will let a witness who is answering a question continue to answer that question. But if each of you can make your questions a little more concise, I think we will have an opportunity for everybody to ask questions.

Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Professor Scott, in your testimony, you talked about—you gave observations on the Volcker Rule and its implementation. And I am concerned that Europe, other countries will not adopt the Volcker Rule which leaves U.S. financial institutions to go it alone and making our financial sector less competitive and forcing, perhaps, businesses and jobs to leave the United States for Europe. Could the Volcker Rule be implemented so it makes our financial system more stable without needlessly making our financial system less competitive?

Mr. SCOTT. I think we need to be very careful how we implement the Volcker Rule. I was not one who supported the Volcker Rule in the very first place, let me be very clear on it. But if we keep it in place, I think we should interpret it narrowly not broadly. And I have offered a definition in my testimony as how that can be done.

If we don't do that, Congresswoman, we are going to be doing two bad things, in my view. First of all, we are going to suffer a lack of competitiveness because of competitive institutions abroad all do this proprietary trading.

Indeed, if you go back to the Glass-Steagall reform, it was to put us on an even competitive balance, in part, that we liberalized Glass-Steagall and now here we are going in the other direction, but we have done it. All I am saying is, let's be conservative in how we implement it.

Secondly, actually a very broad Volcker Rule, in my mind, can impact the safety and soundness of our institutions. These activities, in some ways, were diversification from typical lending, and therefore, over a long period of time made these institutions more stable. And this was not the cause of the financial crisis. Goldman Sachs profited a lot by its proprietary trading activities during the financial crisis. If they had all been making loans, they would have been worse off. So I think we should be very conservative in the way we implement the Volcker Rule.

Mrs. BIGGERT. I haven't been really happy with it either. Do you think it would be better not to have it at all or does it provide the stability that is needed?

Mr. SCOTT. Could you repeat that? It is my hearing; it's not you.

Mrs. BIGGERT. I just wanted to know, would it be better not to have the Volcker Rule at all, or does it provide the stability if it is narrowly defined?

Mr. SCOTT. Yes, I am on record as saying we shouldn't have a Volcker Rule. I testified in the Senate on that. I think we would be better off without a Volcker Rule. But having gotten the Volcker Rule, I think we should be conservative in how we implement it.

Mrs. BIGGERT. All right. Thank you.

Professor Taylor, in your testimony you commented about the fact that the unemployment rate is inversely correlated with private investment. Could you comment further on the ways that we can help spur the private investment and create jobs? I am also on the Housing Subcommittee, so if that relates at all, it would be helpful to me.

Mr. TAYLOR. Sure. It is correct, it is both housing residential investment and business fixed investment. They are both highly correlated. And you can just see in the residential much more clearly where the pockets of high unemployment are right where we had the biggest boom bust in housing. Nevada is the classic extreme. But it is also business fixed investment.

Here it seems to me the most important thing to do is not raise taxes on businesses, period. Try to find ways to reduce them where you can, or corporate rates are still very high. I think it is very important to think about these regulatory issues which some of you have raised in your opening remarks, both on the financial side, but also on the health care side, that really restricts the incentives for businesses to start up, whether it is small or big. And these start-ups, or these expansions, is what investment is. And so investment grows, and you hire people to build the equipment or construct the structure, and that is the most important thing, in my view.

I think there tends to be too much emphasis on the short-term things. Short-term stimulus to investment, and that maybe works a little bit, but then it peters out, and then we are stuck in the same situation. So I would think more long-term sustainable type of things.

Mrs. BIGGERT. And can you give an example of that that?

Mr. TAYLOR. Say the short-term incentives for businesses to write off for a period of time, they sound good, but then they go away and it is reversed. So if you can keep—I think keep the tax rates stable and certain so that a business, or you build a structure or a new plant the returns are going to be coming out for many years, not just 1 year.

Mrs. BIGGERT. Everything seems to depend on uncertainty; it seems like that we have right now, thank you.

Chairman BACHUS. The gentlelady from New York.

Mrs. MALONEY. Thank you, Mr. Chairman, and I thank all the panelists. We did get some good news today; the Dow crossed 12,000 for the first time since June 2008. And that shows that we have some liquidity going, which is a good sign of recovery.

During this financial crisis, which was so painful, and it was difficult at times to get Congress to act. And at one point, we did not pass the TARP program, which put the banks and the money markets, some of them in my district, into a run on the markets. There were some that were calling me screaming, they could see it crashing. And when we finally passed it, they stabilized the markets, and I just came from a hearing with Treasury where they are saying that we literally made money on it by all accounts. Specifically, a report by a Democratic economist, Blinder, and a Republican, Zandi, that is probably the best thing I have read on it where they go into great detail on how this program helps salvage the markets.

My question really is to Mr. Taylor, in your very thoughtful testimony, about the Federal Reserve and going to a rules-based policy. Some economists have given the Federal Reserve a great deal of credit for being flexible, reacting, taking risks that, in many cases, worked out for helping to stabilize the economy.

So my question, Mr. Taylor, or Dr. Taylor, is would the rules-based policy that you are proposing rule out the ability for the Fed to act as they did in this last crisis with great flexibility and great courage and great innovation?

Mr. TAYLOR. I think what it would have done, in my view, is prevent us from getting into the crisis, if the rules-based policy had been followed in advance. So you have to go back and say, if rates had not gotten so low, or if the rules on the books of the regulatory agencies had been enforced properly, rules-based regulation, then I think we could have avoided this crisis.

With respect to, when the crisis came, and especially in the panic, at the time we are talking about with the TARP, I did give the Fed substantial credit for establishing the commercial paper, funding facility, the money market mutual fund interventions.

Those seemed to me quite constructive. But the most important thing at that point was to reduce the uncertainty caused by the TARP. After the TARP was put into action, then you had the crash of the markets. That is when the S&P 500 dropped by 30 percent. It wasn't until how that money would be used that the market stabilized. So there are lots of things going on at that point in time, but I would say, in my view, no better evidence that rules-based policy worked than going back to periods where it was followed and

seeing how good performance was and looking at other periods where it wasn't and seeing how poor performance was.

Mrs. MALONEY. And so you are saying going to rules-based policy, if I understand you correctly, it would give us the format, but in cases of a crisis such as that to have some flexibility for the commercial paper and other things that they did?

Mr. TAYLOR. Absolutely. In fact, my proposal to go back to the kind of reporting that existed before the year 2000 is just that. That reporting was that the Federal Reserve Chairman would come and report on the plans for money growth, and if there were deviations, the Chair would be required to say why. It is the same idea. I would like to suggest that kind of reporting requirement be reinserted, but it focused more generally on the strategy for the Federal Reserve. And if they decide to deviate from their own strategy, then they should be required to come here and tell you why.

Mrs. MALONEY. Dr. Kohn, would you like to comment in my remaining seconds?

Mr. KOHN. Yes, Congresswoman, I would. I don't think that our interest rate policy was the main cause of the housing bubble. I think that the main cause was a breakdown in supervision in regulation, as well as a breakdown in the private markets ability to supervise and regulate itself. And that is what caused all this financial innovation, the CDOs, etc. that people didn't understand, the huge amount of leveraging, etc.

We had in the 1980s and 1990s, a number of business cycles and a number of asset cycles—think about the S&L problem at the end of the 1980s, and the early 1990s that the Congress had to legislate taxpayer money to shore up the insurance fund—that happened when Professor Taylor says we were following a rules-based policy. But it was a failure of supervision and regulation.

Think about the dot.com boom and bust when we were following a rules-based policy according to Professor Taylor. So I think, following John's formula, that wouldn't have prevented what happened, maybe made a small difference around the edges. In the end, inflation was lower; inflation in 2006, 2007 was 2½ percent. It is not that we had such an easy policy that CPI inflation got way high. I don't agree with that.

I do think that the reporting of the Federal Reserve to the Congress could and should be strengthened. From my years of sitting behind this row, right behind Alan Greenspan and consulting with Chairman Bernanke, I think the dialogue between the Congress and the Federal Reserve is in vast need of improvement. And it is from both sdes. You don't need to pass a law for you folks to ask the chairman better questions.

And I think too often the dialogue between the Congress and the Chairman of the Fed gets off on all kinds of directions where—I am going to regret some of these things I say, I think, but where Congressmen are trying to enlist his help in endorsing their particular ideas. I think the Federal Reserve should be required to say what its strategy is, not necessarily on a numerical basis, but how it will react to changes in the outlook for inflation and employment, what it expects the outlook for inflation and employment to be, and how its strategy is consistent with achieving the objectives that Congress has given it.

And I think you guys need to ask really tough questions of the chairman about that. So I think that dialogue definitely needs improving. Whether you need to pass a new law to do that, I am open.

Chairman BACHUS. Thank you. At this time, the gentleman from New Jersey.

Mr. GARRETT. I thank the Chair. Just off the top, the name of the hearing that we are having today is, "Promoting Economic Recovery and Job Creation, the Road Forward." I think what you are testifying to is right on the mark to describe basically where we are, what regulations are in place and whether it is Fed policy, as you were just—Dr. Kohn was just talking about or otherwise. These all go to the point of what do we need to do in order to get our economy back on track and create jobs.

Let me go a little afield on the first question here, and I guess I will throw it out to Dr. Poole, but anyone else can just chime in real quickly on this. There was a piece on CNBC just this weekend with regard to Fed accounting, that is why I throw it out to you. It said in accounting methodology was just recently reported in their weekly report, which is argued that a change in the Central Bank to allow the Fed to incur losses, even substantial losses without eroding capital. Any future losses that are made, the Fed may have occurred said will now show up as a negative liability as opposed to a reduction in Fed capital, thereby making a negative capital situation technically impossible. That was a comment of Brian Smedley, a former New York Fed staffer.

Are you familiar with the recent change they have on their accounting policy?

Mr. POOLE. I am not familiar with that, but I would like to emphasize the following very simple point, the Central Bank is not in business to make a profit; it is in business to make the economy work better. And if the Federal Reserve has to take losses to make the economy work better, to help create jobs, then so be it.

Mr. GARRETT. Right, but don't you want to have—I understand, but don't you want the transparency there to make sure—the argument goes, right now we saw what is going on in Greece and what have you, and the question is can our Federal Reserve basically ever go broke? This accounting change basically—I guess, the Fed, anybody else can chime in on this, the Fed does their own accounting methodology, we are not setting the accounting rules for the Fed, is that correct?

Mr. KOHN. The Federal Reserve does its own accounting, but it is audited by Deloitte & Touche, I think it is D&T these days.

Mr. GARRETT. But the audit goes against the rules that they establish for themselves, right?

Mr. KOHN. To a considerable extent, but the Federal Reserve follows GAAP accounting in most respects. I think the point is that this will be completely transparent, Congressman. If you want to take this account and subtract it from another account, in fact, transparency, if anything, will be increased, because that number will be right there published on a weekly basis. So it is not about transparency.

To Professor Poole's point, this isn't about profitability. The viability of the institution is absolutely unassailable. You, the Con-

gress, have given it the seignorage privilege. We—the Federal Reserve—I am still doing that a little bit, I am sorry. The Federal Reserve issues the currency on behalf of the country and realizes the returns, and returns $30 or $40 billion a year to the Treasury from doing that. And the capital on the books of the Federal Reserve is not, in any way, related to the present value of future stream of earnings.

Mr. GARRETT. Anyway, I don't want to spend a lot of time. But this puts it, as I understand it, as a liability to the Treasury as opposed to a liability of the Fed's balance sheet, which it has been up until this point in time.

Mr. KOHN. This situation hasn't really arisen in a significant way before. But there have been a few occasions where the Federal Reserve delayed sending money to the Treasury in order to replenish the capital account. This is a little bit like a deferred tax asset on the books of a private corporation, I think.

Mr. GARRETT. Okay. Professor Scott, you talked about the issue of cost benefit analysis that you did there. So have you all—I am running out of time already. You have all the Dodd-Frank rules where you are not going to have cost benefit analysis. Do you just want to elaborate quickly as to the need for those there and across-the-board in general, is that a good thing or a bad thing, and what should we be doing?

Mr. SCOTT. I think if we are concerned about the impact on the economy when we are promulgating regulations, it behooves us to look at the costs and benefits of the regulation, pretty simple.

Mr. GARRETT. The Administration doesn't think so because they said they want to scrub all the regulations. There are 195 regulations that are not here, 195 regulations that are just in the formal process, they won't be scrubbed. There are about 300 regulations coming out of Dodd-Frank that won't be scrubbed. So on the one hand last night, they said let's scrub everything, but let's not scrub these 495 regulations and do the cost benefit analysis of it.

Mr. SCOTT. We, at least, Congressman, should require that any regulations now in process be subject to cost benefit analysis. So not everything is done. They are in the process of asking for comments on the regulations. They haven't implemented very much regulation. If the Congress were to act now to require this, I think it would have a major impact.

Mr. GARRETT. Okay, thank you.

Chairman BACHUS. The gentleman from Georgia.

Mr. SCOTT OF GEORGIA. Thank you, Mr. Chairman. This is very frustrating to me, and I think very frustrating to the American people when we are trying to talk about jobs. The American people are suffering out here. And I think that this discussion from the title and moving from the title, not focusing, and I think it points to a kind of a schizophrenic approach we have to this whole issue of jobs and the Federal Government and the spending. It is kind of double-minded. How can we talk about spending money to invest in the economy to create jobs, and at the same time, we are talking about cutting the budgets, cutting deficits.

There are those in this Congress who want to see the Federal budget cut by 25 percent, but there has been no thought as to what that means for employment and jobs. Eighty percent of that cut

means putting people in the Federal Government on the unemployment rolls. There probably would even be a greater, if we follow a pattern of impact on jobs from the Federal Government, of adding to the jobless rate.

And so how do we do both? How do we handle this tug of war, this confliction here? And what spending cuts from the Federal budget would amount to the least reduction in jobs? There has been no talk. Everybody wants to cut, cut, cut, but nobody is stopping to realize the impact that has and will have on the jobless rate. What do we do with that? How do we handle this? And might the Federal Government be playing a more damaging role as far as jobs, not only not being able to create jobs, but the biggest impact we may make is adding to the unemployment that is already out there with these Federal workers who will be cut from the budget. Can you respond to that? How do we do fit this round hole in to a square peg?

Mr. POOLE. Let me dive in very quickly. We have to remember that, of course, our aim is to improve jobs in the entire economy. Hiring more people into the Federal Government does not necessarily improve jobs in the entire economy. It may well displace people from private employment and that is exactly what I think has often happened. You get the surface appearance of more jobs because they are on the Federal payroll, or State and local government payroll, but in fact, they are being displaced from private sector job growth.

Mr. SCOTT OF GEORGIA. All right.

Mr. TAYLOR. Actually, I don't think it is a square, circle issue. It seems to me there is a consistency here between reducing the growth of spending, reducing the share of GDP, if you would like, that goes to government spending and reducing joblessness. We have had huge increase in government spending as a shared GDP in the last 3 years. And unemployment has gone up. I am not saying that is the cause, but you should just think about that for a minute. If you look at some of the charts in my testimony, you see private investment is driving this unemployment rate. I think a closer correlation than you really can understand. But you have to think the best thing may be to get this budget under control, that may be the best thing to reduce unemployment.

Mr. SCOTT OF GEORGIA. Let me ask you this, what spending could be cut, in your opinion, from the Federal budget that would result in the least amount of job loss?

Mr. KOHN. I think what the Congress needs to do is to think about the path of spending over time. So my personal view would be that cutting a lot of spending now would probably cost jobs, not necessarily whether it is Federal Government jobs or other. We do have a 9.5 percent unemployment rate, there are underutilized resources out there. It is not a case of trying to have both under these circumstances, but there is a huge amount of uncertainty about what the path to fiscal sanity looks like. And I think the Congress and the Administration need to get together and figure out that path, even if it doesn't involve cuts today, it will involve some adjustments in entitlements. There is just no way that the path to fiscal sanity, as Professor Poole pointed out in his testimony, can avoid doing something about Social Security and Medi-

care spending in the future, but there needs to be a commitment to doing something in the future to relieve the uncertainty about tax rates and spending.

Chairman BACHUS. Thank you. The gentleman from Texas.

Mr. MILLER OF CALIFORNIA. California.

I love this conversation, fiscal sanity with a $1.5 trillion budget deficit. Government has increased spending every year through this recession when businesses and the private sector have had to reduce spending. Husbands and wives sit at home determining how they will feed their families, pay their rents, pay the mortgage for the next month, and manage their finances through the next year. And we say, what impact will these cuts have on the Federal Government? Woe is us. If you look at the States, and counties and cities, public employ retirements is bankrupting this country. And we are more concerned about how these impacts might impact the Federal Government—these cuts might, is a ridiculous argument.

We need to be competitive globally. And for us to do that, we have to stop mandating the private sector. We have to let the business community know and understand that we are not going to continue to mandate them tomorrow and steal the money from them tomorrow to make us be able to do what we want to do today.

We are trying to compete with India and China. They have great ideas. They are going to grow jobs in their country. And we have the EPA closing down the harbor in Long Beach and LA, and the Mexicans building one in Mexico because regulation in California is driving them out of California. And we worry about what these impacts will have on the Federal Government.

We need to start saying, What can we do to grow the economy? And just based on the basic money multiplier, every time we take a dollar out of the private sector, that is going to impact the growth of this economy. We cannot continue to take from the government and think we are creating jobs. No. We are hiring government employees. And what are we producing in the economy? More paperwork.

And you ask businesses, Why are you not expanding? Because bureaucrats in local, State, and Federal agencies are mandating us to a degree, putting us through a process that is so protracted, we don't know what to do.

I got a call from a dairy 2 weeks ago. They use a product on their floor that says, "If you use a product, just notify everybody." You can use up to 10 pounds if you want to without any notification. You can use 500 pounds if you want to and just notify everybody. They used 30 pounds. It didn't impact police, fire. But they forgot to notify one agency. So they were fined by EPA $182,000 because they forgot to send a letter.

Now what does that do to grow the economy? Nothing. And some of our witnesses today have talked about reducing spending, controlling regulation, reducing regulatory uncertainty. Basically, Dodd-Frank creates a tremendous amount of that. Reducing the size of the Federal balance sheet and keeping inflation in check; those are great. None of that has to do with the impact on the Federal Government because we don't tax enough.

But what we are doing, based on the testimony I have heard today, is ruining this economy. We cannot continue to spend money

we don't have. And then the President gives a speech saying, "the top 2 percent are just going to have to pay more of their fair share." Look at how much they are paying. And every time we take more of their fair share, we hurt jobs in this country, because those are the people providing the jobs.

So if we are going to be globally competitive, we need to make sure regulations are in check and not burdening the American companies that have to compete with China and India.

We say China; you can't even own property in China. If you want to build a building, the government is going to own your property. You are going to build a building, and they are going to be joint partners with you. I have had three people from my community who have been held in China and had their passports taken from them because they owed a business in China some money. And it was a contractual dispute, did not go to court, but the Chinese Government said, "Until you pay the money, you are not leaving our country." Now that is a great democracy. And we are having to compete with them. They are also fixing their currency based on ours so we cannot be competitive.

We need to change the direction of this country. We need to stop looking to get into people's pockets and start protecting the American people. We need to say, "We are not going to regulate you to death; we are not going to tax you death. We are going to create an environment where we cannot guarantee success, but you have an opportunity to succeed." And we are doing quite the opposite.

So would you like to answer my question?

I think we are headed in the wrong direction. I think if we keep talking the way we have talked in the last 2 years, this country is in dire straits. We are going to be in real trouble. We need to start talking from the perspective of the American out there who knows what they are facing in the economy. They are losing their jobs. The ones who have lost it are having to compete with 8 million illegals here who have taken their jobs. And we are talking in a presidential speech of making everybody legalized in this country and not protecting the American worker.

We need to be on the side of the American workers. People who are in this country just trying to survive, are losing their homes. We need to change the direction of this government and make it responsive to them. This is supposed to be a democracy of laws established by the people to govern themselves. And we have become so heavy-handed, that does not work any more.

I yield back. Thank you, Mr. Chairman.

Chairman BACHUS. Thank you.

Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman.

Mr. Chairman, I think that if we are going to properly resolve or solve a problem, we at least ought to define the problem and know what the problem is. One can conclude that the elimination of a finger is appropriate for a hangnail, but I am not sure that is the best way to resolve the problem.

Those who contend that Fannie and Freddie are the problem have to ask themselves: Did Fannie and Freddie mandate 3/27s and 2/28s? Did Fannie and Freddie mandate loans without proper documentation? Did Fannie and Freddie create an environment

such that loans were made and those who made the loans were not responsible for them; they would simply pass them on to others? Did Fannie and Freddie create prepayment penalties that coincided with teaser rates? Did Fannie and Freddie conclude that the persons who created loans could have a yield spread premium that would allow them to force consumers who had good credit into subprime loans?

All of these things can be traced back to the Alternative Mortgages Transaction Act. And those of you who would like to, you may check that and you will find that I am close. I may not have the title exactly right. But we deregulated. We decided that we would allow for greater products in the marketplace. And when we decided to deregulate and allow these greater products in the marketplace, we didn't consider the unintended consequences all of these products in the marketplace going on and being securitized and passed around the world, in fact; not just in the United States of America.

So we really ought to properly define the problem before we decide we are going to eliminate Fannie and Freddie. Fannie and Freddie by any name will do the same thing. So those of you who want to give us another name—Annie and Teddie, Rough and Ready—you are still going to have the same circumstance to contend with. And at some point, we have to have a serious discussion about how are we going to continue to allow an individual with good credit to get a loan and allow that loan to move from the portfolio of the bank to a secondary market? That is really what we are going to have to at a some point have a look at.

Next point: There is a lot of talk about uncertainty. Why do we focus solely on the uncertainty that businesses have? Consumers have uncertainty, too. Multiple uncertainty is what we are dealing with. And the notion that millionaires create jobs ought to be dispelled today. Millionaires don't create jobs. Demand creates jobs. Give a millionaire another million dollars, and if there is no demand, the millionaire pockets the million dollars, and he goes on or she goes on her way. If there is demand, then jobs will be created, because people respond to demand. No demand, no job creation.

So we have to find a way to not only allow those who would facilitate the production of jobs by virtue of having capital to do so, but we also have to understand that there has to be a means by which this uncertainty that the consumer has can be overcome such that the consumer is willing to go back into the marketplace. Without the consumer in the marketplace, without the demand, the jobs don't get created.

Dr. Kohn, do we have jobs created when there is not demand?

Mr. KOHN. At the current time, there is an insufficiency of demand, I agree.

Mr. GREEN. Let me just ask you, if I may, because time is of the essence. I am under the yellow light. You agree that you have to have demand to create jobs, true?

Mr. KOHN. Yes.

Mr. GREEN. Do you also agree, Dr. Kohn, that these exotic products were not mandated by Fannie and Freddie; that the genesis for them was a lack of regulation brought on by deregulation?

Mr. KOHN. I think there is a lot of blame to go around. In the private sector—

Mr. GREEN. But do we want to overlook that blame, is the question.

Chairman BACHUS. Let me—

Mr. GREEN. My time was not up. It was on yellow.

Chairman BACHUS. Let me say this. Let's just pause for a second. The last vote is now going to be at 12:30. We have a second panel. After this question, and then Mr. Neugebauer, if we could go to the second panel, is everybody in agreement?

Mr. Pearce, too?

We will go two on each side. And then you can all question the second panel. Would you rather have your time on this panel?

This panel? The second panel?

We will reserve two for the second panel, and you all will go first on the second panel.

Mr. GREEN. Mr. Chairman, may I just restate that question?

Mr. KOHN. Fannie and Freddie did not create those CDOs and those exotic mortgages. And they came to the party kind of late. I do think that Fannie and Freddie were a systemically risky operation where the losses were socialized; the gains were privatized. And they need to be reformed. It is a position that—

Mr. GREEN. And if I may say so—my time is up—I absolutely concur with you, but let's not overlook how the products got into the marketplace.

Mr. KOHN. The private sector bears plenty of responsibility for what happened.

Mr. GREEN. Thank you, sir.

Chairman BACHUS. Thank you.

Thank you, Mr. Green. And the last vote is now going to be at 1:30. They have announced they are going to close the offices sometime before 4:00.

Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

This is a great panel, and I wish we were going to have more time and could focus in more specifically on some of these issues.

But, Professor Scott, one of the things that I heard you say a while ago was about the regulatory agencies doing some kind of cost-benefit analysis kind of before they get into the rulemaking process. And I think I heard you also say that you thought that they ought to have possibly a comment period on the analysis before they moved into the rulemaking process. I think that is a good idea, and I think that is, in the future, one of the things that may be something we may want to embed into the legislation. Would you agree that that would be beneficial?

Mr. SCOTT. Yes, I do agree with that. The way the process works is when an agency proposes a rule, if it were to work correctly, they would do a cost-benefit analysis to justify the proposal that they were putting forward. We do build into our system comment periods on proposals. So insofar as cost-benefit was part of that, there would be an opportunity to comment.

I think a key part of what I am saying is we should have an expert comment on that, which is OIRA. It is part of OMB. It is their duty to comment on cost-benefit analysis done by the non-inde-

pendent agencies under current executive order. I think that should be expanded. They should comment on the independent agency's cost-benefit analysis, but with a difference from the non-independent agencies, that comment would not be binding. So we would preserve the independence of the agency to take those views into account, do with them what they might.

Mr. NEUGEBAUER. I think one of the things that many of us are concerned with is we had a CBO estimate of what it was going to cost to stand up Dodd-Frank. Chairman Bachus and I are going to send a letter today to all these agencies that were impacted by Dodd-Frank to actually get them to furnish us a financial model of what they think implementation costs are going to be and continuing costs are going to be for this pretty massive blanket of new regulation. And I think that is appropriate. I wish maybe we would have done that in a little bit more detail before we got here.

And when we talk about jobs, we need to get back to that. But when I look at Dodd-Frank, and I am going to ask the panel to respond, can you point to a provision in any of Dodd-Frank that made capital more available, that it made it more accessible, and that it lowered the cost of capital for companies and people who access capital? Can you point to me where in Dodd-Frank we actually maybe accomplish something that is important to job creation in this country, and that is capital access and cost?

One of the things that I believe we have created in this country—back when people were making lending decisions and investment decisions, they were looking at credit risk, interest rate risk. I will tell you that Congress has created a new risk, and I think we need to start measuring it, and it is called regulatory risk. That entities lose their propensity for innovation or providing certain kind of products with some concern that they are going to somehow—either there will be a regulation down the road that will prevent them from continuing that business model or, even worse, that whatever road they have gone down, somehow somebody interprets a regulation that that is not appropriate.

So, Dr. Poole, I will start with you.

Mr. POOLE. I do not believe that Dodd-Frank was constructive legislation—and that it missed the biggest problem—two biggest problems; one is obviously Fannie and Freddie, and the other is a frontal attack on "too-big-to-fail."

Mr. TAYLOR. I agree with those two points, plus it does things that really have nothing to do with the financial crisis. I would mention the new Financial Consumer Protection Bureau on that last.

Mr. KOHN. I think Dodd-Frank is not a perfect piece of legislation; I don't think there has ever been such a thing. But it, combined with the capital requirements—higher capital requirements and better supervision—will make this financial system safer and more resilient. So will it increase credit tomorrow or next year? No, probably not. But will it help to prevent the kind of squeeze in credit that we had last year and the year before and the year before that? I think it reduces the odds on that.

Mr. SCOTT. I am less sanguine about our capital rules than my colleague, Dr. Kohn. This is again, as I said before, not so much Dodd-Frank, but the Basel process over in Switzerland that is over-

burdening the financial system. And I think that Congress needs to get into the weeds on this. We can't let Basel go on without supervision. I think it is irresponsible.

I think there are two examples where I think actually Dodd-Frank may have improved things. First of all, I think in the securitization process, there was a lack of disclosure as to what the risks were on the underlying loans. And I think that actually impeded the process, made it worse. I think Dodd-Frank has corrected that.

I think the provision in Dodd-Frank for central clearing of derivatives is going to reduce risk and make capital more available. I think what would be a very good idea, Congressman, is to do an inventory like this in a systematic way, which has not been done. And I think your question is very well taken.

Chairman BACHUS. The gentleman from New Mexico.

Mr. PEARCE. Thank you, Mr. Chairman.

Again, we have 5 minutes. I don't want to cut you short, but I am going to ask about five questions. First of all, just in response to how many jobs we can cut or how much spending we can cut without hurting the economy, New Zealand tried this back some years ago, and they cut 63,000 jobs out of one department, from 63,000 down to 1, and their economy jumped from the bottom third of the world's economies to the top third.

So, on the questions, first of all, I think, Mr. Taylor, the Federal Reserve started in 2008, October of 2008, paying interest on reserves, IORs. To me, that looks like that is one of the regulations that is somewhat impeding growth because it is causing banks, giving banks reasons that they would not to lend money; instead, they would hold it in the safe harbor of reserves. Is that a correct viewpoint? Is that the one that is incorrect? Should we reconsider that policy?

Mr. TAYLOR. The rate is quite low at this point. I would be more concerned when rates get higher, what is going to happen with that—at this point—but now it seems to me that would be something to focus on as a problem.

Mr. PEARCE. We are losing the entire multiplier effect when we hold those bank reserves drawing interest.

Mr. TAYLOR. When the Federal Reserve does begin to have to raise rates, I think it is important for them to go back to the strategy they used to have, which does not necessarily entail paying interest on reserves.

Mr. PEARCE. Mr. Poole, you talked about Medicare as being a problem. Has anyone to your knowledge ever done a study—I have talked to doctors who tell me for their time, they get maybe $15, $20 for seeing a patient. Is there anyone who has ever taken a look per transaction in the medical doctor's office how much the bureaucracy in Washington actually charges and receives? If we are paying the doctors $15, I would guess we are paying close to $100 a visit. Is there anyone who has actually quantified that?

Mr. POOLE. I am not an expert on health care—

Mr. PEARCE. You mentioned it. I am not asking you to be an expert. Is there someone who has quantified anything like that? You go into great detail, is the reason I am asking you. You go into great detail about Medicare.

Mr. POOLE. I don't know the answer to that.

Mr. PEARCE. You don't the answer to that. If you find that, I would appreciate knowing. I suspect we pay the bureaucrats far more per transaction than they pay the doctors, which, to me, is upside-down.

Mr. Kohn, with the printing of money that the Federal Reserve has done, is there a risk in your opinion of inflation or hyperinflation in the near future?

Mr. KOHN. No, not of inflation or hyperinflation in the near future. There is an inflation risk over the longer run.

Mr. PEARCE. You said no. I am willing to take no. They are seeing extraordinary inflation in China and other countries in food right now. The price of gold has skyrocketed in the last year. The price of silver has almost doubled in the last year. Are those not signs that the dollar is losing confidence?

Mr. KOHN. I don't think so.

Mr. PEARCE. Okay. That is fine. You don't think so. I am really pressed for time. You don't think so, that is fine.

Mr. Scott, you mentioned on page 14 that you believe the Federal Reserve has the expertise for making such decisions as blah, blah, blah, whatever is in your report, and yet when I look at the Federal Reserve, I asked Mr. Greenspan in this room before he left, and I asked Mr. Bernanke, "Don't you think the hedge funds are causing us great uncertainty, maybe the instability of our entire economy?" Both dismissed that. So we had long-term capital as a pre-warner, and then we had the collapse of the rating institutions and the insuring institutions before the major collapse.

With all the expertise that you have put in the Federal Reserve, why do you think that they decided not to do anything? You declared that you believe in them. You declared that they do it. Why do you believe they ignored the warning signs?

Long-term capital collapse, are you familiar with that collapse?

Mr. SCOTT. Yes.

Mr. PEARCE. And the collapse of the rating institutions, we had four insuring institutions that collapsed about a year before we took those TARP votes, which I opposed. So any idea, as you place a great amount of faith in the Federal Reserve, any ideas why they may be, with all the expertise you attribute to them, they didn't get the thing right?

Mr. SCOTT. I can't answer that.

Mr. PEARCE. You can't answer that. Would you speculate that Dodd-Frank is really dealing—there are many things that deal with derivatives and the hedge funds in Dodd-Frank. If we created a stable currency by stopping the printing of money, don't you think that many of the things that we need to regulate—and your presentation deals greatly with the regulatory process—don't you think those regulatory requirements disappear, to an extent, if we create a stable currency, one with value that is stable over a long period?

Mr. SCOTT. No.

Mr. PEARCE. No. So hedge funds—you would be required to need a hedge fund if you had a stable currency. I think maybe a little bit differently.

Mr. Chairman, thanks for the time.

Chairman BACHUS. Thank you.

The gentleman from Connecticut.

Mr. HIMES. Thank you, Mr. Chairman.

I have been sitting here listening a little incredulously to the discussion on debt, which is not unimportant, but of course, there is nothing about this committee that has jurisdiction over either the revenue side of that or the appropriation side of that.

Nonetheless, I take very seriously what I might call the consensus at the table that this is a very serious issue. We heard it from the President last night. We are, I think, developing a consensus in this Chamber that we need to address it in a serious way.

Though I do have questions that are germane to the activity of this committee, I do want to take a minute or two to pursue the future of debt. Looking back, we pursued Keynesian policies in the last couple of years.

Professor Taylor, if we had more time I would ask you why you considered those deviant as opposed to orthodox. Of course, 10 years prior, we added entitlements in Medicare, fought wars, and cut taxes in ways that led to where we are today.

But I want to look forward and just ask questions here, yes or no questions. I have been watching the policies proposed by the Minority. And let's just take the two landmark policies, if you will. One is an extension of the 2001 and 2003 tax cuts which the Congressional Budget Office, which is nonpartisan, tells us is probably $4 trillion in deficit over 10 years. Now I understand that they may be off. They may be off by some. But does anybody on the panel here fundamentally think that the CBO is dead wrong about the $4 trillion over 10 years?

Okay, I don't see anybody saying that.

The Republican Study Committee has said and proposed $2.5 trillion in cuts over 10 years. And we will talk about that. That is going to be a difficult thing. We do need to cut. I applaud their effort. I am sure I am going to disagree with things. But let's just accept that they can get $2.5 trillion.

Now here is where I need the economists: Help me with my math; 10 years, $4 trillion minus $2.5 trillion. Can I conclude that the two hallmark proposals of the Majority will add, over 10, years $1.5 trillion to the Federal debt? Anybody disagree with that math? No.

Does anybody support—and I heard you, Dr. Poole and Professor Taylor in particular, on the urgency of addressing this—does anybody support those two policies in combination as things that this Congress should do?

Mr. TAYLOR. The policy, it seems to me, is consistent with Professor Poole, is to get this deficit down and have CBO score a reduction in the debt rather than an explosion. And I think you can do that without any tax increases. I think it is very possible to get spending back to where it was in 2008, as is being proposed. And, moreover, I think as a share of GDP, there is no reason why we can't—

Mr. HIMES. But, Professor Taylor, time is short. You didn't disagree with the CBO estimate. And you—we are all accepting that there can be $2.5 trillion. We are stipulating that, not accepting it.

So we are all agreeing that we are going to see an expansion of the deficit by $1.5 trillion. My question was: If those two policies in isolation were the two things we got done, would you be supportive of those two things?

Mr. TAYLOR. When you say expansion, our current tax rates—we have—just been extended for 2 years. I think it would be good to just continue that permanently.

Mr. HIMES. And accept the—

Mr. TAYLOR. When you say what are revenues going to be, revenues are not the problem. Those are the same revenues we are getting now. Where is the loss of revenues relative to some hypothetical of tax increases?

Mr. HIMES. So, over 10 years, if we extend beyond the 2-year period in which we have extended the 2001 and 2003 tax cuts, there is a revenue effect that the CBO has estimated over 10 years. Granted, we have already taken a trillion of that, which is $4 trillion. That is my logic. You didn't disagree with me that $1.5 trillion is added to the deficit if those are the two policies that we enact.

I want to come back because I actually have—this is not germane to this committee. I actually have a few questions that are germane.

Dr. Poole, I am very interested in something you said about the possibility that the private market could fully substitute for the activities of Fannie Mae and Freddie Mac. The people I have talked to suggest that the 30-year fix, the refundable, long-term piece of paper, probably doesn't exist in the market, or, if it does, it exists at a very substantial premium to what it exists today. No government guarantee on the 30-year fix. Do you agree with that? And if so, do you have an estimate for how much more expensive the 30-year fixed mortgage is if there is no government guarantee or implicit subsidy?

Mr. POOLE. I don't have that estimate, but I will tell you this: If it is dramatically more expensive and you want to propose that it be guaranteed by the Federal Government, then it is the taxpayers who are picking up that cost.

Mr. HIMES. Agreed. But we could take the policy decision to, if you will, implicitly subsidize, as we have, the existence of a 30-year fixed piece of paper. I am just curious about what the effect is on the availability of the 30-year fix, which, let's face it, it is mom, apple pie, and core to American families. What is the pricing effect if we take away all government subsidy and intervention in that market?

Mr. POOLE. The mortgage market works just fine in other countries that do not have GSE-type institutions. And I don't know why you should conclude that the mortgage market can't work here; that there is something special about the United States' mortgage market.

Mr. HIMES. Does the 30-year fixed mortgage exist in those countries?

Dr. Kohn, you are nodding "no."

Mr. POOLE. Probably not as extensive as the United States.

Mr. HIMES. My time has expired.

Mr. POOLE. The 30-year mortgage is actually typically not outstanding for anything close to 30 years. Most people are repaying them in about 7 years, anyway.

Mr. HIMES. Thank you.

Mr. Chairman, I yield back.

Chairman BACHUS. Thank you.

Mr. Duffy.

Mr. DUFFY. Thank you, Mr. Chairman. I just need to follow up on a few points that my colleague from Connecticut made. He is talking about increasing taxes, and he is looking at the amount of money that, if we increase taxes, would come into Federal coffers, I believe. Is there a correlation between the amount of taxes an investor may pay and the decisions they make to invest in their businesses or ideas? And I guess I will throw that to you, Dr. Poole.

Mr. POOLE. The answer is, of course. That is a no-brainer. Of course there is, because taxes affect the rate of return on an investment.

Mr. DUFFY. So it is fair to say that we aren't going to look at the same GDP pie and say, if we raise taxes by 4 percent on a certain segment, we are going to be drawing from the same size of GDP. That very well may shrink because there is not enough—there is not as much investment, there are not as many jobs. There is not as much economic activity.

Mr. HIMES. Will the gentleman yield for 5 seconds?

Mr. DUFFY. No.

Mr. POOLE. I am not in favor of tax increases as—following my colleague here, John Taylor. But my emphasis above all is that tax increases cannot solve the problem. If we do not go full-bore on the spending side, we can't solve the problem. I would be willing, if you had a grand compromise, possibly, depending on the nature of it, to accept some tax increases. But if Congress keeps coming back to tax increases to solve our problem, that solution will not work. It will fail.

Mr. DUFFY. I would agree with you. Did you hear the State of the Union speech last night?

Mr. POOLE. Yes.

Mr. DUFFY. The President had proposed we cap spending at current levels as a way to get our budget under control. Do you think that is a sound plan to get our budget under control?

Mr. POOLE. I do not because I think that—it depends on what spending you are talking about. I suppose that he is talking only about so-called discretionary spending.

Mr. DUFFY. I think he was, yes.

Mr. POOLE. There are essential functions of government that are financed that way, such as the work of Congress, the court system, national defense, the maintenance of domestic law and order, and if we do not tackle the entitlements, then we are going to fail.

Mr. DUFFY. Yes. I am going to pivot here quickly. I think most of the folks in America here when they looked at this finance reform bill, or Dodd-Frank, they were concerned that it didn't address Fannie and Freddie. There was some outcry in northern Wisconsin especially. And I think folks are concerned about having a government backstop to these organizations.

I have also heard, though, if we privatize Fannie and Freddie, there is a concern for what happens to our 30-year fixed rates, our mortgage rates, and also what that does to our housing market. Would any of the panel members speak to whether you favor privatizing Fannie and Freddie and what that would do to 30-year fixed rates?

Mr. POOLE. I am absolutely opposed to privatizing them, because it would put them back—after all, they were private companies before they were "conserved." But they had such strong political ties that they ended up costing the American taxpayer a huge amount of money. And I would not want to risk that happening again.

Mr. DUFFY. Okay. Anyone else?

Mr. TAYLOR. I like this idea of gradually phasing them out through changing the conforming loan limits. I think that is a good way to proceed. Otherwise, you could slow it down a little bit if you are worried about some of the particular mortgages, but I think we should do that.

Mr. KOHN. I think we should constrain the role of Fannie and Freddie. I don't think they should be allowed to be portfolio lenders, for example. I think the Congress needs to think carefully about whether it wants to encourage home ownership among certain classes of folks, and a new, smaller Fannie and Freddie that was funded by insurance charges, for example, on the users might be part of that thing. I do also think we need to separate concerns about affordable housing from these entities. I think conflating those is part of what led to things. So address affordable housing separately.

Mr. DUFFY. Is there a correlation now with 30-year fixed rates and the implicit belief that government is backing up these loans?

Mr. POOLE. Not necessarily. That wouldn't have to be the case.

And, incidentally, locking people into 30-year mortgages is not necessarily a good idea because it may reduce their job mobility. So I would let people make that choice themselves. I don't understand why the government should subsidize it and encourage people to go one direction or another.

Mr. DUFFY. Very well. Thank you very much. I appreciate it.

I yield back.

Chairman BACHUS. Thank you. Our final questions will come from—no, we have two more members.

Mr. Canseco.

Mr. CANSECO. Thank you very much, Mr. Speaker.

These questions are directed to Professor Scott regarding Dodd-Frank. Dodd-Frank hands over even more regulatory power to the SEC and to the FDIC and to the Federal Reserve. These are the same agencies who were in charge during the last 10 years. Yet, during that timeframe, we have seen gigantic accounting scandals, such as Enron and Worldcom; billion-dollar Ponzi schemes, Madoff and Stanford; and a mortgage meltdown that has left millions of Americans unemployed and wondering if they will be able to pay their bills.

The regulation was there. The money was there. But regulation failed. And now we have given even more power to a lot of these same agencies that failed the American people this last decade. Do

we have any reason to think, in your opinion, that more rules and more money will produce a different outcome this time?

Mr. SCOTT. I would like to think we learn by experience, Congressman. I think many of these agencies have learned lessons from these crises, and hopefully things will be improved.

But I believe fundamentally that what has been lacking in the rulemaking process of these agencies is any serious cost-benefit analysis. And I think it is incumbent upon the Congress to charge them with doing this.

Mr. CANSECO. Has recent legislation really altered the underlying structure of our regulatory agencies, which is what really needed to be changed?

Mr. SCOTT. Structure?

Mr. CANSECO. Yes.

Mr. SCOTT. Yes, absolutely. I commented on this in my written testimony. FSOC is not the answer to our structural problem. The President talked last night about reforming the Federal Government structure. Part of that Federal Government is the financial regulators. And since Secretary Paulson issued his Blueprint, our committee has issued recommendations for serious consolidation.

I don't think—if you have the best policies in the world and you don't have a good way of implementing them, they are not going to work. And I think we failed on that. Dodd-Frank did not accomplish a real fundamental change in the regulatory structure our financial system has desperately needed.

Mr. CANSECO. Let me move into a little different area of Dodd-Frank.

I come from Texas, and I have a huge swath of a lot of small towns, hamlets, and villages all through West Texas. In November of 2007, one month before the recession began, the unemployment rate in the United States was 4.7 percent. Today, it has actually doubled to 9.4 percent. Small businesses have been hit the hardest. According to the Small Business Administration, firms that employ fewer than 100 workers account for about 35 percent of the workers in our economy.

In my district, which is the 23rd District of Texas, these companies are often financed by small community banks. And, unfortunately, it is these small community banks so vital to our economy that will suffer the most from overregulation, such as Pecos County State bank in Fort Stockton, Texas. It takes in over 50 percent of its deposits in the Fort Stockton area. Before the passage of Dodd-Frank, their annual audit cost them $30,000 to complete. And they have informed me that now it costs them over $112,000 to perform the same audit because of all these new regulations.

Regulators have continually said small banks should not be overburdened, yet they are. Do you believe the supposed benefits that have come from Dodd-Frank, aside from what you have just alluded to, outweigh these costs to small banks that have resulted from this regulation—legislation?

Mr. SCOTT. Congressman, I haven't done the analysis, but I would doubt it. There is a parallel here with SOX's 404 and its application to small business. And we went through a long period where everybody wanted to fully apply SOX 404 to all businesses. But to small businesses, it was a big deal. They had these costs,

the small businesses; they couldn't afford them. So, finally, one good feature of Dodd-Frank for sure is a permanent exemption of the small business from part of 404.

So I think we need to take a serious look at how all these regulations are, as part of our cost-benefit analysis, impacting small business. Because that is where our economy starts, with small business.

Mr. CANSECO. Ergo, a bad regulation.

Mr. SCOTT. Yes.

Mr. CANSECO. I yield back the balance of my time.

Chairman BACHUS. Thank you.

The gentleman from Ohio, Mr. Stivers.

Mr. STIVERS. Thank you, Mr. Chairman.

I just want to follow up on a question from the gentleman from Texas and something that Professor Scott has been talking about all day. Does anybody on the panel have any reason why all these independent agencies should not perform a basic cost-benefit analysis?

Thank you.

The second question I have is for Dr. Taylor.

Dr. Taylor, you talked about how private investment—and you had the graph about how private investment drives our economy. And with businesses sitting on more retained earnings than any time in the last 50 years, is there a prescription to help them take that cash they are sitting on that obviously has the potential to create jobs and help them do that?

And please try to be brief.

Mr. TAYLOR. This uncertainty out there, which is continuing partly just because the economy is still—recovering is still somewhat still fragile, but in addition, I think all these regulatory issues, the uncertainty about what is going to happen with the debt, uncertainty about what is going to happen with taxes, uncertainty about regulations, uncertainty about monetary policy, I think those are all factors that could be addressed and would lead to a more healthy attitude about investing.

Mr. STIVERS. Thank you.

Something Dr. Kohn said earlier I want to kind of address to the whole panel. Doesn't innovation help encourage demand? In fact, it is the psychology of demand. I would use the iPad as an example. I don't know if any of you own an iPad, but that is something that was just an idea a year and a half ago, and now everybody owns one.

I guess I will put it to Dr. Poole—or Dr. Kohn, since you have said it before, does innovation help create demand?

Mr. KOHN. Of course it does. New products, new innovations, new ways of doing things help increase productivity, and over time, productivity increases demand and living standards.

Mr. STIVERS. Thank you.

To Professor Scott, you talked a little bit about—your third or fourth point was about regulatory reform. And I can count seven agencies if you are a big financial institution: the SOC, the SEC, the FDIC, the Federal Reserve, the new Bureau of Financial Protection; and the OCC. I don't know if I missed anybody. I think that is seven. And with the 200 new regulations that are coming

in Dodd-Frank, if any of them are in conflict, how do these companies deal with this?

Mr. SCOTT. The answer is, not well. FSOC has limited authority in some instances to try to reconcile differences between the age-old fight between the SEC, and the CFTC was granted some kind of muscle. But apart from that, we have seen the FDIC, for instance, disagree with the SEC on securitization issues, retention questions. This is going to go on.

Mr. STIVERS. Doesn't that actually reduce the ability to get capital to businesses and create jobs?

Mr. SCOTT. Absolutely. Dysfunctional regulators are not helping our economy.

Mr. STIVERS. Thank you. One other question that I had was, I talked to a banker, a small community banker from First Community Bank, Roger Blair, in my area. He told me a story about a regulator. He has a gentleman who borrowed money for a commercial building 5 years ago. He has never been a day late on a payment. The cash flows are exactly the same. The building is leased the way it was at the beginning. The appraised value has gone down, obviously, by about 50 percent. And the regulators came in and made him write that loan down by 50 percent. So every month when the man makes his payment, Roger has to basically find profit against a bad debt. Doesn't that reduce the amount that First Community Bank that Roger Blair is the CEO of has available to lend.

Dr. Poole?

Mr. POOLE. The answer is yes. But we do need to be careful about picking out particular cases, because you need to look at regulation—

Mr. STIVERS. Let me ask you a follow-up question. I totally understand. Do bankers make loans on cash flow, or do the bankers make loans on loan-to-value? Because my grandfather was a banker. He made it on loan-to-value. My father was a banker. He made it on cash flow. And I am pretty sure the bankers today make it on cash flow.

How do bankers make loans today?

Mr. POOLE. The problem with doing it only on cash flow is that if you have good reason to believe that the cash flow is going to stop, then the loan may be in trouble.

Mr. STIVERS. I understand. But what really determines whether a loan can be paid back?

Mr. POOLE. Obviously, the cash flow.

Mr. STIVERS. Thank you. I have just one last question. This is for the entire panel. Do we have a revenue problem in this country, or do we have a spending problem?

Mr. POOLE. I have said over and over again, spending.

Mr. TAYLOR. Spending.

Mr. KOHN. Entitlements.

Mr. STIVERS. That is a good point.

Mr. SCOTT. I plead ignorance. I am not the economist on the panel.

Mr. STIVERS. Thank you.

I yield back.

Chairman BACHUS. Thank you.

Mr. Schweikert.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

I don't want this to come across as too esoteric. When we look at the debt overhang, whether it be nonperforming mortgages or the nonperforming assets, how much of a hindrance, in your opinions, is that to economic growth and job creation? I have been spending a lot of time looking at the amount of MBS out there, other assets that are not performing but are still sitting on our books. What is that doing to us growth wise?

Mr. KOHN. On the books of banks, for example?

Mr. SCHWEIKERT. Banks, or even within the secondary markets.

Mr. KOHN. So I think certainly the increase in nonperforming loans and problem loans took capital away from banks. They needed to reserve for it, and it probably made them much more cautious in lending. I think there is some sense now that things are beginning to peak out and that, as the economy recovers, nonperforming loans would go down. And as I think one of your colleagues pointed out before, some of the more recent information from the Federal Reserve is that banks are becoming a little more aggressive in making those loans. Certainly, the increase in bad loans was a problem for banks that they needed to address. And that probably impinged on their ability to make loans for a while.

Mr. SCHWEIKERT. Mr. Chairman, where I am partially heading with that is I am still stunned how much is still sitting on the books or is in the process of still moving into, particularly for myself, who focuses often on the real estate market, the amount that is delinquent but not actually technically in foreclosure.

Just in my county, Maricopa County in Arizona, I have 50,000 residential units that have been notified of foreclosure, and it is often said there may be 2, 2½ times that many that should have been notified.

Mr. KOHN. I think moving through this problem quickly is one of the things that will help to reduce uncertainty, but it is a very difficult problem, given all the servicing that is scattered, the second mortgages, etc. But I agree that this overhang, the so-called shadow inventory of homes that might be foreclosed against or probably will be foreclosed against, is hanging over the housing market and impeding the recovery of that market.

Mr. POOLE. And will likely for some years to come. It is just a very big problem we dug for ourselves.

Mr. SCHWEIKERT. Mr. Chairman, the last part.

Does anyone have a brilliant suggestion on how we push this nonperforming overhang through the system; how we incentivize both lenders, secondary holders, whoever it may be, to help us chew this up? Because we are turning what appears to be a few-year real estate depression and we are going to make it last well over a decade unless we get this off our books.

Mr. POOLE. I will just take a quick stab at that. I think we need to let that be done primarily in the private sector. I think the efforts of government to get into that business have simply not been very successful. And as I look at the numbers, the number of foreclosures that are assisted in some way by the Federal programs is simply not going to the heart of the problem.

Mr. KOHN. I don't have any suggestions. It is a very difficult problem. The private sector is bringing more resources to bear on this issue. I think they are concerned about litigation, obviously. I don't have any quick answers to this very difficult problem.

Mr. SCHWEIKERT. Mr. Chairman, thank you very much. Many of us believe, unless we can push through much of this nonperforming inventory, we are never going to hit our true bottom and never going to start to work our way back up.

Chairman BACHUS. Thank you.

The first panel is dismissed. We appreciate your testimony.

The Chair notes for the hearing record that members will have 30 days to submit additional questions to this panel.

At this time, I will recognize Ms. Waters for an unanimous consent request.

Ms. WATERS. Mr. Chairman, I have an unanimous consent request to enter two statements in the record, one from the National Low Income Housing Coalition and the other from the Credit Union National Association.

Chairman BACHUS. Thank you.

I also have an unanimous consent request that we introduce a letter from the Associated Builders and Contractors.

If there is no objection to either request, they are so granted.

We welcome the second panel. Thank you.

I would like to take this opportunity to introduce one of the witnesses today who is a former intern of mine, a congressional intern, Eric Hoffman. His mother, back in, what was it, 1998—

Mr. HOFFMAN. That is correct.

Chairman BACHUS. —mortgaged her house and started a small business, which today is Hoffman Media, and has a staff of 135 and net sales or revenue of $42 million and publishes several magazines. Eric, once he graduated from the university, joined that office. He had, about a month and a half ago, called concerning some of the regulations that we had passed and how he was afraid that it would affect their funding going forward. So, we will listen to his testimony.

One of our other witnesses, Mr. Charles Maddy, is president and executive officer of Summit Financial Group. Located in—is that in Kansas?

Mr. MADDY. West Virginia.

Chairman BACHUS. Mr. Andrew Bursky, managing partner of Atlas Holdings. Where is that located?

Mr. BURSKY. In Greenwich, Connecticut.

Chairman BACHUS. Mr. Ken Brody, partner, Taconic Capital. Where is that located?

Mr. BRODY. New York City.

We welcome all four of you gentlemen. Somebody had a flight at 4 o'clock, or was that the first panel? So we will be through by that time.

So we will start, Mr. Hoffman, with your testimony.

STATEMENTS OF ERIC HOFFMAN, EXECUTIVE VICE PRESIDENT AND CHIEF OPERATIONS OFFICER, HOFFMAN MEDIA, LLC

Mr. HOFFMAN. Great.

I want to begin by thanking Chairman Bachus and the members of the Committee on Financial Services for the invitation to speak today.

I have had the privilege to work at our family business, Hoffman Media, and be part of an incredible growth story. As I strategize about both our company's continued growth as well as small business growth across the United States, I am concerned by recent changes in financial regulation, health care, and taxes.

In this testimony, I will share with you the history of Hoffman Media; the concerns that I have on the Volcker Rule and long-term negative effects on small business and growth; and concerns of future burdens caused by health care reform and higher taxes.

Overall, I am concerned that the significant changes we are seeing will hurt our future ability to grow, as uncertainty is the worst headwind we face. I remember President Obama said last night that we can do big things. It is possible to do big things, but uncertainty prevents that.

Hoffman Media was founded in 1998 by my mother, Phyllis Hoffman, who currently serves as chairman and CEO. After successfully working for 5 years at a large publicly-traded company, she left the business. She acquired two magazines and financed the startup by mortgaging her house, a true sign of an entrepreneur.

From 1998 to 2003, the company ran on an extremely tight budget, whereby all operating profits were reinvested in the business to fund continued growth through the launching of new magazine brands. In 2003, the company had approximately 20 employees and generated approximately $4 million of sales. It was during this period that Phyllis decided in order to properly fund growth and scale the company both through organic growth and acquisition, that Hoffman Media would need to raise capital.

Since Hoffman Media was not producing net income, it prevented the company from accessing traditional commercial lending from a bank. And after a 24-month search, interviewing private equity funds, Hoffman Media successfully raised $5 million from BIA Digital Partners and Frontier Capital. This capital raised allowed Hoffman Media to complete a strategic acquisition of a complementary business and fund additional marketing and hiring needs.

From the period of 2004 to 2010, the company has scaled, growing revenue from approximately $10 million to $40 million, while also growing our employee count from 20 to 135. The capital raised is worth explaining further. BIA Digital Partners provided mezzanine debt with warrants to the company, which Hoffman Media successfully paid back in 2009. The outcome was a win for all parties involved: it was a win for Hoffman Media; it was a win for the private equity firm; and it was a win for the LPs.

I want to point out that half of the fund's LPs are banks, large national banks, some of the best institutions in the land. And I will go as far as saying that Hoffman Media would not be where we are today had it not been for the support of both BIA and also their LP support, which included banks.

The Volcker Rule's proposed limitation on banks being owners in or holding equity in hedge funds and private equity firms concerns me in that if it is done away with altogether or it is limited to roughly 3 percent of tier 1 capital, which I believe is proposed, I

fear this could lead to a substantial decrease in the funding that supports private equity, in particular, those covering the lower middle market.

If the pie gets smaller and banks can only invest a small portion of their capital, my fear is that it will only reach the larger buyout funds and not the lower middle market. The total economics of those relationships with the larger buyout funds are obviously more important. However, the value created in larger private equity is generally done through leverage, dividending out excess cash, cutting costs, taking companies private, and then returning them to the public market later.

Firms like Hoffman Media can obviously show that a private equity investment works. It works for us. We have grown a real sustainable business. We are now producing substantial sales tax that impacts the local sales levels. We generate taxable income. We have 135 people who are impacting our local economy every day by paying their mortgages, buying groceries, etc.

My biggest concern is that if companies like Hoffman Media have additional hurdles that are put in place to prevent us from growing, it is going to slow down this economic recovery, I have no doubt. This recovery will come from small business. And it is businesses like ours. We have entrepreneurs who take risks, go after their dreams. And then when they scale and need that capital, if they can't get it from a traditional bank, which is incredibly difficult to do—we have tried, and it took us years to finally work with a traditional bank—it will have big negative impact on the recovery.

In passing, I will say health care reform and higher taxes are also hurdles that can potentially slow down the economy. I know that as we produce profits, if the cost of our profit goes up by tax rates or our costs of operating goes up with health care costs, that directly steals money off the bottom line. And one of the Congressmen earlier said that millionaires don't produce jobs. The fact of the matter is if a millionaire is given another million dollars, they reinvest it. They don't put it in their pocket. And we are an example of that.

So, in closing, I believe that the story of Hoffman Media is compelling. I urge the Members of Congress to pay close attention to our story because there are thousands of companies just like Hoffman Media out there. We don't want to put limitations on our banks. The fact of the matter is if they want to invest in smaller private equity firms or large buyout funds, it is their choice, but let's not limit the capital that is flowing down the lower middle market because that is where a significant amount of jobs will be created. Thank you very much.

[The prepared statement of Mr. Hoffman can be found on page 72 of the appendix.]

Chairman BACHUS. Mr. Maddy.

STATEMENT OF H. CHARLES MADDY, III, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SUMMIT FINANCIAL GROUP

Mr. MADDY. Chairman Bachus, members of the committee, my name is Charlie Maddy. I am president and CEO of Summit Financial Group. My bank serves communities located in south central

and the eastern panhandle of West Virginia, as well as in the Shenandoah Valley and northern regions of Virginia.

Summit Community Bank has more than a half billion dollars in small business loans. We contribute a quarter million dollars to our schools and nonprofit and community organizations annually, and our employees volunteer thousands of hours to support our schools, nonprofit organizations, and charities. We are very proud of the relationships that we have with our customers and community. They are our friends and neighbors, and our success is linked to their success.

We now have the benefit of history, which clearly shows that community banks were not responsible for the great recession we are currently experiencing. However, banks like mine continue to be subjected to intense regulatory scrutiny. Calls for expensive and scarce capital and pressure to add compliance staff to deal with all the new regulations are currently plaguing us.

How can I be out in my community helping someone improve their quality of life or helping a small business grow if all I do is deal with the aftermath of problems that I did not create?

Let me give you a bit of perspective on this. We used to all know where we stood with capital rules. We could plan for growth and make new loans without being criticized for having too little capital. This has all changed. Banks are being asked to raise capital, in some cases, even if they are well managed and have no significant asset quality problems.

Most importantly, there is no clarity on how much capital is required. It has clearly become a moving target. This uncertainty, combined with pressure to raise new capital, makes it hard to grow and seek new lending opportunities. Please keep in mind that the most efficient way to raise the capital ratio in one's financial institution is to simply shrink the size of your assets, including your loan balances.

Another disturbing trend is that the new standards are being applied to banks without having a clear understanding of what they are. Banks should at least be told what ratios examiners are using as standards. Moreover, what used to be guidance is now being enforced as if there were hard and fast rules. In our case, the bright-line test currently being applied will reduce our ability to make new commercial real estate loans by over $100 million.

The regulators in Washington seem intent on twisting the screws tighter and tighter. After all, regulators do not lose their jobs for being too tough. The time to be tough is before an economic turndown, not after. In fact, being tough makes things worse at this stage in the recovery. It is like adding fertilizer to your lawn in the heat of the summer; it is only going to kill the grass, not help it.

Regarding the Dodd-Frank Act, it will have an enormous and negative impact on my bank. Already, there are over 1,000 pages of new proposed rules and there will be many thousands more, many of which will come from the Bureau of Consumer Financial Protection. We have already added one new full time member to our compliance staff and this may not be enough. These are resources that won't help us make new loans in our communities.

We are also bracing for the loss of revenue from interchange. The so-called carve-out under Dodd-Frank for community banks won't

work. Revenue from interchange is important to my bank, as it helps offset some of the cost of providing checking accounts to my customers. We cannot afford to offer financial services if we cannot cover the cost of doing so.

The people who get hurt most by these changes are the hard-working men and women in West Virginia who earn just enough to make ends meet. They are currently able to get most of their basic banking services free of charge. If we lose fees like interchange revenue, free checking and similar services are likely to disappear for everyone. I think this is bad public policy.

Summit Community Bank will survive these changes, but many other community banks may not. In fact, regulators have told some banks that if you are under $500 billion in assets, you may want to consider merging, as you may be simply too small to survive. This would translate to over 90 percent of all banks headquartered in my home State of West Virginia. Higher costs, restrictions on income, limits on new sources of capital, and regulatory pressure to limit lending in certain sectors all make it harder to meet the needs of our communities.

Madam Chairwoman, I truly appreciate the opportunity to be here today and I will be happy to answer any questions that you may have.

[The prepared statement of Mr. Maddy can be found on page 88 of the appendix.]

Mrs. CAPITO. [presiding] Thank you, Mr. Maddy. And I apologize for not being here to formally introduce Charles Maddy. I know he was introduced, but he is one of my constituents and has been a longtime and very active banker in our State. I thank you for your service to our State and your community. He lives in Moorefield. He is also an executive of the Federal Home Loan Bank of Pittsburgh, has been active with that as well and has been a great resource for me in terms of trying to unwind all of these issues, besides inviting me to his bank to meet all the great folks who work in Moorefield, which I said was not really named after me, but I will claim the "Moore" part of Moorefield. So thank you, Charles.

Mr. MADDY. Thank you.

Mrs. CAPITO. Where we are right now is we are voting. And so Chairman Bachus went to vote, so we can keep the hearing going. He is going to come back and relieve me, and then I will have to slip back out again.

So I would like to recognize our next witness, Mr. Andrew Bursky, who is the managing partner of Atlas Holdings LLC. Welcome.

STATEMENT OF ANDREW M. BURSKY, MANAGING PARTNER, ATLAS HOLDINGS, LLC

Mr. BURSKY. Thank you, Madam Chairwoman, and distinguished ladies and gentlemen of the committee. I appreciate the opportunity to address you today. I am Andrew Bursky. I started my first business in my hometown of Indianapolis when I was 11 years old.

Today, at Atlas Holdings, I employ 5,000 individuals directly or through the portfolio companies of my private equity fund. These jobs are the result of three kinds of private equity activity. We ac-

quire struggling businesses and rehabilitate them by investing our own capital and extensive managerial resources. We grow businesses whose expansion had been stunted by capital or managerial constraints, and on occasion we will start a business and partnership with experienced operating partners.

Our work is quite similar to that of other small to mid-sized private equity firms, of which there are more than a thousand in the United States. Our collective activity has been a well documented, if not well publicized engine of growth for the U.S. economy for more than 2 decades.

A recent study by Ernst & Young stated that 80 percent of private equity owned businesses increased employment during the period of PE ownership, even though most of these companies were in mature industries or had been stress companies when purchased.

Another study for the Center for Economic Studies found that prior to investment private equity portfolio companies were losing jobs at a rate of 1 to 3 percentage points faster than their competitors. After PE investment, companies initially experienced a dip in employment that saw employment growth rates rise above industry averages within 4 years.

Let me briefly share with you an example of our activities which occurred in Michigan, the State with the Nation's second highest unemployment rate. In 2002, we became aware of a shuttered specialty steel mill in South Lyon, Michigan. The mill, Michigan Seamless Tube, had been profitable for 75 years, but had fallen upon hard times as a result of problems at a sister division and a series of management blunders.

The banks had taken over, dismissed the workforce, and were planning on a full liquidation. In these settings, rarely will an industry buyer appear. What is required is a private equity investor with the experience to work through a complicated bankruptcy and the operational skills to shepherd the business through the process.

Working closely with the U.S. steelworkers in the State of Michigan, we crafted a plan to restart the facility. We committed $10 million of our own capital, enormous time, and 18 months of sleepless nights. By 2004, the business was operating profitably and today MST employs 250 in high-paying manufacturing jobs in a State where every job counts. As an aside, MST ships about 20 percent of its production into highly competitive export markets, demonstrating that well positioned U.S. manufacturers can in fact compete globally.

In 2010, two of our three transactions were similar to Michigan Seamless, our acquisitions of Bridgewell Resources, a Portland Oregon-based global trading company that was being liquidated through a Federal receivership, and Detroit Renewable Power, a shuttered green energy from waste business in downtown Detroit. All that kept these businesses from final liquidation was our willingness to invest our time and money, work cooperatively with affected parties to seek resolution to seemingly intractable problems, and bet on our conviction that we could undertake these challenges profitably. These two acquisitions in 2010 have already put more than 350 people back to work.

Occasionally, we hear of a PE-owned overleveraged business failing or being forced to reduce employment, just as businesses not owned by private equity firms sometimes fail. But the work of the many small to mid-sized PE firms like mine is focused on saving and growing businesses.

It is worth noting that a study by the private Equity Growth Council credits private equity with preserving 185,000 jobs since January of 2008 through investments in 137 bankrupt businesses, to say nothing for the hundreds of thousands of new jobs created by providing capital to growing businesses.

Unfortunately, this engine of economic growth is about to have its wings clipped as an unintended consequence of Dodd-Frank. Harvey Pitt, former SEC Chairman, stated just last Thursday that, "My own belief is that private equity firms are the engine of economic growth and we are now imposing restrictions on them simply for the sake of restrictions."

Shame on all of us, business people, financiers, and legislators if we fail to learn the lessons of Madoff and the financial crisis. So I applaud your efforts to create balanced legislation that addresses real problems of the past. But one important lesson of the financial meltdown is that private equity did not contribute to systemic risk. No investors were harmed, nor was there any lack of transparency or fraud perpetrated on investors by any private equity fund.

We have asked the SEC to delay implementation of the Dodd-Frank requirements on PE firms until the issues involved are thoughtfully reassessed. No public purpose is served by implementation but the costs are very real. We will spend hundreds of thousands of dollars and, far more damaging, we will reallocate our resources to registration, regulatory, and compliance matters and away from our highly productive focus, which has consistently created jobs for America.

Thank you very much.

[The prepared statement of Mr. Bursky can be found on page 65 of the appendix.]

Mrs. CAPITO. Thank you.

Next, we have Mr. Ken Brody of Taconic Capital, and where are you located, Mr. Brody?

Mr. BRODY. New York City.

Mrs. CAPITO. New York City. Thank you.

STATEMENT OF KENNETH D. BRODY, PARTNER, TACONIC CAPITAL

Mr. BRODY. The last time I appeared before this committee was about 3 years ago when I was a lone ranger among a whole slew of hedge funds calling for mandatory regulation by the SEC of all hedge funds.

Mrs. CAPITO. Mr. Brody, I'm sorry. I hate to do this but since I am the only one left, and we have a vote going, could I ask you to suspend and we will be right back?

Mr. BRODY. In mid-sentence, I will. We will see you when you come back.

Mrs. CAPITO. The committee will stand in recess.

[recess]

Chairman BACHUS. You started your statement, you may resume.

Mr. BRODY. This is better. Here we go.

As I started out before, the last time I appeared before this committee was 3 years ago when I was the lone ranger among a slew of hedge funds that were asking for some upgraded regulation of hedge funds, and specifically asking for you all to make mandatory hedge funds registering with the SEC and then the SEC getting better with their oversight at what they do. So it is good to be back here again, on a different topic. I have a few comments. They will all be focused on Dodd-Frank, but I am open to any questions that you might have of me.

Dodd-Frank is obviously not perfect legislation. It has flaws, but it is a step in the right direction. It is but a part of international regulation of the financial system, particularly Basel III, that is aimed at creating more equity in the financial system. The goal is to have safer and duller banks. And, so far so good, we are heading in that direction.

In the United States, lending has picked up and most borrowers, not all, but most borrowers are getting the money that they need. To the extent that banks are still cautious in their lending, it is more a function of their recent history and current economic uncertainty than Dodd-Frank.

Where certain companies can't borrow, particularly those seeking loans based on cash flows, help is on the way. Our free market economy works well, and there are a number of firms looking to plug that hole because they can make money by doing so. So I am not very concerned about the effects that Dodd-Frank is having on the lending market in the near term.

Of course, the bureaucracy involved in writing the rules and overseeing the rules for Dodd-Frank creates uncertainty, but the uncertainty involved with the writing of the rules will pass and we will end up with a sounder financial system. We should not look to go back to where we are. It was too loose, too liberal, and helped us land in disaster. So that is not the right standard to say, geez, we used to do that and now we can't do that anymore. We do need a safer banking system, and we are well on the way to creating it.

Thank you.

[The prepared statement of Mr. Brody can be found on page 64 of the appendix.]

Chairman BACHUS. Do you have any questions, Mr. Green?

Mr. GREEN. I will be very brief if you are going to pass, Mr. Chairman. You are going to pass?

Chairman BACHUS. I will let you go.

Mr. GREEN. Okay, thank you very much. And I thank the witnesses for testifying today. As you know, we have votes and I did miss some of your testimony, but you did submit your testimony for the record.

Let me start by asking a very basic question. What happens to a business that attempts to serve a clientele that doesn't exist or tries to cater to a demand that doesn't exist?

Mr. Hoffman, would you quickly tell me what happens to such a business? If you try to serve a demand that there is no demand for the product, what happens to the business?

Mr. HOFFMAN. I think that you know there is R&D that companies do to sort of figure that out.

Mr. GREEN. Let me just say this to you, Mr. Hoffman, to help you along. It goes out of business. You can't cater to a clientele that doesn't exist and stay in business. Businesses stay in business because they have a demand that they satisfy. And my point that I was making earlier that I appreciate your addressing had to do with the fact that businesses are not going to invest when there is not a demand or at least the potential demand for them to meet. Innovation is a great thing. When companies innovate, they do so in anticipation of a demand that will be there. Demand drives these things. You don't just do it because you have money to invest, good business people don't.

Moving to my next point.

Mr. HOFFMAN. Can I respond to that?

Mr. GREEN. Excuse me, sir, I control the time.

Mr. Brody, is that correct?

Mr. BRODY. Yes.

Mr. GREEN. Mr. Brody, I want to thank you for your comments because I think that Dodd-Frank has served a meaningful purpose as well. I am of the opinion that "too-big-to-fail," nobody wanted it, but we did have to have a means by which we could wind down these huge institutions that were creating systemic failure. Dodd-Frank addressed the question of systemic failure. Is it perfect? My suspicion is, it is not, but we have at least made an attempt to move in a positive direction with Dodd-Frank. Just as we wind down banks when they have problems, we go in on a Friday, shut them down and open them up on Monday, the FDIC has a means by which this can be done. This is another means by which we take on large institutions that can create systemic failure. So I think that there is a lot of merit to Dodd-Frank.

The Volcker Rule quickly, before I left, there was an indication that someone was disenchanted with the Paul Volcker Rule. The Rule keeps banks from using taxpayer money in proprietary trading. Am I incorrect on that; anybody want to differ? Okay.

Is there anything wrong with being concerned about how taxpayers may have to bail out institutions that engage in proprietary trading with taxpayer dollars and moving to some means by which we try to protect taxpayer dollars? What would we do if we had no such rule and a large institution overextends itself and is about to fail? Mr. Hoffman, what should we do?

Mr. HOFFMAN. First of all, there is a big difference in—and you have a difference between proprietary trading and also private equity investing. Those are two unique differences and—

Mr. GREEN. I understand the difference between private equity investing, but do you not believe that we should in some way protect taxpayers who end up bailing out these companies?

Mr. HOFFMAN. I think that private companies or corporations that are using their own capital to invest on their own account, they use it for more than just getting risky return rates, they do it for business development, they do it to allow companies like Hoffman Media and thousands of examples like ours. It gives us a chance to prove creditworthiness. So these alternative investments help them gauge how they build their business downstream.

Mr. GREEN. I understand.

Mr. HOFFMAN. Explain to me taxpayer dollars.

Mr. GREEN. Excuse me if I may, sir, since I have the questioning time. Thank you. Should banks invest in private equity funds?

Mr. HOFFMAN. Absolutely.

Mr. GREEN. Should there be any limit on how much they can invest? And when they fail, what should happen, if that happens?

Mr. HOFFMAN. The bank should go under.

Mr. GREEN. And if the bank goes under and that failure is systemic and it impacts the entire economy, what should happen? The economy should go under?

Mr. HOFFMAN. Is that what you believe?

Mr. GREEN. I am asking you.

Mr. HOFFMAN. I believe the bank should go under.

Mr. GREEN. Okay, the bank goes under, banks go under. The entire economy is impacted.

Mr. HOFFMAN. Right.

Mr. GREEN. It is your opinion that is just the risk the economy takes by letting this do this?

Mr. HOFFMAN. Correct.

Mr. GREEN. Okay. Thank you. My time is up.

Chairman BACHUS. Thank you.

Mr. Maddy, you are a community banker and you kind of have a unique view of "too-big-to-fail" because probably one out of every thousand businesses is deemed "too-small-to-save" when you have "too-big-to-fail." How does that strike you as a banker of a smaller institution? Do you think there is any fairness in the "too-big-to-fail" doctrine?

Mr. MADDY. As a small banker, and I speak for myself here of course, not the industry, I do think that we should have limits in place that keep institutions from being so large that they create risks that endanger our entire economy. I don't think that is sound policy, and I think it should be dealt with. And I think that we can do that, we can keep these institutions from being so large, and then we can allow them to invest in some of these private equity situations. Then, if they do go under, the whole process works, because it is true capitalism, and that is my opinion.

Chairman BACHUS. I think it would be true capitalism. If you are "too-big-to-fail," you are "too-big-to-exist."

Mr. MADDY. Right.

Chairman BACHUS. And I think actually Mr. Volcker and many of us in Congress say if our only choice is we either bail them out or they will bring down the economy if we don't bail them out, then they are just too big. The new report by the overseer of the TARP has said that Dodd-Frank actually institutionalizes "too-big-to-fail." So you have these institutions that are just—"you can't let me fail, I am too big, I'll bring down the economy." I think our choices are, are we going to bail them out or we are not going to allow them to exist in that form.

I heard your testimony and had read part of it and it is the same conversation I have had with small banks and even regional banks all over the country, before Dodd-Frank, even before that, they were micromanaging your loans and second-guessing your loan decisions. Do you believe that you are best able to make decisions on

who to loan money to and under what terms or that a bank examiner or a regulator in Washington is best able to do that?

Mr. MADDY. Clearly, I think that the community bankers are in the best position to make those decisions. I would even go a step further and point out, at least in my own experience, the examiners who have come onsite, the people who know the area and who have worked in those areas for years actually have been pretty reasonable throughout this entire process. Most of the stringent and overzealous actions have come from somewhere above. We don't know exactly where, but it is certainly somewhere outside of their hands, and in candid conversations to the degree they feel comfortable even admit that, that in some cases they don't really agree with this but this is just how it is.

Chairman BACHUS. I heard Paul Ryan use the same term I used last week when I was appearing before the—I was on a panel with Sheila Bair and Ben Bernanke—and that is "American exceptionalism." We in America—the whole country was founded on the premise that we all have the freedom to succeed or fail and we don't look to the government to direct that or to pick winners or losers or to be there as a safety valve for a "too-big-to-fail" company, that really the people are entrusted with the ability to make choices. And then they should live with those choices.

If you are talking about the FDIC and insurance, deposit insurance, obviously if your underwriting standards as a whole bring risk to that, that is one thing. This idea, and I have talked to a community banker in Alabama, who a regulator, examiner, and he was new, had been on the job about a year, looked at an $8,000 car loan to an 82-year old woman whose son owned the biggest business in the county and said the car is not worth $8,000 and made him write it down to $6,000. Even though the loan was current, she owned her own house, and as the banker—and this is relationship banking. I think that examiners and regulators ought to appreciate those relationships and they should not violate those relationships. And when he said to this family—I have dealt with this lady for 30 years, her son is a customer of the bank, he is good for it, an examiner ought to trust the business, they ought to trust that you are in business to make a profit, not to go broke. I think what they are doing, I hear this, that they were too lax in the good times and you mentioned and now they want to kind of make it up.

Mr. MADDY. Right.

Chairman BACHUS. The time to be tough, I think in your testimony, is before when there is—you were doing something before an economic turndown, and I think that is going to be one of our challenges, but I am not sure that we can all of a sudden start—you can't have capitalism without capital. And whether you reserve it under Dodd-Frank to telling end-users or derivatives, none of which still haven't seen a case where it caused any harm to our financial system or to those industries, by end-users like a Southwest Airlines or a John Deere hedging gasoline or fuel or currency. We have never seen an incident where they did anything that caused the financial system any concern or even that wasn't profitable to them, yet under this new bill, they have to reserve capital for that. They will be going into job creation. I will say there is a

bipartisan consensus building that we need to change that. I have said before there are good things about Dodd-Frank, there are bad things and there are ugly things, and that is one of the ugly things.

Mr. GREEN. Would the Chair yield for just 30 seconds, if I may?

Chairman BACHUS. I will. You have 2½ minutes.

Mr. GREEN. Thank you, Mr. Chairman. I concur with you that there is a consensus building that we can tweak and we can mend the bill. I don't think that it is perfect. I do want to just make note of this. In a free market economy, it is very difficult to limit the size of private enterprise when the businesses are desiring to grow. I don't know how we in a free market economy will decide you are only as big as you can get now and if you get any larger we are going to find a way to downsize you. This is why you have to have some means by which you can deal with those, just as a matter of fact, who are so large that they can create systemic failure. There is no desire to have "too-big-to-fail." I don't think any business is "too-big-to-fail." That is why we want to have a means by which they can wind down when they get in a position that they are about to fail. We don't want them to bring the economy down, and let's let them pay for their own failure. That is what Dodd-Frank proposes do, to put them in a position where they have to cover their own failure.

And I am with the chairman, all businesses count. Small banks didn't create the crisis and we ought not have them pay a price that is unacceptable given that they were not a part of the problem. I stand with community bankers, but we also have to understand as a reality we had these huge conglomerates that were so large that they were impacting the entire economy. What do you do with them? That is what we—and we have tried to do something with them. And Mr. Chairman, thank you. You have been very generous with the time.

Chairman BACHUS. Actually, we have additional time, and we have a little time on the Floor. So if you want to ask an additional question, I think I will follow up.

Mr. GREEN. I will go to Mr. Brody and I am going to ask that we make those names a little bit larger just for those of us who are still trying to read without our glasses. I think it is Brody, I can't quite see it.

Mr. Brody, would you do this, in the absence of the mechanics in Dodd-Frank, what will we do in the future when we have these huge companies that may create systemic failure?

Mr. BRODY. The first thing that we do is what we are starting to do. First of all, it is the financial system that is the key to systemic failure. Most other companies can fail and don't have the interrelationships that causes systemic problems.

With the big financial companies, the thing that you all are doing with Dodd-Frank and which Basel III will do is it is making these banks safer, basically safer and duller, by having them have more equity and engage in fewer volatile operations. So that is a big part, is to make it much more difficult for them to fail, and that is the direction that we are headed in and that is a good thing. That has other consequences but the world is about a tradeoff, and that is probably the key thing to look at going forward.

With respect to—in spite of everything, what happens if there is a big systemic failure, you need to have a system in place which allows for a gentle, not-disturbing-the-rest-of-the-world system that can help unwind it. One of the things you can do short of unwinding it is to attack the capital issues by having various forms of debt take hits, to basically have the institution save itself by being able to increase its equity by moving debt into equity, and there are bunches of efforts on that score going on around the world and that will probably end up being a big solution to the problem.

Chairman BACHUS. Thank you. Let me follow up with one question to our community bank representative. Interchange fees, how will that affect your bottom line and that of most community banks?

Mr. MADDY. I think as a practical matter, when all is said and done, and I guess that is my biggest point, we can't allow it to affect our bottom line. We will have to make up for those fees in some other way, but it costs hundreds of thousands of dollars to offer free checking, free Internet banking, free debit cards, free services to so many of the folks out there who are balancing their checkbooks accurately and taking care of things and not incurring any fees whatsoever. And one of the ways we do that, frankly, is from the fees that we collect on some of these other products. And so what will happen is there will simply be a transfer of those fees. Either the lenders—the borrowers will have to pay for it, other deposit services will end up making it up. In the end, somebody is going to have to pay the price because we have to continue to have a profit that makes it worthwhile for investors to want to buy our stock.

Chairman BACHUS. All right. Thank you.

I appreciate the testimony, and I do think one thing that we highlighted here is that private equity companies and hedge funds as well as community banks can be part of the solution and that none of them I think were part of the problem. They didn't create a problem, they created jobs and they have sustained jobs, and we should be very careful in the level of regulation.

Thank you very much for your testimony.

The Chair notes that some members may have additional questions for this panel that they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

Also, we have an unanimous consent request to enter into the record letters from the National Association of Federal Credit Unions and the Manufactured Housing Association for Regulatory Reform. Without objection, that is so ordered, and this hearing is adjourned, thank you.

[Whereupon, at 2:00 p.m., the hearing was adjourned.]

A P P E N D I X

January 26, 2011

OPENING STATEMENT OF REP. BILL HUIZENGA

House Financial Services Committee

Hearing on Promoting Economic Recovery and Job Creation: The Road Forward

January 26, 2011

Good morning, and thank you Chairman Bachus and Ranking Member Frank for holding this important hearing today.

Being a small business owner, I know firsthand that the country is still feeling the effects of the financial crisis from 2008. The economy has been slow to recover, and in turn job creation has lagged. Many Americans are still out of work, and many have simply stopped looking for employment. Spending is at a record high, and because of this, our nation is in major debt, hurting our chances for recovery and prosperity.

In November, the people of America said, "Enough," and called for a new direction. They spoke out in record numbers both at rallies and at the voting booth, calling for us to work together to create policies that will help them get back to work, restore fiscal discipline to their government, and live the lives promised in the great founding principles of our country.

During the last 12 months, the Obama Administration has said that the economic stimulus, the passage of healthcare reform, and the regulatory overhaul of the financial services sector would save jobs and keep unemployment below 8 percent. However, that is not the case. Earlier this month, the Bureau of Labor Statistics reported that the national unemployment rate fell from 9.6 percent to 9.4 percent. That equates to roughly 14.5 million Americans without a job. While this is a staggering number, in my great state of Michigan, the unemployment rate is above the national average at an astounding 11.7 percent and in some areas in the Second District, it is almost double the national average.

Last year, we saw enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was the largest overhaul of the financial services sector since the Great Depression. According to the Congress Research Service, with its enactment also came more than 300 rulemakings by 10 different federal agencies. As you know, the devil is always in the details and many large and small businesses across the country are anxiously awaiting those details. Not to mention that this regulatory implementation and uncertainty has had a detrimental effect on large and small businesses across the country and small businesses in particular have been reluctant to hire new workers.

Small businesses are the backbone and engine of the U.S. economy and provide more than two-thirds of American jobs. As a small business owner, I know there are some universal principles of successful businesses that Congress could work towards to grow our economy again. First, don't spend more than you're taking in. Second, do what you need to do to create an atmosphere for success. For government, that means creating an atmosphere for success through tax and regulatory environments, and a

cooperative, not adversarial, attitude with those who create jobs. Finally, don't expect miracles. Change requires hard work, self-sacrifice, and tough decisions.

Yet we violate that first principle annually as we spend more than we earn and are dangerously close to doing it on a long-term basis by accruing so much national debt, which is now about $14.1 trillion. Our GDP, or how much we make, is about $14.7 trillion. That means we owe nearly 96 percent of what we make. It also means just four percent of our money is really our own. This makes our nation vulnerable to bankruptcy and economic stagnation. But by simply having a plan, starting now, we can avoid this.

We need to create an atmosphere in our country that will foster job growth. Simply put, the private sector, not the public sector, creates prosperity. We don't need more government or a bigger one. We just need our government to focus on accountability, responsibility and oversight.

My hope lies in this new Congress, with so many new members fresh from districts across America, where we got our marching orders in November. The message was loud and clear: Americans understand the stakes are too high to continue down the path we are on. Now we have to figure out how to work together to help them a chieve the American Dream promised in the founding principles of our country.

As a member of the 112th Congress and a member of this important committee, we must fulfill our promises to our constituents, and we are resolved to undertake the hard work and make the tough decisions necessary to do so. This is truly a critical moment for our country, and it is my hope that we can come together to help this country turn around, so once again our children and citizens may have the full opportunities promised to them.

Mr. Chairman, thank you for holding this important hearing and I look forward to hearing from the witnesses today.

Testimony of Kenneth D. Brody - "Promoting Economic Recovery and Job Creation: "The Road Forward" on January 26, 2011 at 10am - 2128 Rayburn House Office Bldg.

The Dodd-Frank legislation is but part of international activity, specifically Basel III, that will have the effect of making banks safer and duller in part by requiring greater equity or equity-like capital to support the operations of the banking system. This is a step in the right direction. We need a safe and stable financial system in the long run.

Hundreds of rules need to be written by regulators and this, of course, is creating uncertainty. Unfortunately it is probably unavoidable and brings with it a bit of a bureaucratic mess. The good news is that it will be sorted out, probably within 1-2 years and we will have a safer financial system at the end of the day. In the interim, banks are lending today and borrowers are borrowing to the extent they need to do so and are credit worthy. A National Federation of Independent Businesses survey conducted in December reported that 91% of respondents were either getting the bank loans they needed or did not need loans. Of course, firms that are not credit worthy are not able to borrow and that is as it should be. And banks with relatively low equity ratios or excessive bad loans on their books are likely to be cautious about lending in this uncertain regulatory environment. But the main story is that the financial system is working well even while the rules to Dodd-Frank are being written.

Testimony of Andrew M. Bursky, Chairman – Atlas Holdings LLC
Presented to House Committee on Financial Services
Wednesday, January 26, 2011

EXECUTIVE SUMMARY

- **Small and mid-size private equity firms ("PEs") have a long track record of preserving and generating jobs by providing capital and management resources to small and mid-size American businesses**
  - *PEs provide capital and management to struggling companies that have lost access to capital and need assistance to resolve operational, technical or financial problems*
  - *PEs provide capital and expertise to growth companies whose development is constrained because of managerial limitations and restricted access to capital*

- **Atlas Holdings, as a representative PE, has been responsible for preserving or creating more than 3,000 jobs in the last eight years**
  - *Many of these jobs are at U.S. small businesses that were either bankrupt or in the process of liquidation prior to Atlas' involvement*
  - *Atlas has worked in partnership with various unions as well as state and municipal governments and agencies to create long-term sustainable enterprises*

- **PEs will be damaged under Dodd-Frank, reducing their capacity to preserve and create jobs while producing no public benefit**
  - *No rational argument that PEs contribute to systemic risk*
  - *Investors in PEs are highly sophisticated and rely upon their own extremely detailed review for investment decisions rather than SEC dictated disclosure*
  - *PE investors are not seeking registration by PEs and are already protected by existing securities laws*

- **Regulatory requirements under Dodd-Frank will be costly to PEs, diverting PE activities from job-creating investments and reducing returns to institutional investors**
  - *PEs will be forced to divert professional staff from productive investing and business support activities to regulatory compliance*
  - *Cost of compliance for new PE registrants is estimated to be as much as $500 million; these costs reduce returns to PE investors such as endowments and pension funds*

- **Inclusion of PEs in Dodd-Frank will divert focus of SEC**
  - *It is estimated that 1,000+ PEs will be required to file as Registered Investment Advisers*
  - *Without a massive expansion of its budget, the ability of the SEC to focus on potential generators of systemic risk will be severely diluted*

- **PEs seek immediate 1-year delay, considered review by SEC and ultimately, an exemption from registration requirements**
  - *Substantial cost of compliance incurred by PEs without any public benefit*
  - *Precedent established by Venture Capital exemption*
  - *Time is of the essence; current legislation requires compliance by July 21, 2011 and substantial costs and diversion of resources to meet compliance deadline has begun*

I: JOB PRESERVATION AND GROWTH DRIVEN BY PEs

- **PEs have an impressive track record of job preservation and job creation**
- **PEs invest in small and mid-market private companies, the growth engines of the U.S. economy**
- **PEs play a vital role as patient capital providers to smaller companies that face increasingly hostile public financing markets and increasingly restrictive commercial banks**
- **PEs contribute operating knowledge and expertise that enhance business performance**

The case for job preservation and job creation by PEs is compelling, yet it has not been made with the clarity or vigor it deserves. Many studies evidencing substantial job creation by PEs have been published, some of which are quoted below. The case for job growth by PEs is even more impressive, considering the adverse selection inherent in the population of many businesses acquired by PEs, i.e. these businesses are generally available for acquisition or other forms of private equity investment because of historic underperformance, operating challenges, leadership issues or capital constraints.

- Companies backed by private equity investment employed more than 6 million Americans as of June 30, 2009, according to data collected by PitchBook, Hoovers, and the PEGCC. Since the recession began in January 2008, private equity firms have invested more than $23 billion in 137 bankrupt businesses. This rescue financing saved an estimated 185,895 jobs relative to Chapter 7 liquidation (2010 Private Equity Growth Capital Council).
- "In the current period of record-high U.S. job losses, the private equity sector's record on job creation is also particularly pertinent. There is clear evidence that private equity acquired firms expand employment in normal times ... another analysis of a sample of large companies acquired by major private equity firms from 2002 to 2007 found that their U.S. workforces grew at average annual rates of 5.7 percent, compared to 1.1 percent for all U.S. companies" ("The Role of the Private Equity Sector Promoting Economic Recovery," *Private Equity Council*, Robert J. Shapiro, March 2009).
- Ernst & Young found that in 4 out of 5 cases, employment levels at PE-owned companies in the U.S. were the same as or higher at the conclusion of the PE investment than they were at the beginning, despite the fact that the bulk of the investments were in mature or distressed companies (2007 Ernst & Young).
- "Consultancy AT Kearney's analysis, which was based on a review of a number of studies in the area (albeit some conducted by industry associations with a vested interest in preserving the industry's reputation), found that private equity backed firms have created ... more than 600,000 new jobs" ("Private Equity – good for jobs?" *PEI*, March 2007).
- "Inmar, a technology-driven systems and services business, is funded and supported by New Mountain Capital ... Inmar has added more than 500 new jobs in the last several years under New Mountain's ownership, and we are one of the few companies headquartered in the Winston-Salem area that has been growing and hiring steadily through the Great Recession. In fact, we are adding another two dozen high-quality jobs right now, which will bring our employment in the state up to more than 750 people. Overall, New Mountain has added or created more than 7,000 jobs at the companies it has owned nationwide, net of all job losses, including about 1,000 new jobs in North Carolina." ("Private Equity Firms Provide Capital to Grow Business and Jobs," *Citizen-Times.com*, L. David Mounts, November 2010).
- "Several studies have concluded that in the markets most thoroughly penetrated by PE players, job creation by PE-controlled firms significantly outpaces job creation in the rest of the

economy" ("Lessons from Private Equity Any Company Can Use," *Harvard Business Press*, Orit Gadiesh and Hugh MacArthur, 2008).

- Researchers compiled a dataset of 288 exited private equity transactions from 1984 to 2006 that ranged in size from $1.4 million to $4.5 billion (at acquisition). PE-sponsored companies in the sample exhibited strong employment growth (13.9%), capital expenditure growth (8.3%), and operating earnings growth (EBITDA; 11.6%; all figures annualized). Employment increased at 71% of the PE-backed companies in the sample. (University of Missouri)
- According to a review of 5,000 transactions over 25 years, prior to investment, private equity portfolio companies were, on average, losing jobs at existing facilities at a rate one to three percentage points faster than their competitors. After private equity investment or acquisition, companies initially experienced a dip in employment but saw their employment growth rates rise above the industry average within four years (2008 Center for Economic Studies, Bureau of the Census).

II: JOB PRESERVATION AND CREATION – TRUE LIFE STORIES

The most telling examples of job preservation and creation by PEs are told through the actual stories of real businesses and real people across the United States. The following profiles are representative of the kind of work PEs engage in everyday – committing both capital and managerial resources to arrest the decline of a failing business or to address the challenges of funding and managing a growing manufacturing enterprise.

Importantly, as these stories describe, the work of PEs is often targeted at small to mid-size businesses, the primary growth engines of the U.S. economy. As many of these businesses are manufacturers, PEs have demonstrated that, with proper leadership, capital resources and operating strategies, U.S. manufacturers can be highly competitive in the global economy.

PRESERVING JOBS BY REVIVING FAILED BUSINESSES

Detroit Renewable Energy LLC

- **Company Location(s):** Detroit, MI; Hamtramck, MI; Flint, MI; Shreveport, LA
- **Transaction Overview:**
  - Company operates the largest "Green energy" from waste facility in the U.S. and a 39-mile, low-pressure steam loop in downtown Detroit that is the sole source of heating for 104 buildings and 144 customers in the Detroit urban core.
  - In October 2010, after years of neglect and acrimonious relations with the city, the prior owner (a large public company) elected to idle the facility, laid off 134 employees and began preparations for a permanent shutdown.
  - In November 2010, Atlas worked cooperatively with the International Union of Operating Engineers Local 324, Utility Workers of America, AFL, and CIO Local 223 and the City of Detroit to acquire the business. Atlas invested in excess of $50 million of its own capital to acquire the assets and upgrade the facilities.

- **Job Growth:** Rehired 123 workers and preserved the jobs of over 100 contract and indirect jobs that these facilities support.

Bridgewell Resources LLC

- **Company Location(s):** Tigard, OR; Bend, OR; Clackamas, OR; Dierks, AR; Gunnison, UT; Penn Laird, VA
- **Transaction Overview:**
  - Bridgewell is a global trader and value-added distributor of oils and shortenings, organic foods and bakery items, feeds and seeds, fertilizer and minerals, mat products, utility poles, construction products, and wood products.
  - In 2008, deteriorating housing markets destroyed the profitability of Bridgewell's sister division, severely constricting the liquidity of Bridgewell's prior owner.
  - In January 2010, unable to arrange DIP financing, a receiver was appointed at the request of its lending group and the liquidation of the company commenced.
  - In March 2010, Atlas invested $27 million of its own capital to acquire Bridgewell and provide liquidity to restore its market position.
- **Job Growth:** Preserved the jobs of approximately 130 skilled workers upon acquisition. Subsequently, Bridgewell has hired 20 additional employees. In 2011, Bridgewell plans to hire 25 new employees.

Michigan Seamless Tube LLC

- **Company Location(s):** South Lyon, MI
- **Transaction Overview:**
  - Company manufactures highly customized, precision-tolerance cold drawn seamless pressure and mechanical steel tubes used primarily in niche applications in the power generation, oil and natural gas extraction and non-automotive industrial markets.
  - In November 2000, the Company's former parent filed for Chapter 11 bankruptcy protection as a result of an over-leveraged balance sheet and a poorly executed capital project at a sister plant.
  - In February 2002, the Company was idled at the direction of its senior creditors to allow for liquidation of receivables and inventory and a Section 363 sale of the operating assets. All but 12 maintenance workers were released.
  - In October 2002, Atlas worked cooperatively with USW Local 1900 and the State of Michigan to acquire the business. Atlas invested $10 million of its own capital to purchase the facility and fund the restart of operations.
- **Job Growth:** Rehired 51 workers upon restart. As the result of continued investment in operations and success in the marketplace, including rapid growth in export markets, ultimately created approximately 250 high-skilled manufacturing jobs.

CREATING JOBS BY FUNDING GROWTH BUSINESSES

Phoenix Services LLC

- **Company Location(s):** Roanoke, VA; Sparrows Point, MD; Riverdale, IL; Vinton, TX; Latrobe, PA; Wilton, IA; Weirton, WV; Mingo Junction, OH; Indiana Harbor, IN; Johnstown, PA; Warren, OH; Georgetown, SC; Galati, Romania
- **Transaction Overview:**
  - Phoenix Services operates primarily in the slag processing and metal recovery business, servicing steel and non-ferrous mills and landowners with significant slag banks from former mill operations; core services include: slag removal, metallic recovery and slag processing.
  - In January 2006, Phoenix Services was formed by R. Douglas Lane, an experienced executive in the Mill Services sector, in partnership with Atlas, to acquire Thor Mill Service, Inc.
  - In partnership with Olympus Partners, Atlas has funded $76 million of growth capital and supported the expansion of the company into a leading, international service provider in its sector. As a result of winning new contracts and site revenue growth, Phoenix Services has approximately $900 million of future revenue under contract.
- **Job Growth:** Beginning with one employee in 2006, Phoenix Services has created approximately 340 jobs.

Pepper Dining Inc.

- **Company Location(s):** Pepper Dining operates over 100 restaurants in the Northeastern and mid-Atlantic region.
- **Transaction Overview:**
  - Pepper Dining is a leading franchisee of Chili's Grill and Bar restaurants.
  - Olympus Partners acquired Pepper Dining in 2007
  - Since the acquisition in 2007, Pepper Dining has opened 12 new stores across New England and in Virginia and the Carolinas, spending approximately $2.5 million per new store.
- **Job Growth:** Pepper creates 75 new jobs per store, including several management positions.

TravelCenters of America, Inc.

- **Company Location(s):** TravelCenters of America ("TA") operates a nationwide network of truck stops with over 160 locations in 41 states.
- **Transaction Overview:**
  - TA operates facilities on U.S. interstate highways which provide a variety of products and services to professional truckers and motorists, including fuel, food, merchandise, repair services, and other driver amenities.

- In 1993, Olympus Partners and others acquired the U.S. truck stop businesses of Unocal and BP to form TA.
- During the 14 years of private equity ownership, as a result of new investment in sites through new builds, renovations and acquisitions, adding new services, brands, and information systems, TA increased its business almost five-fold, in terms of volume and non-fuel revenues.

- **Job Growth:** From 1993 to 2007, TA increased employment at both the management and site levels from approximately 3,000 employees to approximately 15,000 employees.

These are a small sample of the businesses whose futures were enabled through the efforts of two PEs. In the 6 cases described above, more than 600 jobs were preserved in businesses that would not be in existence today absent the actions of Atlas Holdings and more than 12,000 new jobs were created as a result of the actions of Atlas and Olympus Partners. Atlas (and its principals) and Olympus have executed more than 150 transactions like these over the course of their existence. There are more than 1,500 PEs in the United States, most engaged in job preservation and creation activities comparable to Atlas and Olympus.

III: ATLAS HOLDINGS LLC (www.atlasholdingsllc.com)

Atlas Holdings owns a diverse group of paper, packaging, capital equipment, construction materials and other basic manufacturing companies. Atlas also manages a $365 million pool of institutional capital which is being invested in new companies, with a particular focus on businesses that have struggled through the recession and which can benefit from Atlas' unique blend of operating expertise and financial acumen.

Andrew Bursky, Chairman of Atlas, is an entrepreneur who, with his partners, has been responsible for the preservation or creation of thousands of manufacturing and industrial jobs in the United States. Mr. Bursky formed his first business at age 11 which grew to employ 40 individuals in his hometown of Indianapolis, IN. He received a BA in Economics and a BS and MS in Chemical Engineering from Washington University in St. Louis and an MBA from Harvard Business School. Mr. Bursky is married with two children. He serves, or has served, on the Board of Directors of numerous public and private businesses. He also serves as a Trustee of the Eisenhower Fellowships and of Washington University in St. Louis.

IV: THE DIRECT AND INDIRECT COSTS OF DODD-FRANK ON PEs

- **Regulatory requirements under Dodd-Frank will be costly to PEs, diverting PE activities from job-creating investments and reducing returns to institutional investors**
  - *PEs with more than $150 million of capital will be required to register as Registered Investment Advisers*
  - *The cost to prepare for RIA filing, inclusive of legal advice and review, preparation of internal documentation as specified by the SEC and auditor review is anticipated to be $250,000 to $500,000 for a PE*
  - *PEs will also bear custodial fees, paying large commercial banks to secure non-negotiable stock certificates of private companies in which PEs invest*

- *Total cost of compliance for all new filing PEs is estimated to be as much as $500 million; these costs reduce returns to PE investors such as endowments and pension funds*
- ***Most critically, PEs will be forced to divert professional staff from productive investing and business support activities to regulatory compliance***

- **Inclusion of PEs in Dodd-Frank will divert focus of SEC**
  - *It is estimated that 1,000+ PEs will be required to file as Registered Investment Advisers*
  - *Without a massive expansion of its budget, the ability of the SEC to focus on potential generators of systemic risk will be severely diluted*

V: WHY PEs PRESENT NO SYSTEMIC RISK

- Capital is provided to PEs by investors only when called to fund a discrete investment.

- PEs do not create counter-party risk. *PEs are not deeply interconnected* with banks or with other non-bank financial companies through derivatives positions, exposure relating to swaps or securities lending, reliance on short-term credit for their operations, or the provision of credit to financial system participants. Furthermore, PEs are not interconnected with each other because they neither pledge their assets as security for, nor do they guarantee each others' obligations. The failure of a PE could not create cascading negative effects on other parts of the financial system.

- PEs invest in long-term illiquid assets, typically the equity of operating companies. PEs do not normally invest in short-term instruments like options, swaps or public equities.

- PE investments are not cross-collateralized, which means that neither investors nor debt holders can force a PE to sell unrelated assets to repay a debt. In a sense, PE investments are structurally firewalled from one another so that any nonperforming investment does not negatively affect another investment. Losses are limited to the underlying value of the original investment.

- PEs are diversified by industry sector, geography, and time horizon, thereby safeguarding against over-exposure.

- PEs do not rely on short-term financing that could dry up in times of financial stress. In addition, the investors in PEs do not have redemption or withdrawal rights that would enable those investors to force a fire sale of assets were those investors to attempt to make a "run on the bank." PEs, therefore, *do not face liquidity concerns* that could result in forced massive asset sales to meet investor (or other) claims—and which in turn could drive down investment values, thereby adversely affecting other financial system participants.

- PE funds typically *are not leveraged*. Even the degree of leverage at the portfolio company level is significantly less than that of most large banks and broker-dealers.

- PEs are *relatively small in size* (whether measured by assets available for investment, risk capital, liabilities or transaction volume) compared to large banks, insurance companies, broker-dealers and advisors to registered investment companies.

United States House of Representatives

Committee on Financial Services

"Promoting Economic Recovery and Job Creation: The Road Forward"

January 26, 2011

Eric Hoffman – Written Testimony

I want to begin by thanking Chairman Bachus and the members of the Committee on Financial Services for the invitation to speak today. I have had the privilege to work at our family business, Hoffman Media, LLC (or "Hoffman Media"), and be a part of the incredible growth story; and as I strategize about both our company's continued growth, as well as small business growth throughout the United States, I am concerned by recent changes in financial regulation, healthcare and taxes. In this testimony I will share with you the history of Hoffman Media, concerns I have on The Volcker Rule and long-term negative effects on small business and job growth, and concerns of future burdens caused by healthcare reform and higher taxes. Overall I am concerned that the significant changes we are seeing will hurt our future ability to grow as uncertainty is the worst head wind we face.

Overview of Hoffman Media:

Hoffman Media was founded in 1998 by my mother, Phyllis Hoffman who currently serves as Chairman & CEO. After successfully working for five years at a large publicly-traded publishing company (through the acquisition of her first start-up company), Phyllis left in 1998 to start Hoffman Media. She formed the company by acquiring two magazines, and financed the start-up by mortgaging her house (true sign of an entrepreneur). From 1998 – 2003 the company ran on an extremely tight budget whereby all operating profits were reinvested in the business to fund continued growth through launching of new magazine brands. In 2003, Hoffman Media had approximately 20 employees and generated revenues of approximately $4,000,000 annually. It was during this period that Phyllis decided in order to properly fund growth and scale the company, both through organic growth and acquisition, that Hoffman Media would need to raise capital (since Hoffman Media was not producing net income it prevented the company from accessing traditional commercial lending from a bank). After 24 months of meeting with private equity firms, Hoffman Media successfully raised $5,000,000 from BIA Digital Partners and Frontier Capital. This capital raise allowed Hoffman Media to complete a strategic acquisition of a complementary business, Martha Pullen Co., and fund additional marketing and hiring needs. From the period of 2004 – 2010, Hoffman Media was able to grow revenues from approximately $10,000,000 to $40,000,000, while also growing employee count from approximately 20 to 135.

The capital raised from BIA Digital Partners is worth explaining further. BIA Digital Partners provided mezzanine debt with warrant coverage to Hoffman Media, which Hoffman Media successfully paid back in 2009. The outcome was a win for all parties involved in that BIA Digital Partners (including their LPs) achieved a healthy rate of return on the investment, and Hoffman Media was able to properly fund the growth strategy. As a result, Hoffman Media's economic impact has grown dramatically, having created jobs, and generating substantial sales tax at the state and local level while also producing taxable income. This growth would not have been possible without the financial support of BIA Digital Partners (and their LP investments).

The Volcker Rule and Long-term Negative Effects on Small Business and Job Growth:

Highlighting BIA Digital Partner's investment in Hoffman Media is important because it is my understanding roughly half of the firm's LPs are some of the greatest and largest banks in North America. It is my opinion that the restrictions being proposed on banking entities abilities to own or invest in private equity funds will have long-term negative implications for small business and job growth, and had BIA Digital Partners not had banks as LPs, Hoffman Media would not have secured the same level of funding (structure, commitment size, etc.).

The Volcker Rule's hedge fund and private equity fund investment restrictions generally prohibit a banking entity from acquiring or retaining any equity, partnership, or other ownership interest in, or sponsoring a private equity fund (other than perhaps 3% or less of Tier 1 capital). I fear this could lead to a substantial decrease in the funding support of private equity firms, especially those firms covering the lower middle market (companies similar to Hoffman Media in 2004). My concern is that there will be a small amount of capital, if any, available to invest in lower middle market private equity funds. Instead it will all be allocated to the larger buyout firms (examples: The Blackstone Group, KKR, The Carlyle Group, TPG, Apollo Management, etc.) because of the total economics related to those relationships with those firms (investment banking advisory fees related to M&A, equity and debt capital raising, leverage buyout financing, etc.). While Hoffman Media has demonstrated credit worthiness and strong growth, it is highly unlikely we will gain the coverage from the larger financial institutions (other than commercial lending), however, unlike most larger buyout transactions, Hoffman Media has created real value (job growth, revenue and sales tax growth, etc.) not generated through financial engineering and the use of high amounts of leverage.

As EVP & COO of Hoffman Media, I have had the opportunity to speak at BIA Digital Partners' annual LP meeting, where I have been able to present the company performance as well as network with some of

the leading banks in North America. This opportunity eventually allowed Hoffman Media to seek traditional bank lending and repay BIA Digital Partners' debt they provided the company.

Small business is where sustainable economic growth will come from. It is companies like Hoffman Media that take risks, seek funding, and grow out of the dreams and passions of an entrepreneur. As a representative for small businesses across this country it is our desire to see as few hurdles as possible for small business to grow and seek growth capital. The Volcker Rule is one more hurdle that will slow down this economic recovery. Financial institutions should always be focused on maximizing shareholder value, and if they choose to allocate capital to private equity funds, both large and small, in order to generate profits and future business development, they should be able to do so without restriction or limitation from the government.

I've been at ground zero and seen this work, and I urge members of the committee to please limit the impact the Volcker Rule has on the funding of small business.

Future Burdens Caused By Healthcare Reform and Higher Taxes:

It is with great concern I also address the healthcare reform and the risk of higher taxes. Hoffman Media currently has 135 employees, of which, a large majority are using benefits provided through the company. Just in the past 12 months our health insurance costs have risen 8% (far lower than the rate of other small businesses in our area) and are expected to increase again soon. In an environment where unemployment is over 9%, housing foreclosures are higher than ever, it is already incredibly hard to run a successful business, but with extremely large increases in employee benefit expenses, it makes it even harder. If this trend continues, whereby operating expenses grow at a faster rate than revenue growth, our country will continue to see the jobless level remain high. This creates a disincentive towards companies hiring, rewarding employees with raises, or even keeping the current level of headcount you have, rather, it creates a real bottom line need to cut other costs, which ultimately leads to a weaker long-term outlook. With the new healthcare laws, and the future requirements for everyone to be offered insurance, I am deeply concerned that this will put undue pressure on businesses, especially small businesses. There are additional compliance and regulatory costs, estimated increases in health insurance costs, and unjust penalties proposed, all of which negatively impact this country's ability to create jobs and generate real GDP growth.

In addition to healthcare changes, I have great concern over the future of tax rates, both individual and corporate rates. Increasing tax rates will negatively impact Hoffman Media, and other companies just like us. Tax increases directly diminish our after tax free cash flow and after tax margins, thus reducing the amount of money available for reinvestment. I know how difficult it is to operate in a tough

economic environment like we are in now, so effectively decreasing margins is one more disincentive to hire, give raises, or keep our current headcount. In addition, companies like Hoffman Media who are faced with the need to pay down loans are further impacted by tax rate increases since principal payments on debt are not tax deductible, only the interest expense. Hoffman Media has cut its debt level in half over the past 24 months, and had our tax rate been higher we would not have been able to do so as it would have effectively cost us more to pay down the same level of principle. Going forward we will be faced with tougher challenges as business operators and employers, where the costs of being successful and generating profits are higher.

I urge members of the committee to please review these points. I do not speak alone. Millions of small business operators in this country feel the burden ahead. An economic recovery and job recovery are very possible if we reduce the hurdles of higher taxes and higher healthcare costs. We need an environment that encourages risk taking and entrepreneurs to follow their dreams, and unfortunately I do not see this ahead.

Closing:

In conclusion, I believe the story of Hoffman Media's growth performance and path to growth capital is one of several thousand examples throughout the United States. It is a success story, for our business, for our investors, for banks, and for our country. My hope is that complicated law and regulation, such as The Volcker Rule and healthcare reform, do not negatively impact our economy, the entrepreneurial spirit of this country, and the access to capital for small businesses, but I am afraid that currently they will. Please reduce the impact the Volcker Rule has on our financial institutions. Please do not raise taxes on anyone, or any corporation, in fact, lower the taxes and reduce the hurdles put in place by our government. And finally, limit the healthcare reform so businesses like Hoffman Media are not faced with ever increasing costs and increased regulatory oversight...it is bad for business and our economy.

Testimony of Donald Kohn*

on

Promoting Economic Recovery and Job Creation: The Road Forward

before the

Committee on Financial Services

United States House of Representatives

January 26, 2011

*Senior Fellow, The Brookings Institution. The views expressed in this statement do not necessarily reflect those of other staff members, officers, or trustees of the Brookings Institution

Mr. Chairman and Members of the Committee,

I appreciate this opportunity to address the topic of promoting recovery and job creation. I can think of no more important economic topic facing the Nation today. We have been through the deepest and most persistent economic recession since the 1930s. The unemployment rate rose more than 5 percentage points in the recession and its decline in the recovery has been painfully slow. One consequence of that performance has been a very marked rise in the number of Americans who have been unemployed for a very long time. Not only is this an immense human and economic waste, but long-term cyclical unemployment can too readily turn into even longer-term structural unemployment as skills erode or fail to keep up with advancing technology and attachment to the labor force weakens. We must carefully consider possible additional policy steps to promote faster recovery and greater job creation.

The Economic Setting

At the same time, we also need to recognize that correcting the circumstances that led us to this pass—the bubble in housing prices and associated over-building of homes, the excessive leveraging by both households and lenders, the inadequate compensation for risk and weakening in lending standards across many forms of credit, the funding by both bank and nonbank lenders of long-term risky assets with short-term liquid debt, and the resulting financial crisis—will inevitably require some time. The recovery has been held back by the need for both households and lenders to rebuild financial strength through higher saving and more cautious lending; balance sheet repair is an inherently slow process. Growth

has also been restrained by the need to work off a large overhang of houses from the bubble years; residential construction cannot play its usual role of leading the economy out of recession. Sluggish growth in many of our most important trading partners has held down demand from abroad. And the depth of the recession and weakness of labor markets has undermined both business and household confidence. Labor markets have been especially anemic. The flexibility of our labor markets is a key long-term strength of the U.S. economic system, but in the short-run it has enabled businesses to produce more with less, leaving households worried about their job prospects. Finally, this period has also been marked by highly uncertain government tax and spending plans on the state, local, and federal levels, and by an unusual level of new regulatory initiatives. I do not believe these initiatives and associated uncertainties are the main reason for the slow recovery, but they likely have contributed to it. I'll return to this subject later in my testimony.

Many of the headwinds facing the economy are abating. Household saving has risen to a level consistent with rebuilding wealth and reducing debt burdens and saving rates should not continue to rise at the rate they have in the past few years. Financial intermediaries have increased capital and reserves against bad loans; we see early signs of a more competitive lending environment with a slight easing of very tight terms and conditions for loans. Perhaps as a consequence, recent data suggest some acceleration in economic activity, and, with added fiscal and monetary stimulus undertaken late last year, many forecasters have raised their projections for growth this year. Still, most people expect the recovery to remain

moderate and the unemployment rate to decline from its elevated level only slowly; so the subject of this hearing remains very much on point.

The recession and slow recovery and resulting high level of unused resources and intense competition in the economy have contributed to a substantial decline in inflation over the past few years. CPI inflation, which was running in the neighborhood of 2.5 percent in 2006 and 2007 before the financial turmoil hit has fallen to just over 1 percent. Headline inflation will probably move up some as the recent increases in energy prices get passed through to consumers. But core inflation has been exceedingly low—below 1 percent—suggesting an absence of underlying inflation pressures. If energy prices rise more slowly, as they have in recent weeks, and if the recovery is as gradual as most expect it to be, inflation is likely to remain quite damped over the next few years. Indeed, excess capacity of labor and capital will tend to put downward pressure on prices; what has kept inflation from becoming deflation are inflation expectations anchored somewhat above actual inflation.

The Role of Monetary Policy in Promoting Economic Recovery and Job Creation

As you know, I was a member of the Federal Reserve Board from August of 2002 until September 1, 2010. In that role, I participated in the decisions of the Board and Federal Open Market Committee, and I voted in favor of and fully supported the decisions made by these bodies. In my view, the actions of the Federal Reserve from the fall of 2007 on were crucial to containing the fallout on the economy and jobs from the financial crisis and promoting recovery and the resumption of job creation. Critically, these actions were taken in the context of also

preserving price stability. When inflation is already low, the economy is weak and slack in labor and product markets abundant, no conflict exists between pursuit of the Federal Reserve's legislative mandates to promote maximum employment and price stability over the long run.

We acted forcefully with both the major macroeconomic instruments available to us—lending at the discount window and easing the stance of policy by lowering interest rates. These are separate instruments, but they are complementary and their use in both cases was intended to cushion the effects of the problems in the financial sector on the jobs and income of ordinary Americans.

From early on we could see that the difficulties of lenders in accessing liquidity were impeding their ability to extend credit to households and businesses. And if lenders needed to sell assets to obtain funding, those sales—often firesales—led to further declines in asset prices and further distress among lenders and their customers. Stabilizing the situation by lending against illiquid assets has been recognized as an essential function of a central bank in a financial crisis since the 19th century. In this crisis, because lending had shifted in large volume to securities and securitization markets, we found it necessary to extend the provision of discount window credit beyond banks to the intermediaries in those markets and to the markets themselves. In doing so, we adhered to the basic principle of extending credit to solvent institutions against collateral at a penalty. In many cases the announcement and then the implementation of these programs helped to stem the panic, reduce the pressure on lenders, and stabilize markets. And those programs were terminated without adverse effects. Most of those loans have already been

repaid—and repaid with profits, not losses, for the central bank and the taxpayers. The borrowing institutions were able to repay and reclaim their collateral; the penalty rates were sufficient to induce them to do so.

From early on we could also see that the tightness in credit markets and the drop in house and equity prices were going to weaken the economy and reduce employment. In response we eased the stance of monetary policy—at times aggressively. The National Bureau of Economic Research has designated the peak of the previous cycle as December 2007. We tried to head off the recession by easing somewhat in the fall of 2007. By January 2008, it was evident that the economy was slipping into recession as a consequence of the dislocations in financial markets and we eased aggressively through the spring. The reductions in our federal funds rate targets were intended to stop the slide in spending and prevent disinflation from becoming deflation.

In that regard, because the underlying financial situation kept deteriorating, the rate reductions were not as successful as I had hoped and the decline in economic activity steepened in the third quarter of 2008 and steepened substantially further in the fall of 2008 after the bankruptcy of Lehman Brothers, the distress of Merrill Lynch and AIG, and the panic that followed. To ameliorate the effects of these developments on growth and jobs, we cut our federal funds target effectively to zero and embarked on large-scale purchases of agency mortgage backed securities and, in March of 2009, of Treasury securities. With short-term rates already at zero, the only way to reduce longer-term interest rates further and ease financial conditions was to purchase intermediate- and long-term securities.

These purchases appear to have been effective, especially judging from the reactions in markets to their announcement. Declines in mortgage rates enabled some households to ease financial strains by refinancing their mortgages. Lower rates on mortgages and Treasury bonds, in turn, helped to reduce rates on business credit and to bolster asset prices, including in the stock market. Higher equity prices have bolstered household wealth, counteracting a portion of the decline in home prices. As I noted, I was at the Federal Reserve for all the actions I have just described and supported them wholeheartedly. They helped to prevent an even worse outcome—deeper recession, slower recovery, fewer jobs, with a real risk of slipping into deflation, perhaps of the sort that has plagued Japan for several decades now. By November of 2010, when the decision was made to resume large-scale asset purchases, I was no longer at the Federal Reserve and hence did not participate in policy discussions leading up to that decision. Judging from the statements of the FOMC and the speeches and testimony of Chairman Bernanke, the aims of this most recent action were similar to those we had when we took similar actions in the fall of 2008 and spring of 2009—that is, to lower intermediate- and long-term rates below what they otherwise would be, to have those rates feed through to easier financial conditions more generally to stimulate spending. As we discussed earlier, most economists see the economic recovery as likely to remain relatively slow and the decline in the unemployment rate very gradual from an unusually high level. In those circumstances, inflation is likely to be very low for some time. With the federal funds rate already at zero, further purchases of intermediate- and longer-

term securities were the only way the FOMC had of promoting recovery and job creation—the subject of your hearing.

Such a policy is not without risks. There is a chance—relatively small in my view-- that inflation could begin to rise quickly and unexpectedly toward unacceptable levels, forcing the Federal Reserve to reverse course sooner and more rapidly than it or most other observers appear to expect, with disruptive effects on the financial markets and perhaps the economy. And even in the absence of a sudden surge in inflation the more gradual removal of accommodation could cause financial instability, given the extraordinarily low levels of many interest rates and associated distortions in asset markets. But the U.S. economy is producing far from its potential right now. All policies have risks on several sides, and the job of policymakers is to weigh those risks. The Federal Reserve has made what is, in my view, a credible case that it expects this policy to boost growth modestly while keeping inflation very low.

Promoting Economic Recovery and Job Creation: The Road Forward

A slow economic recovery is a predictable consequence of a financial crisis that impairs lenders and destroys wealth. The headwinds seem to be abating and many economists, myself included, expect that the pace of growth will pick up a little this year and the job market will improve somewhat. The natural healing powers of a market economy are being complemented by very accommodative monetary policy and by the boost to spending that will come from the fiscal package the Congress and the President agreed to late in 2010. To a considerable extent, patience may be the most potent weapon we have now to promote economic

recovery and job creation. I doubt there are a set of policy actions that will greatly speed this process along. That said, I can identify a few broad areas in which policymakers can constructively contribute to faster recovery—in some cases by avoiding mistakes and reducing uncertainty.

The challenge for ***monetary policy*** will be to promote expansion without allowing fears of deflationary or inflationary spirals to take hold. Longer-run inflation expectations must continue to be well anchored for economic performance to improve. The Federal Reserve should continue to emphasize its willingness to adjust its policy based on the changing outlook for growth and inflation and its determination to return consumer inflation to the range of 2 percent or a little below that forms the central tendency of FOMC members' expectations for inflation over the longer-term, and then to keep it there.

High and variable inflation and inflation expectations weigh heavily on growth and job creation, as we saw in the 1970s. To keep inflation from rising above 2 percent the Federal Reserve will need to exit its extraordinary policies in a timely way. It has a number of tools that will enable it to raise short-term interest rates and absorb reserves when it decides that financial conditions should be tightened. I have no doubt that these tools, including interest on reserve balances and a number of new techniques to absorb excess reserves, will be effective at raising interest rates. In addition, the Federal Reserve will be able to resume the runoff of maturing securities and to sell securities into the market to reduce reserve balances. In the end, however, it will not be technical factors that determine whether the Federal Reserve makes progress toward the objectives it has been

given. Rather it will be judgment and, critically, a continued high degree of independence from short-term political pressures so that it can exercise that judgment, that will determine its success.

In ***fiscal policy*** the lack of a clear and committed path to fiscal and debt sustainability is an important source of uncertainty for households and businesses and a risk to stability in financial markets. Demographic trends interacting with promises made by our government over several decades have put Federal debt on a steeply rising trajectory that clearly cannot be sustained. This problem has been exacerbated by the legacy of debt and interest payments left by the recession and the efforts to use spending increases and tax reductions to bolster demand. As the recovery gathers momentum, the public and private sectors will come increasingly into competition for scarce saving, causing interest rates to rise. The pressures on rates will be greatly intensified if the investors come to doubt the willingness of the Congress and Administration to confront and make the very difficult choices on spending and taxes that are required. At this point, households and businesses in the United States are very uncertain about the level and composition of government spending and taxation over coming decades. Surely, this sort of uncertainty tends to undermine the willingness of firms and households to make the investments that would promote longer-run economic growth. And as you deal with the budget situation, the Congress should take that opportunity to encourage growth by reforming our tax code by broadening the base and lowering marginal tax rates.

As I noted before, ***regulatory policy***, including uncertainty about regulations, has probably been one of the factors holding back spending, though in my view it is

probably not one of the main factors. To some extent, both greater regulation and uncertainty about that regulation have been byproducts of efforts to achieve important societal goals.

That certainly is the case for financial regulation, which you asked about in your invitation letter. In writing and implementing the Dodd-Frank legislation, the near-term costs of greater regulation are being weighed against the promise of a more stable and resilient financial system that will be able to avoid the types of systemic problems that have proven so disruptive and costly for jobs and incomes over the past several years. It is a complex, complicated, piece of legislation touching many aspects of our nation's financial system. Its net effect will depend mportantly on how it is implemented. The balance of regulation and resilience will also depend on other responses to the crisis: the work of the Basel Committee on Bank Supervision on global standards for bank capital and liquidity; the efforts of the Federal Reserve and other supervisors to improve their oversight processes; and the attempts at international coordination of standards and adherence to those standards by the Financial Stability Board.

I believe that on balance the new legislation will make our financial system stronger and more resilient to unexpected developments; will reduce the moral hazard effects of the too-big-to-fail phenomenon; and will increase transparency for better monitoring by both the supervisors and the private sector. I hope that implementation of the legislation is not materially slowed; in many cases putting in place some rules—even if they are adjusted later—will do more to relieve uncertainty and allow the private sector to adapt and move forward than would a

generalized slowing of most implementation. Of course the Congress should continue to evaluate whether the benefits of specific requirements of the law and of the law's implementation more generally are likely to exceed their costs.

As our economy recovers from this painful episode, it must be re-oriented from excessive dependence on debt and especially from dependence on foreign saving and capital inflows to finance spending in excess of production. In particular we must rely much less on consumption and residential housing construction to support jobs and incomes than we were earlier and much more on investment and net exports. Fiscal and regulatory policies must be structured to reduce government borrowing over time and to encourage private saving and business capital spending. Monetary policy must contribute to a macroeconomic environment characterized by stable prices and moderate fluctuations in economic activity to facilitate longer-term planning by governments, households, and businesses. None of this will come easily or quickly. But it is essential to promoting longer-term economic growth and job creation.

Testimony of

H. Charles Maddy, III

President and CEO, Summit Financial Group

Before the

Committee on Financial Services

United States House of Representatives

January 26, 2011

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President and CEO, Summit Financial Group
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Chairman Bachus, Ranking Member Frank, Congresswoman Capito, and members of the Committee, my name is Charlie Maddy, President and CEO, Summit Financial Group. My bank, Summit Community Bank is headquartered in Moorefield, West Virginia, and serves communities located in the south-central and eastern panhandle regions of West Virginia as well as in the Shenandoah Valley and northern regions of Virginia. I am pleased to be here today on the subject of how the financial crisis and the Dodd-Frank financial reform bill affects community banks like mine.

At my bank, as is true of my community bank colleagues in West Virginia and around the country, we are intensely focused on building and maintaining long-term relationships with our customers. We have to have this long-term view because we plan to be here for a very long time, and that requires us to provide the financial services that will keep our communities strong and growing. The success of Summit Community Bank is inextricably linked to the success of the communities we serve, and we are very proud of our relationships with them. They are, after all, our friends and neighbors.

Let me just give you a couple of examples of why our bank matters to our communities:

- My bank presently has more than half a billion dollars in loans outstanding to West Virginia and Virginia small businesses located within these same communities.
- We annually contribute more than a quarter million dollars to schools, charitable organizations, and civic and community organizations throughout our service area.
- Over the years, our employees have contributed thousands of hours of community service in support of local non-profit organizations and charities.

As a community bank, I am very concerned with all the new laws and regulations that my bank will have to contend with. I can tell you that the impact will certainly be enormous in terms of staff time, compliance obligations, reduced income, and most importantly, fewer resources that I will have to meet the needs of the communities in West Virginia that I serve. It is particularly frustrating to me, and I'm sure most other community bankers, that we end up being punished for the actions taken by others. We never made an exotic mortgage loan, changed our underwriting standards, or took excessive risks. Yet, in the last two years, community banks in my state and around the country have been subject to intense regulatory scrutiny, calls for more capital (at a time when new capital is hard to find), and pressure to add compliance staff to deal with all new regulations. How can I be out in my community, helping individuals improve their quality of life, or helping small businesses grow if all I end up doing is dealing with the aftermath of problems that I did not create?

The pressures come from both the regulators (who are naturally reacting, but I'd say over-reacting, to the economic downturn) and the new rules that are just beginning to be felt from the Dodd-Frank Act.

Let me give you a bit of perspective on the regulatory side first.

Prior to the current economic crisis, bankers were well aware of where their institutions stood in terms of capital adequacy. Capital guidelines were well established, and bankers could plan for growth (i.e., make new loans) without concern that they would be criticized by regulators for having insufficient capital. Over the past couple years though, I have heard from many bankers who have complained that whatever capital their institutions presently have, it's not enough in the eyes of their regulator. Well managed and profitable community banks with capital-to-asset ratios at or above that of their peers, and without significant asset quality problems, are being told their capital is inadequate and to increase it. Given this pressure to raise capital-to-assets ratios, you can understand why some of these same bankers may not be anxious to grow their balance sheets and aggressively seek new lending opportunities.

I and other community bankers have also observed another trend: certain bank regulations which were promulgated as "guidance" before the financial crisis are now being enforced as strict regulatory "limits." An example of this is in regards to the Interagency Guidance on *Concentrations in Commercial Real Estate Lending* (December 12, 2006). In its introduction, this Guidance reasonably states that it "does not establish specific CRE [commercial real estate] lending limits; rather, it promotes sound risk management practices and appropriate levels of capital that will enable

institutions to continue to pursue CRE lending in a safe and sound manner". However, the supervisory criteria contained in the Guidance is intended only for use by "regulators" to "identify" those institutions which "may" have CRE concentration risks; but instead it is now being interpreted and applied by the regulators as firm CRE lending limits. Prior to 2010, my bank operated with CRE levels in excess of the Guidance's criteria -- and without regulatory criticism. But only recently, our regulator strongly "encouraged" my bank to adopt CRE lending policy limits which essentially mirror the Guidance's supervisory criteria – and in so doing it will reduce our ability to make new commercial real estate loans by well over $100 million.

Another regulatory issue which community bankers are experiencing during this economic downturn is that often the conclusions and recommendations of local field examiners – who annually visit our banks to conduct extensive examinations lasting numerous weeks – are being overruled by their superiors at the regional or even national level. During a recent examination of my bank, I witnessed this first hand as the conclusions we were given by our senior field examiner at the exam-exit conference in regards to my bank's liquidity and interest rate sensitivity were markedly different from that which were ultimately included in the final report of examination. Upon my questioning of the field examiners about the necessity for the changes in the report, we were told that they had been dictated by the regional office, ostensibly due to their concern that certain of our financial ratios were outside a range which they had established. Certainly, you can understand my and my fellow bankers' exasperation when the observations and conclusions by the regulators who know our banks best are overturned by those who we have never even met.

Unfortunately, in my view, banking policy has become too D.C.-centric. Changes are being made without any formal process, and new standards are being applied without banks having a clear understanding of what they are. Banks should at least be told what ratios the examiners are using for standards. Moreover, often these changes are applied differently from bank to bank.

In addition, the regulatory higher-ups seem to have taken away much of the discretion from the regulators which are closest to the banks. As a result, field examiners and regional offices are not free to design remedial action plans which address the specific needs and issues of a particular financial institution. The regulators in Washington seem intent on twisting the screws tighter and tighter, rather than whether or not the terms of a particular remedial action are, in fact, appropriate for the bank to which it is directed.

So why is this? Well, I believe the answer may start with the Congress. Invariably, at the beginning of an economic downturn, the regulatory policy-makers are called before Congress to

explain why they are not using ***all*** sanctions at their disposal – in other words, why are the bank regulators not being "tough enough"? For instance, if a bank fails without a formal administrative action in place, there will be criticism leveled upon the regulator responsible. Further, in the case of every single bank failure, the FDIC's Office of Inspector General will perform a review of the causes for the failure, and such reports will likely criticize the regulator for being slow to act. Such institutionalized feedback serves only to further the pre-existing regulatory tendency for overkill. After all, regulators do not lose their jobs for being too tough.

The time to be "tough" is before an economic downturn when it can help head off problems. But when employed after the crisis has started, it accelerates the problems and can drive viable institutions over the cliff. It's like adding fertilizer on your lawn in the heat of the summer; it's only going kill the grass, not help it. At the current stage in the economic cycle, it is too late to simply be tough. There needs to be more cooperation amongst all parties involved to work towards the greater good, which in my opinion promotes economic recovery.

Regarding the Dodd-Frank Act, it will have an enormous and negative impact on my bank. Already there are over 1,000 pages of new proposed rules and there will be many thousands more, many of which will come from the Bureau of Consumer Financial Protection (Bureau). Summit Community Bank is larger than many banks in West Virginia, and we have about 200 people serving our customers. ***We have already added one new full time member to our compliance staff. This may not be enough.*** The typical bank in West Virginia has only about 50 employees. I know how demanding the crush of paperwork is for my staff, and I can't imagine the pressure that most community banks face with far fewer employees.

One of the claims was that small banks would not be affected by the new Bureau. But all banks will be subject to any new rules, even though community banks like mine will not be directly supervised by the Bureau. The FDIC (my bank's federal regulator) will examine for compliance at least as aggressively as the Bureau would do. In fact, the FDIC has created a whole new division just to implement the rules promulgated by the new Bureau. Once again, my bank's philosophy has always been to treat our customers right and do whatever we can to make sure that they understand the terms of the loans they are taking on and their obligations to us. We will continue to do this, but now there will be many new hurdles that we'll have to jump that will inevitably add costs, time, and hassle for my customers.

Another so-called "carve-out" under Dodd-Frank for community banks that will not work in practice is the exemption from interchange price setting. Under the act, the Fed must mandate prices for interchange (which is the fee merchants have paid when customers use debit cards to buy goods and services) for banks over $10 billion in assets. The Fed has proposed a rate that would reduce interchange revenue by more than 70 percent. Smaller banks can theoretically charge a higher interchange fee, but the economic incentives are so large that smaller banks like mine will almost certainly be forced to adopt the same price level or risk losing business to the largest banks. Market share will always flow to the lowest priced product, even if those lower prices are mandated only for some. The result for small banks is either a loss of market share, loss of revenue that supports free checking and other valuable services, or both.

Revenue from interchange is very important to my bank as it helps to offset some of the costs of providing checking account services to my customers. If I lose even a portion of interchange revenue, I have to rethink how I can cover my costs, whether it's in new debit card fees, or a reduction in staff, or in how I price loans. I cannot offer financial services if I can't cover the costs of doing so.

What seems to be missed here is the profile of the customer who will be most unjustly affected by the change in the way we are being forced to cover our costs and generate our revenues. Here in West Virginia, we have many hard working men and women who make just enough to "make ends meet". But they are some of the most honest and ethical individuals you will ever meet. They balance their checkbook to the penny and rarely, if ever overdraft. So, they currently are able to get most of their basic banking services free of charge. Yes, the revenues of others support these free services, but I can't think of a group that deserves it more. If trends continue, free checking and similar services are likely to disappear for everyone. We think this is bad public policy.

Summit Community Bank will survive these changes. But it is important to understand that our bank, indeed, any small business, can only bear so much. Higher costs, restrictions on sources of income, limits on new sources of capital, regulatory pressure to limit or reduce lending in certain sectors, all make it harder to meet the needs of our communities.

I have spoken to many bankers throughout the country who describe themselves as simply miserable. Some have already sold their banks; others plan to do so once the economic environment improves. As I mentioned before, most small banks do not have the resources to manage the flood of new rules. In fact, I have heard from bankers in two separate forums say that

regulators have told them that banks under $500 million in assets should consider merging as they are too small to survive. That translates to 90 percent of all banks headquartered in West Virginia. The Dodd-Frank Act was intended to stop the problem of too-big-to-fail, yet now we have even bigger institutions; ironically, the result may be that some banks will be too-small-to-survive the onslaught of the Dodd-Frank rules.

Mr. Chairman, I truly appreciate the fact that this committee is looking at the impact of recent regulatory and legislative changes that are affecting small banks like mine. There is so much more to tell. I'm hopeful that through these types of hearings, there is some recognition of the importance that community banks play throughout our country, the extra burden they must now bear, and the relief that is needed to restore the balance so that we can continue to make loans and meet the financial needs in our community.

Thank you and I'd be happy to answer any questions you might have.

United States House of Representatives
Committee on Financial Services

Hearings on
Promoting Economic Recovery and Job Creation:
The Road Forward
January 26, 2011

Testimony of
William Poole[1]

Mr. Chairman, members of the Committee, I am William Poole, Senior Fellow, Cato Institute. I was President of the Federal Reserve Bank of St. Louis from 1998 to 2008. As is my custom, I am speaking for myself and my views do not necessarily reflect the views of any of the organizations with which I am or have been affiliated.

I am pleased to be here today to discuss issues with regard to promoting economic recovery. The topic is obviously a huge one; what aspects of federal policy deserve to be at the top of the list of concerns? Because the recovery process may take five years or more to bring the unemployment rate below six percent, it is critical that we examine appropriate policies in a long-term context.

However well the economy may perform this year—four percent GDP growth seems a reasonable projection—growth over an extended period will require that the federal budget be put in order. There must be no higher priority. Jobs created this year at the expense of jobs created in future years will not get us to where we want to go.

Before I get to budget issues, a few brief comments on regulation. There are scores of disquieting anecdotes circulating about the depressing effects of regulation. One that I heard recently concerned a company that had for many years hired summer interns. Not this past summer, however. Following an examination of the effects of the Affordable Care Act in increasing insurance costs and risk, the company decided to forego its usual summer intern program. I find the anecdotes persuasive, but whether regulation adds up to a significant impediment to growth is yet to be determined. To my knowledge, we do not have evidence of sufficient quality to justify publication in a peer-reviewed economics journal to reach a conclusion. We do have our common sense, however; regulatory burden and regulatory uncertainty cannot be helping to speed economic recovery.

The Federal Budget Issue

The general public does not understand the enormity of the budget challenge. I fear that many members of Congress do not understand the challenge either. The Congressional Budget Office has said clearly that the current budget is not sustainable. It is natural, and often

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appropriate, to view the task of repairing a budget problem as involving some combination of tax increases and spending cuts. It would be useful if Congress would ask the CBO to clarify this issue by projecting the tax rates that would be necessary to finance spending in current policy projected over the next 30 years. What will be immediately apparent, I believe, is that there are no tax rates consistent with the functioning of a market economy that could finance projected spending.

If tax increases cannot fix the budget problem, then Congress will have to cut outlays. Above all, Congress will have to scale back entitlement spending. That means Social Security, Medicare and Medicaid. I will be blunt: we cannot save Medicare in its current form.

Note that I said that the issue is spending in current *policy*, not spending in current *law*. As the CBO emphasizes in its very important study, *Long-Term Budget Outlook*, released this past August, the Administration and Congress have quite systematically set current law to understate likely outlays and overstate likely revenues. That is a problem with the current Administration and is how the Nation ended up with Bush Administration tax cuts that expired at the end of 2010. Here I will be blunt again: current law budget projections for future years have become so distorted that they are hardly worth looking at.

The problem of inaccurate and distorted budget projections is especially acute with regard to Medicare. The chief actuary said this in the appendix to the Medicare Trustees Report released August 2010.

> In past reports, and again this year, the Board of Trustees has emphasized the strong likelihood that actual Part B expenditures, [which are those for physician services], will exceed the projections under current law due to further legislative action to avoid substantial reductions in the Medicare physician fee schedule. While the Part B projections in this report are reasonable in their portrayal of future costs under current law, *they are not reasonable as an indication of actual future costs. Current law would require physician fee reductions totaling an estimated 30 percent over the next 3 years—an implausible result.* [Emphasis added]
>
> Further, while the Patient Protection and Affordable Care Act, as amended, makes important changes to the Medicare program and substantially improves its financial outlook, there is a strong likelihood that certain of these changes will not be viable in the long range. …
>
> Without major changes in health care delivery systems, the prices paid by Medicare for health services are very likely to fall increasingly short of the costs of providing these services. By the end of the long-range projection period, Medicare prices for hospital, skilled nursing facility, home health, hospice, ambulatory surgical center, diagnostic laboratory, and many other services would be less than half of their level under the prior law. Medicare prices would be considerably below the current relative level of Medicaid prices, which have already led to access problems for Medicaid enrollees, and far below the levels paid by private health insurance. Well before that point, Congress would have to intervene to prevent the withdrawal of providers from the Medicare market and the severe problems with beneficiary access to care that would result. Overriding the productivity adjustments, as Congress has done repeatedly in the case of physician payment rates, would lead to far higher costs for Medicare in the long range than those projected under current law.

> For these reasons, the financial projections shown in this report for Medicare do not represent a reasonable expectation for actual program operations in either the short range (as a result of the unsustainable reductions in physician payment rates) or the long range (because of the strong likelihood that the statutory reductions in price updates for most categories of Medicare provider services will not be viable).

A U.S. federal budget crisis is improbable this year. However, without action to stabilize federal finances, a crisis will eventually occur, although its timing is impossible to predict. Consider the sovereign debt situation in Europe, which seemed relatively benign in mid 2009. Then, Greece blew up and Europe's credit markets have been in turmoil ever since. Could such a situation arise here? Yes.

Everyone agrees that tough decisions are needed, but many say "not yet" because of the importance of nurturing the recovery. I doubt that federal spending is as important to the recovery as many believe, but suppose I accept the argument that Congress should go slow in cutting spending. Many things could and should be done now that would have a minor effect on current spending but a major long-run effect. The report, issued this past December, of the President's Deficit Commission (officially, National Commission on Fiscal Responsibility and Reform) contains many useful recommendations. Modifying Social Security to place the program on a sound basis need not involve any changes to current benefits or taxes; following the Commission's recommendation would demonstrate that the federal government can get serious about fixing the budget problem. Another good candidate, in my view, would be to phase out ethanol subsidies.

There are scores of outlays and tax expenditures that ought to be phased out. Along with many others—probably a clear majority of citizens—I have low expectations. People are losing confidence in the federal government.

Something must be done to resolve the situation with Fannie Mae and Freddie Mac; they should not be permitted to remain alive on government life support. They should be phased out, saving billions on the current federal budget in the form of credit subsidies.

If Congress sets Fannie and Freddie on a shrinking path, I myself am optimistic that private firms could pick up the slack quickly. For those less optimistic, a cautious plan is feasible. The two companies should stop their purchases of new mortgages and permit their existing mortgage portfolios to run off as homeowners pay down mortgages in the normal course of business. The companies should announce a gradual increase in securitization fees, which would permit room for private financial firms to enter the business over time. How can Congress permit these two firms to survive? After all, with their proven record of failure costing taxpayers $150 billion and counting, they are not shining success stories. Other high-income countries have successful mortgage markets without GSE-type mortgage subsidiaries. We can, too.

I began my study of economics using the justly renowned textbook by Paul Samuelson. Early in the text is a subheading "The Law of Scarcity." Samuelson points out that, "In the world as it is, even children learn in growing up that 'both' is not an admissible answer to a choice of 'which one.'"

When will American voters and Congress learn that "both" is not an admissible answer when it comes to federal spending?

WRITTEN TESTIMONY

OF

HAL S. SCOTT
NOMURA PROFESSOR OF INTERNATIONAL FINANCIAL SYSTEMS AT HARVARD LAW SCHOOL AND
DIRECTOR OF THE COMMITTEE ON CAPITAL MARKETS REGULATION[1]

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

JANUARY 26, 2011

EXECUTIVE SUMMARY

- Sound regulatory implementation of the Dodd-Frank Act is vital to economic growth and maintaining America's competitiveness. President Obama should not leave the financial system behind in his new initiatives in these areas.

- The rulemaking process is a massive undertaking in which over 200 new rules are being implemented in one year, completely revamping the regulation of our financial system. This is too fast a timetable to do the job correctly. It does not permit adequate public input and is devoid of meaningful cost-benefit analysis.

Recommendations for Dodd-Frank Regulatory Implementation

1. Congress should urge the President to require OMB to comment on the adequacy of cost-benefit analysis of the independent financial agencies in promulgating new rules, *e.g.*, the CFTC, FDIC, Federal Reserve, and SEC. Congress should require by statute that all these agencies engage in cost-benefit analysis.

2. Congress should encourage the financial agencies to report on progress toward meeting statutory deadlines and permit the missing of deadlines if truly justified.

3. Congress should encourage the financial agencies to make proposed and issued rules available to the public promptly.

4. Congress should give the financial agencies the resources they legitimately need to implement Dodd-Frank.

[1] Biography available at http://www.law.harvard.edu/faculty/directory/index.html?id=63.

Needed Changes in the Dodd-Frank Act

1. Do not require the Federal Reserve to get advance Treasury Secretary approval for emergency lending.

2. Narrowly define "proprietary trading" under the Volcker Rule to include only "trading activities set up with segregated capital and separate teams of personnel that do not interact with customer businesses or rely on customer deposits."

3. The Congress, not the Federal Reserve, should fund the activities of the Bureau of Consumer Financial Protection and should urge the President to promptly nominate a director of the new agency.

4. Fundamental structural reform of the regulatory system is needed, beyond the creation of the Financial Stability Oversight Council.

5. The ban on the use by the government of credit ratings in formulating regulations should be somewhat relaxed by providing that the government cannot unduly rely on such ratings.

* * *

Thank you, Chairman Bachus, Ranking Member Frank, and members of the Committee for permitting me to testify before you today on promoting economic recovery and job creation. I am testifying today in my own capacity and do not purport to represent the views of the Committee on Capital Markets Regulation, although much of my testimony is based on the Committee's past reports and statements.

I will focus my remarks on the process of the regulatory implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),[2] as well as some proposals for legislative improvements. These rules will have a profound long-term impact on our financial system, which is crucial to the U.S. economy. President Obama has recently shifted his focus to American competitiveness and the increasing burden of the regulatory system. Financial regulations and regulators should not be exempt from these concerns. Competitiveness of our

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 [hereinafter "Dodd-Frank Act"].

financial system has long been a concern of the Committee on Capital Regulation, indeed spurring its creation in 2005. Rushed regulation devoid of public input and sound cost-benefit analysis will harm the competitiveness of the U.S. financial markets and will in turn be a drag on our economy.

As the Committee knows, the unprecedented scope and pace of agency rulemakings implementing Dodd-Frank has created unique challenges for businesses and regulators. The Securities and Exchange Commission (SEC), Federal Deposit Insurance Corporation (FDIC), Commodity Futures Trading Commission (CFTC), Board of Governors of the Federal Reserve System (Federal Reserve), and the new Financial Stability Oversight Council (FSOC) are collectively responsible for at least 230 rulemakings.[3] Many more are likely to follow from those and other agencies. The scope of these rulemakings is vast and encompasses almost a complete revision of the regulation of the financial system. President Obama, keenly aware of the danger of poorly formulated rules to economic growth, moved improvements in the regulatory process near the top of his agenda last week.[4] I applaud him for doing so.

This is a particularly opportune time to consider the regulatory process because last week we also crossed the six-month anniversary of the Dodd-Frank Act. This puts us halfway to the one-year deadline this July, by which time the regulatory agencies must finalize the majority of important rules implementing the Act. In revising our regulatory structure, the most important objective should be to get the rules right, not to act quickly. While a prolonged process may result in some uncertainty for our economy, bad rules will result in more serious and permanent damage. Let me be clear: I am not urging delay to avoid or unnecessarily defer regulation; I am simply advocating taking the time we need to get it right.

[3] Sec. Industry & Fin. Mkts. Ass'n, *Regulatory Action Database*, http://www.sifma.org/members/dodd-frank.aspx.
[4] *See* Barack Obama, *Toward a 21st-Century Regulatory System*, WALL ST. J., Jan. 18, 2011, at A17.

I will begin by detailing needed improvements in the regulatory process and then turn to some more substantive issues that would require revisions of the Act.

I. The Dodd-Frank Implementation Process

The Committee on Capital Markets Regulation recently examined how the financial agencies are handling the daunting task of writing these rules to implement the Dodd-Frank Act. In its December 15 letter to you and your counterparts on the Senate Committee on Banking, Housing, and Urban Affairs, it detailed how "the current rulemaking process is sacrificing quality and fairness for apparent speed."[5] The current rulemaking process is undoubtedly rushed, and even the most interested and sophisticated parties, including the trade associations, are finding it very difficult to keep up and offer meaningful input.

As the Committee's letter explained, speed can kill.[6] This push for speed can be traced, in large part, back to Secretary of the Treasury Geithner's promise in August 2010 to change the "glacial pace" of rulemaking.[7] This was done to blunt charges that a slow pace of implementation would create economic uncertainty and impede economic recovery. At that time, Glenn Hubbard and I wrote an op-ed in the Wall Street Journal urging federal agencies not to sacrifice the requirement for deliberative and rational regulatory implementation in search of speed.[8] Since our

[5] Letter from the Comm. on Capital Mkts. Reg. to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs and Barney Frank, Chairman, Spencer Bachus, Ranking Member, H. Comm. on Fin. Servs. 1 (Dec. 15, 2010), http://www.capmktsreg.org/pdfs/2010.12.15_Rulemaking_Timeline_Letter.pdf [hereinafter "CCMR Dec. 15, 2010 Letter"].
[6] *See id.* at 4.
[7] Timothy F. Geithner, *Rebuilding the American Financial System*, Address at New York University Stern School of Business (Aug. 2, 2010), transcript available at http://www.treasury.gov/press-center/press-releases/Pages/tg808.aspx ("First, we have an obligation of speed. We will move as quickly as possible to bring clarity to the new rules of finance. The rule writing process traditionally has moved at a frustrating, glacial pace. We must change that." (internal paragraph break omitted)).
[8] Glenn Hubbard & Hal S. Scott, *Geithner's Hollow 'Speed' Pledge to Business*, WALL ST. J., Aug. 5, 2010.

call, and those of others, particularly after the November elections, the pace has slowed down somewhat but not nearly enough.

Our nation's rulemaking process, as codified in the Administrative Procedure Act (APA), is founded on the principles of transparency and responsiveness to the views of the public. Historically, the SEC, CFTC, FDIC, and Federal Reserve have all respected this process. In 2005 and 2006, the SEC issued on average fewer than ten new substantive rules. It must now issue approximately 100 rules, 60 of them by this July. Meanwhile, the CFTC, which issued a total of 11 substantive rulemakings in 2005 and 2006 combined, must now issue nearly 40 by July.

Table 1: Average annual rate of rulemaking (rules per year)[9]

Agency	Pre-Dodd-Frank (2005–2006)	Post-Dodd-Frank
SEC	9.5	59
CFTC	5.5	37
FDIC	8	6
Federal Reserve	4.5	17

Agencies are abandoning their responsible, deliberative rulemaking processes in favor of a faster process. A random sample of rulemakings by the SEC, CFTC, FDIC, and Federal Reserve from 2005 and 2006 revealed that during that time those agencies provided more than 60 days on average for public comment on proposed rules. They often left the comment period open for as long as 90 or 120 days for major rulemakings. In contrast, in the first three months since the passage of the Dodd-Frank Act, these same agencies and the new Financial Stability Oversight Council (FSOC) gave, on average, just over 30 days for comment.[10] The average comment period for all rulemaking since the Dodd-Frank Act was passed is now about 45 days (the pace having

[9] Includes only formal, notice-and-comment rulemaking. Does not include technical amendments or interim final rules.
[10] CCMR Dec. 15, 2010 Letter, *supra* note 5, at 3.

slowed somewhat in recent months), but this is still not enough time, especially since these agencies issued nearly 50 proposed rules in the last two months of 2010, nearly 40 of which came in November. Further, some of the most significant rules have very short comment periods. For example, one of the most important tasks FSOC has is to determine which "systemically important" nonbank financial companies should be subject to enhanced supervision by the Federal Reserve.[11] Yet FSOC provided only 30 days to comment on both the advance notice of proposed rulemaking and the proposed rule itself.[12] The latter was even subject to review by Executive Order 12866, which states that in most cases the comment period should be "not less than 60 days."[13] Indeed, President Obama recently reaffirmed the long-standing presidential policy that in order to "afford the public a meaningful opportunity to comment," the comment period "should generally be at least 60 days."[14]

The statutory requirement and historical practice of allowing all interested parties to provide input during the rulemaking process is made only more important when, as now, agencies are considering complex and critical policies like those in the Dodd-Frank Act. The rules regulators are drafting will dramatically reshape entire industries; the affected people, companies, and industry groups need extra time to process these fundamental changes. Instead they are getting less time.

[11] *See* Dodd-Frank Act § 113(a)(1).
[12] *See* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 75 Fed. Reg. 61,653, 61,653 (Oct. 6, 2010); *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, FSOC, RIN 4030-AA30.
[13] Exec. Order No. 12,866, § 6(a)(1), 58 Fed. Reg. 51,735, (Oct. 4, 1993). *See Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, FSOC, RIN 4030-AA30 ("It has been determined that this regulation is a significant regulatory action as defined in section 3 of Executive Order 12866 ('Regulatory Planning and Review') and it has been reviewed by the Office of Management and Budget.").
[14] Exec. Order No. 13,563, § 2(b), 76 Fed. Reg. 3,821 (Jan. 21, 2011); *see also* Exec. Order No. 12,866, § 6(a), 58 Fed. Reg. 51,735, (Oct. 4, 1993).

The present lack of coordination among agencies also contributes to making the process unwieldy. In many instances Dodd-Frank requires agencies to coordinate rulemaking, sometimes even requiring the promulgation of joint rules. A total of 43 rulemaking provisions involve two or more agencies, 25 of which involve three or more.[15] Unfortunately, the progress thus far does not bode well for this process. Dodd-Frank requires joint rulemaking among several agencies in the field of securitization, yet the SEC and the FDIC have each already released proposed or final rules, which conflict with each other, in advance of the joint process.[16] Such conflicts are, in part, a reflection of different agency views on substance. But they are also a result of a process in which the promulgation of rules lacks overall consistency and direction. This is a legacy of our continuing fragmented regulatory structure.

An inadequate process will also make successful challenges in federal court more likely. The APA forbids rulemaking practices that are "arbitrary and capricious"; a rushed and uncoordinated process is, unfortunately, very likely to live up to that standard. The short time limits permitted by the statute are no excuse. The D.C. Circuit has stated that even if the Congress "vest[s] broad rulemaking authority in an agency…[and] charge[s] the agency with swiftly and effectively implementing a national policy,…the agency remains bound by the APA's notice and comment requirements."[17] Rules that are likely to be overturned in court only add to uncertainty and make the speed of implementation nothing more than an illusion.

[15] *See* Curtis W. Copeland, Cong. Research Serv., R41472, *Rulemaking Requirements and Authorities in the Dodd-Frank Wall Street Reform and Consumer Protection Act* 7 (Nov. 3, 2010),
[16] *See* Dodd-Frank Act § 941(b); *compare* Asset-Backed Securities, 75 Fed. Reg. 23,328 (May 3, 2010) (SEC) *with* Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation After September 30, 2010, 75 Fed. Reg. 60,287 (Sept. 30, 2010) (FDIC).
[17] Chamber of Commerce of U.S. v. SEC, 443 F.3d 890, 899 (D.C. Cir. 2006).

Some agencies have statutory responsibilities to engage in some form of cost-benefit analysis. The CFTC is required to "consider the costs and benefits" of its rules, and the SEC is generally required to consider whether its rules "will promote efficiency, competition, and capital formation."[18] Similarly, FSOC is required to conduct cost-benefit analysis when completing some of its studies.[19] The Executive Order the President issued last week reaffirms the importance of cost-benefit analysis in rulemaking.[20] But doing proper analysis takes both data and time. The present pace of rulemaking makes it extremely difficult for the regulators to do such analysis. In a recent release proposing rules on reporting requirements for swap transactions, the CFTC devoted one paragraph to examining costs and two paragraphs to benefits.[21] Moreover, rather than quantify the costs for a typical transaction or examine the tradeoffs for each required data element, the CFTC took a qualitative and holistic approach and concluded *ipse dixit* that "the additional cost imposed by the [rules]...would be minimal."[22] One must bear in mind that regulators do not have a particularly impressive historical record of sound cost-benefit analysis, even when they take more time. When implementing the last significant piece of financial legislation, the Sarbanes-Oxley Act of 2002, the SEC dramatically underestimated the cost of Section 404 requirements for internal controls.[23] The SEC originally estimated that internal costs (exclusive of audit fees) would average $91,000 per company.[24] Subsequent studies have shown that the true cost is on the order

[18] 7 U.S.C. § 19(a) (CFTC); 15 U.S.C. § 78c(f) (SEC); *see also* 15 U.S.C. § 78w(a)(2) (SEC required to consider burden on competition).
[19] Dodd-Frank Act §§ 115(c)(1), 123(a)(1).
[20] Exec. Order No. 13,563, § 2(b), 76 Fed. Reg. 3,821 (Jan. 21, 2011).
[21] *See* Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, 75 Fed. Reg. 76,666, 76,673 (proposed Dec. 9, 2010).
[22] *See id.*
[23] *See* 15 U.S.C. § 7262.
[24] *See* Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Companies That Are Not Accelerated Filers, 70 Fed. Reg. 56,825 (proposed Sept. 29, 2005). Note that this estimate covered only § 404(a), not § 404(b).

of $3.5 million per company—more than 35 times the SEC's estimate.[25] In a rushed environment, where not even rudimentary data is collected, the results will be worse.

To be sure, the deadlines imposed by the Congress in the Dodd-Frank legislation are part of the problem. The overambitious timeframe is evident when compared with past practice. Before the Dodd-Frank Act, in 2005 and 2006, the SEC took an average of 524 days between proposing and finalizing a rule. For the rules it has proposed so far, it has an average of only about 200 days before the Dodd-Frank Act requires final rules. Although the CFTC now has more time to finalize its rules than it typically takes (it has 238 days, compared to its 109-day historical average), it has never before been tasked with writing so many complex rules.[26]

Table 2: Average number of days between proposed rule and final rule

Agency	Pre-Dodd-Frank (2005–2006)	Post-Dodd-Frank[27]
SEC	524	206
CFTC	109	230
FDIC	154	248
Federal Reserve	596	229

The implementation of the Dodd-Frank Act is daunting. But this is no excuse for abandoning the traditional practices of sound rulemaking. Slowing things down admittedly will create some uncertainty, but the economic damage will be less than if bad rules are adopted. The 112th Congress can take some very important steps toward ensuring more responsible rulemaking in this area.

Let me turn to some specific recommendations.

[25] *See* COMM. ON CAPITAL MKTS. REG., INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 1, 126 (Nov. 30, 2006), [hereinafter "CCMR Interim Report"].
[26] CCMR Dec. 15, 2010 Letter, *supra* note 9, at 4.
[27] Calculated using the number of days between the proposed rule and the statutory deadline.

Recommendation 1: Extend OMB Review to the Independent Agencies

For the last 30 years, a period spanning nearly five presidents, a series of executive orders has added additional requirements to the rulemaking process to the skeletal requirements of the APA. The current system, under the 1993 Executive Order 12866, generally requires governmental agencies to conduct cost-benefit analysis, leave comment periods open for at least 60 days, and submit proposed rules for review by the Office of Information and Regulatory Affairs (OIRA) within the Office of Management and Budget.[28] President Obama recently reaffirmed these principles in a new executive order.[29]

Many financial regulators, however, escape these requirements. The "independent regulatory agenc[ies]" are exempt under both the 1993 Order and the President's new Order.[30] The list of these independent agencies includes the Federal Reserve, CFTC, FDIC, and SEC.[31] Cass Sunstein, presently the Administrator of OIRA, has long called for expanding the Executive Order to subject proposed rules of the independent agencies to OIRA review, and therefore a requirement to engage in cost-benefit analysis.[32] This approach may go too far because it impinges on the independence of the "independent agencies" created by Congress and conceivably could raise constitutional issues.[33]

A more moderate approach that avoids issues of separation of powers would be for OIRA to file comments with the agency, with respect to important rulemakings (as determined by OIRA)

[28] *See* Exec. Order No. 12,866, § 6(a), 58 Fed. Reg. 51,735 (Oct. 4, 1993).
[29] Exec. Order No. 13,563, § 2(b), 76 Fed. Reg. 3,821 (Jan. 21, 2011); 44 U.S.C. § 3502(5).
[30] *See* Exec. Order No. 12,866, § 6(a), 58 Fed. Reg. 51,735 (Oct. 4, 1993); Exec. Order No. 13,563, § 2(b), 76 Fed. Reg. 3,821 (Jan. 21, 2011); 44 U.S.C. § 3502(5).
[31] *See id.*
[32] *See* Robert W. Hahn & Cass R. Sunstein, *A New Executive Order for Improving Federal Regulation? Deeper and Wider Cost-Benefit Analysis*, 150 U. PA. L. REV. 1489, 1531–37 (2002); *see also* Richard H. Pildes & Cass R. Sunstein, *Reinventing the Regulatory State*, 62 U. CHI. L. REV. 1 (1995).
[33] *See* Hahn & Sunstein, *id.*, 150 U. PA. L. REV. at 1531–37; Pildes & Sunstein, *id.*, 62 U. CHI. L. REV. at 24–33; *see also* Elena Kagan, *Presidential Administration*,114 HARV. L. REV. 2245, 2319–31 (2001).

on the adequacy of whatever cost-benefit analysis the agency is required to do under statute or decides to do on its own. The agency would be free to incorporate or disregard OIRA's comments as it sees fit, although the final rules would still be subject to review in court and ignoring OIRA comments would obviously be taken into account in deciding whether the agency action was "arbitrary" or "capricious."[34]

This approach assumes that the agencies are required to engage in some form of cost-benefit analysis. Some agencies, such as the CFTC, are already required to do so. This requirement should be extended and strengthened so that all of the financial regulators (including FSOC) are required to determine whether the costs of its rules exceed the benefits. President Obama cannot expect to avoid harm to the economy through ill-advised regulation as a whole unless financial regulation is included.

Recommendation 2: Encourage Agencies to Report on Deadlines

This Congress should also encourage agencies to report on their progress toward statutory deadlines. Such reporting would make it easier to determine when more time is required. Indeed, the CFTC has already missed a statutory deadline to set position limits on some commodities,[35] and the Financial Crisis Inquiry Commission announced that it will not issue its report on the financial crisis to the President and Congress before its statutory deadline.[36]

[34] 5 U.S.C. § 706(2)(A); CCMR Interim Report at 60–63 (noting that "because OMB and OIRA are offices of the White House, [review by those offices] would bring an "independent" agency under the political influence, if not control, of the Executive Branch").
[35] *See* Charles Abbott & Tom Doggett, *CFTC Admits Will Miss Deadline on Position Limits*, Reuters (Dec. 15, 2010), http://www.reuters.com/article/idUSTRE6BE4OX20101215; *see also* Dodd-Frank Act § 737(a)(4) (requiring rules on some position limits within 180 days).
[36] *See* Exec. Order No. 13,563, § 2(b), 76 Fed. Reg. 3,821 (Jan. 21, 2011).

The ability of agencies to meet statutory deadlines has always been stretched during times of increased rulemaking. As the Fifth Circuit Court of Appeals noted, agencies do not always "regard the statutory deadline[s] as sacrosanct."[37] For example, during the implementation of the SOX, the SEC missed at least two statutory deadlines.[38] Such a reporting system should acknowledge that Congress will tolerate delays in implementation where such delays are justified.

Recommendation 3: Prompt Availability of Proposed and Issued Rules

President Obama's new executive order from last week highlighted the importance of the internet in the regulatory process, particularly for public input.[39] Yet it can typically take days, and sometimes weeks, for agencies to make available the full text of proposed and even final rules. Although agencies frequently issue press releases and summaries of the rules, interested parties need access to the full rules in order to understand their full contours. The full text of regulations should be posted immediately to the agencies' own websites and should be posted to regulations.gov as soon as possible.

Recommendation 4: Agencies Need Adequate Resources

It is unwise to cut the budgets of the financial regulatory agencies in an attempt to control or derail the regulatory reforms prompted by Dodd-Frank. Tightening the purse strings will not stop the rulemaking process; it will only make it worse. Independent agencies deprived of funds will not stop writing rules—they will only do a worse job or shift resources from other important

[37] U.S. Steel Corp. v. U.S. Environmental Protection, 595 F.2d 207, 213 (5th Cir. 1979); *see also* Jacob E. Gersen & Anne Joseph O'Connell, *Deadlines in Administrative Law*, 156 U. PENN. L. REV. 923, 954 (2008) (discussing missed deadlines).
[38] *See, e.g.*, Improper Influence on Conduct of Audits, 68 Fed. Reg. 31,820, 31,820 (May 28, 2003) (issuing final rule two months after statutory deadline); Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6,006 (Feb. 5, 2003) (announcing final rule after statutory deadline had passed that would not become effective for over two months).
[39] *See* Exec. Order No. 13,563, § 2(b), 76 Fed. Reg. 3,821 (Jan. 21, 2011).

areas such as enforcement. As the Committee on Capital Markets Regulation said in its December letter to Congress, "bad rules [will] interfere with the proper functioning of the financial system for years to come."[40] I agree with some members of Congress that there are major problems with the implementation of Dodd-Frank, but they should be fixed through legislation and oversight, not through withholding funds in the appropriations process. Starving the agencies of necessary funds risks making a bad situation worse.

II. Substantive Issues with the Dodd-Frank Act

I would also like to take this opportunity to highlight five areas of the Dodd-Frank Act itself that deserve your attention.

A. Requiring the Federal Reserve to Get Treasury Secretary Approval for Emergency Lending

Section 1101 of the Dodd-Frank Act provides that the Federal Reserve may establish an emergency lending facility only with "the prior approval of the Secretary of the Treasury."[41] As the Committee on Capital Markets Regulation argued in its June 2010 letter to Congress, this approach "imposes unnecessary procedural hurdles on the Federal Reserve, potentially hampering its ability to act decisively in a crisis."[42] The Federal Reserve, not the Secretary of the Treasury, is the proper decision-making body for emergency lending, assuming such lending is adequately collateralized, a result Dodd-Frank makes more likely because any lending facility must ensure "that the security for emergency loans is sufficient to protect taxpayers from losses," may not be

[40] CCMR Dec.15, 2010 Letter at 5.
[41] Dodd-Frank Act § 1101(a)(6)(B)(iv).
[42] Letter from the Comm. on Capital Mkts. Reg. to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs, Barney Frank, Chairman, Spencer Bachus, Ranking Member, H. Comm. on Fin. Servs. 6 (June 14, 2010), http://www.capmktsreg.org/pdfs/2010.06.14_CCMR_Reconciliation_Letter.pdf.

used to lend to insolvent borrowers, must have "broad-based eligibility," and is subject to audits by the Comptroller General of the United States.[43]

Not only does the Federal Reserve have the expertise for making such decisions, but as we saw in the crisis, it is also uniquely capable of acting with the speed and decisiveness that is required in any emergency. Although it may be proper and prudent to require the Federal Reserve's general procedures for administering such facilities to be approved by the Secretary of the Treasury, it is unwise to require, as the Dodd-Frank Act currently does, approval of the facility itself. Federal Reserve lending may be demonized as a bailout; if done properly however, it is a well-collateralized loan. Nonetheless, Treasury Secretaries, particularly in the anti-bailout environment following our crisis, may be reluctant to approve needed lending facilities for fear of political consequences. This is why we need to rely on independent agencies to make what may be necessary but unpopular decisions. Lender of last resort authority is a key power of independent central banks.

B. The Definition of "Proprietary Trading" under the Volcker Rule

The Volcker Rule, as enacted in § 619 of the Dodd-Frank Act, prohibits any bank from "engag[ing] in proprietary trading."[44] In testimony I delivered last year to the Senate Committee on Banking, Housing, and Urban Affairs, I showed how restrictions on proprietary trading are both over- and under-inclusive. They are over-inclusive because not all banks engaged in proprietary trading contribute to systemic risk, and under-inclusive because some non-banks engaged in proprietary trading may contribute to systemic risk.[45] In addition, such rules risk

[43] Dodd-Frank Act §§ 1101(a)(6), 1102(a).
[44] *Id.* § 619.
[45] *Implications of the 'Volcker Rules' For Financial Stability: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 111th Cong. 2, 5 (Feb. 4, 2010) (statement of Hal S. Scott).

making our banks uncompetitive internationally, a result the President seeks to avoid. Again, the financial system cannot be left outside the concern of competitiveness. Further, proprietary trading was not a cause of our financial crisis, and can make banks more safe and sound by diversifying their activities beyond risky lending.

The term "proprietary trading" in section 619 is ambiguous. That is why the FSOC has called for input on further defining the term through the rulemaking process, but has yet to give any specific guidance on a proper definition.[46] The Act defines "proprietary trading" as follows:

> engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the [regulators] determine.[47]

The implementation of the Dodd-Frank Act would be greatly improved if, through rule or amendment, the term "proprietary trading" is defined narrowly and the various exceptions defined broadly. The definition should be limited to "trading activities set up with segregated capital and separate teams of personnel that do not interact with customer businesses or rely on customer deposits."[48]

[46] *See* Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds, 75 Fed. Reg. 61,758, 61,759, § 4(v) (Oct. 6, 2010).
[47] Dodd-Frank Act § 619(h)(4).
[48] *See* Comm. On Capital Mkts. Reg., comment to Financial Stability Oversight Council Advance Notice of Proposed Rulemaking, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 75 Fed. Reg. 61,653 (filed Nov. 5, 2010).

C. Funding and Management of the Bureau of Consumer Financial Protection

Under the Dodd-Frank Act, the newly created Bureau of Consumer Financial Protection (Bureau) is funded from the profits of the Federal Reserve.[49] The Bureau receives whatever amount its Director determines is "reasonably necessary to carry out [its] authorities," subject to a cap of about $550 million.[50]

Funding the Bureau through Fed profits, particularly without any review of the justification for the money claimed, is problematic because it sets a bad precedent for appropriating Federal Reserve profits to particular budgetary needs. Budgetary determinations should be made through the normal appropriation process, where justification is required.

In addition, the Bureau is in need of a permanent Director. Professor Elizabeth Warren, a wonderful colleague of mine, is doing an admirable job in helping to set up the Bureau. But the Bureau needs a real Director, properly appointed by the President and confirmed by the Senate as required by Dodd-Frank, whether it be her or someone else.[51] Dodd-Frank allows the Secretary of the Treasury to perform some functions of the Bureau before a Director has been confirmed, a power which Secretary Geithner has delegated to Warren in her role as Special Advisor to the Secretary.[52] That interim authority is limited, however. It presently includes establishing the Bureau, hiring its employees, and working with other regulators.[53] On the "designated transfer

[49] *See* Dodd-Frank Act § 1017(a)(1).
[50] *Id.* § 1017(a); *Annual Report, 2009, Board of Governors of the Federal Reserve System* at 475, 491. Note that this cap, which increases slightly for fiscal years 2012 and 2013 and is adjusted for inflation thereafter, does not include the additional appropriations through fiscal year 2014 provided by § 1017(e).
[51] *See* Dodd-Frank Act § 1011(b)(2).
[52] *See Id.* § 1066(a). Letter from Eric M. Thorson, Inspector General, Department of the Treasury, and Elizabeth A. Coleman, Inspector General, Board of Governors of the Federal Reserve System, to Hon. Spencer Bachus, Chairman, Committee on Financial Services, and Hon. Judy Biggert, Chairman, Committee on Financial Services, Subcommittee on Insurance, Housing, and Community Opportunity, OIG-CA-11-004, FRB OIG 2011-01 Enclosure at 2 (Jan. 10, 2011) [hereinafter "OIG Letter"].
[53] OIG Letter at 4-5. Note that § 1066(b) also permits the Treasury to provide additional "administrative services."

date,"[54] currently set for July 21, 2011,[55] many of the Bureau's substantive powers and responsibilities will begin. The Inspectors General for both the Treasury and the Federal Reserve have concluded that after this date, the powers of the Secretary of the Treasury, or his delegate, are limited to the Bureau's functions under subtitle F of Title X of the Act, which generally encompass the existing authorities of *other* regulators that will be transferred to the Bureau.[56] The Inspectors General have concluded that only a Senate-confirmed Director may exercise the *new* authorities that the other subtitles of the title establish, including the new powers to prohibit unfair, deceptive, or abusive practices and to control disclosures about consumer financial products.[57]

The Bureau needs to have a head that is capable of executing the full powers of the office. It will not get off to a good start if, when it becomes a functional agency, its head is operating with one hand tied behind his or her back.

D. Structural Reform Beyond the Financial Stability Oversight Council

In 2009, the Committee on Capital Markets Regulation called for the reorganization of the U.S. regulatory structure, calling it "an outmoded, overlapping sectoral model."[58] The Dodd-Frank Act has not rectified the problem. Although it eliminated the Office of Thrift Supervision,[59] it created the Bureau of Consumer Financial Protection, the Federal Insurance Office, and the FSOC.[60] I urge this Congress to make real structural reform a top priority. Regulation of the U.S.

[54] Dodd-Frank Act § 1062.
[55] Designated Transfer Date, 75 Fed. Reg. 57,252, 57,253 (Sept. 20, 2010).
[56] OIG Letter at 5-6.
[57] *Id.* at 6–7; *see* Dodd-Frank Act §§ 1066(a) ("The Secretary is authorized to perform the functions of the Bureau under this subtitle until the Director of the Bureau is confirmed by the Senate."), 1031 ("prohibiting unfair, deceptive, or abusive acts or practices"), 1032 (disclosures).
[58] COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM 1, 203 (May 2009) [hereinafter "CCMR May 2009 Report"].
[59] *See* Dodd-Frank Act § 312(b).
[60] *See id.* §§ 111(a) (FSOC), 502 (FIO), 1011(a) (CFPB).

financial system should be concentrated in no more than three federal regulatory bodies, as the Committee has recommended.[61]

Although the FSOC has been tasked with some oversight and coordination roles, and may represent a transition toward real reform, it is not a real solution to our fragmented regulatory structure. First, it has little direct supervisory authority—authority remains dispersed among the other agencies. For example, although it has the authority to designate nonbank financial institutions as systemically important, Dodd-Frank places enhanced supervisory authority in the hands of the Federal Reserve.[62] It can make recommendations to the Federal Reserve, but cannot force it to act.[63] Similarly, it can resolve some disputes among agencies, but its recommendations are generally nonbinding.[64] In addition, the two-thirds supermajority vote for many of its actions may be difficult to achieve. More generally, it is hard to run anything in a timely and important way by committee.

E. Credit Ratings

The Dodd-Frank Act requires federal agencies to purge from regulations "any reference to or requirement of reliance on credit ratings."[65] Yet the Act provides no solution as to what should replace reliance on these ratings beyond calling for "uniform standards of creditworthiness for use by each such agency."[66] Many important regulations like capital requirements and those of the Investment Company Act rely heavily on credit ratings.

[61] CCMR May 2009 Report at 203.
[62] *See* Dodd-Frank Act § 113.
[63] *See id.* § 115.
[64] *See id.* § 119.
[65] *Id.* § 939A(b).
[66] *Id.*

This problem requires immediate action by Congress. In the short term, the Act should be amended to allow the use of credit ratings but forbid "undue reliance" on them. Although this approach may still give too much influence to the ratings agencies, it will give the regulators more flexibility and discretion than an absolute prohibition while the regulators, Congress, and the public determine how to replace credit ratings.

In the longer term, the Congress can explore alternatives. One alternative might be to create a Credit Assessment Panel composed of not only rating agencies, but also other expert firms, like PIMCO and BlackRock, that already provide credit analysis to private financial firms. Each member of the Panel would evaluate creditworthiness using its own proprietary methodology but would provide credit assessments in a standardized format. The government could then use each firm's contribution in forming a composite assessment. The government itself would be prohibited from devising its own ratings; it would have to rely exclusively on the input from the Panel. The Panel members would have to be compensated, a major challenge of this approach. In principle, beneficiaries could be charged a fee. This is only an idea to explore; I am not now advocating its adoption.

Thank you and I look forward to your questions.

Economic Growth and Job Creation: The Road Forward

John B. Taylor*

Testimony Before The
Committee on Financial Services
U.S. House of Representatives
January 26, 2011

Chairman Bachus, Ranking Member Frank, other members of the House Committee on Financial Services, thank you for the opportunity to testify at this important time on monetary and fiscal policies to promote economic growth and job creation.

After more than three years since the financial crisis flared up and the recession began, the unemployment rate is still over 9 percent, and has been over 9 percent for 20 consecutive months. Individual durations of unemployment have gotten so long that this month the Bureau of Labor Statistics lengthened the maximum unemployment duration in its monthly survey from two years to five years. As I testified[1] last year, my empirical research shows that discretionary government interventions in the monetary, fiscal, and regulatory policy areas are unfortunately largely responsible for much of the crisis and lower economic growth which has led to the high unemployment. The clear implication of this research is that a reform of policy is the key to sustained economic growth and reduced unemployment going forward. In this testimony I focus on fiscal and monetary policy reforms.[2]

Many discretionary interventions were taken before or during the panic in the fall of 2008, but in the past two years policy makers have doubled down on the interventions. On the fiscal side we have seen an $862 billion stimulus package, an increase in annual federal spending from 21 to 25 percent of GDP, and a corresponding explosion of federal debt. On the monetary side we have seen Quantitative Easing 1 (QE1) of $1.55 trillion, Quantitative Easing 2 (QE2) of $600 billion, and a corresponding explosion of the Federal Reserve's balance sheet. On the regulatory side we have seen thousands of pages of legislation with new regulations in the health and financial sectors.

When you look at each of the monetary and fiscal interventions during the past two years you see that they had little effect in stimulating the economy or reducing unemployment. The one-time stimulus payments to people did not jump-start aggregate consumption. The federal stimulus funds sent to the states did not increase infrastructure spending. The cash for clunkers

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[1] "An Exit Rule for Monetary Policy," Testimony before the Committee on Financial Services, U.S. House of Representatives, March 25, 2010; "Perspectives on the U.S. Economy: Fiscal Policy Issues," Testimony before the Committee on the Budget, U.S. House of Representatives, June 30, 2010; "Assessing the Federal Policy Response to the Economic Crisis," Testimony before the Committee on the Budget. U. S. Senate, September 22, 2010.

[2] Other important policy reforms in the financial area include Fannie Mae, Freddie Mac, and the bankruptcy code for large financial firms (Chapter 11F).

program merely shifted consumption a few months forward in time. The purchase of mortgage backed securities under QE1 did not have a material impact on mortgage interest rates once other risks are taken into account. At best these actions had a small temporary effect which dissipated quickly with no lasting boost to economic growth or job creation. Moreover, the increased debt, monetary overhang, and uncertainty about new regulations have likely been a drag on the economy.

None of this should be surprising. Well-known economic theories of consumption—such as the permanent income or life cycle theory—predict that temporary payments to households will not increase consumption by much. Careful empirical studies of fiscal stimulus programs in the late 1970s showed that sending stimulus grants to the states did not increase infrastructure spending. A vast literature and experience from the 1970s shows that discretionary monetary policy, as distinct from more rules-based policy, leads to boom-bust cycles with ultimately higher unemployment and higher inflation. In contrast when sounder, more stable and more predictable monetary and fiscal policies were followed in the 1980s and 1990s we had higher economic growth and lower unemployment.

In sum, basic economic principles and practical experience—including the painful experience of the past few years—point clearly to the best road forward to promote economic recovery and job creation: *restore sound fiscal policy and sound monetary policy.*

Historical research shows that the policy pendulum swings back and forth over time. The discretionary monetary and fiscal policies which brought on double digit unemployment, interest rates and inflation in the 1970s, gave way to sounder monetary policy and less interventionist fiscal policy in the 1980s and 1990s and economic performance improved. So too the recent discretionary policies which led to poor economic performance may be giving way to sounder policies and thereby improved economic growth and job creation.

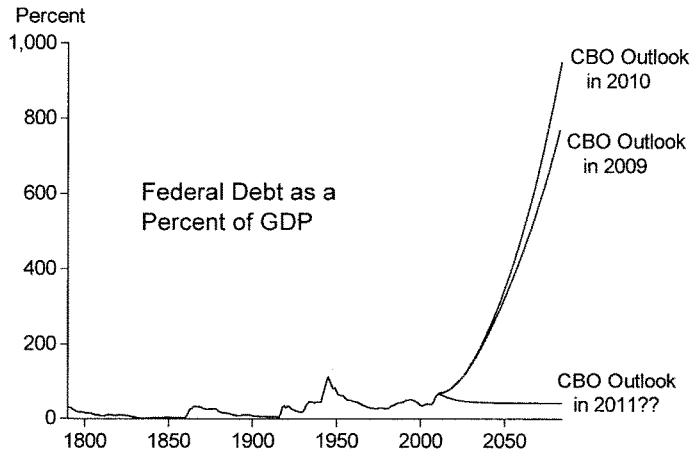
Indeed, there are welcome signs that the policy pendulum has begun to swing back to sound policies. Opinion polls reveal great concern about the higher debt, deficits, and government spending; the recent election brought the same message from the electorate. Three-fourths of business economists and one-half of academic economists in a recent poll now say that overly easy monetary policy exacerbated the housing boom and thus the bust which led to the financial crisis. Reactions to QE2 have been quite negative at home and abroad. The very word "stimulus" is now avoided by former proponents of the stimulus packages. The recent agreement to extend existing income tax rates across the board—and the expectations that the agreement will eventually extend beyond two years—provides additional evidence of an actual shift to more predictable and less uncertain policies. We can hope that the mantra "temporary, targeted, and timely" will be replaced with "permanent, pervasive, and predictable."

But it is essential for policymakers to grab the pendulum, pull it back toward sound policy, and tie it in place before it swings back again.

Toward a Sound Fiscal Policy

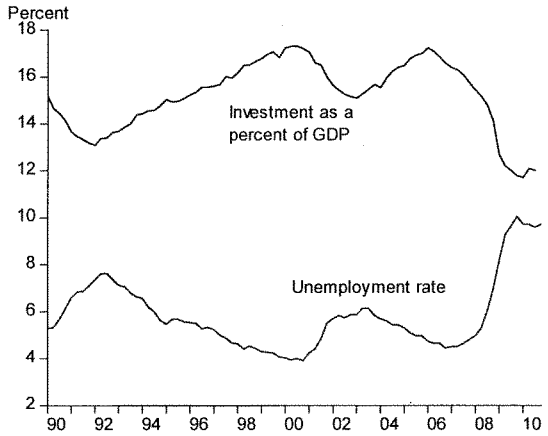
In the area of fiscal policy it is important to lay out a credible long term plan to reduce spending and stop the exploding debt. The plan should start immediately by bringing fiscal year 2011 levels of discretionary spending to 2008 levels; if spending can then be further brought toward 2000 levels as a share of GDP and held there with entitlement reforms, then the budget can be balanced without growth-retarding tax rate increases.

A concrete goal should be to lay out a credible budget reform plan which the Congressional Budget Office (CBO) can credibly score as reversing the debt explosion they projected last summer. Making the plan ready in time for the CBO's long term projections of next summer will give a good boost to economic growth and job creation as uncertainty about the future sustainability of the debt is reduced. An example of what next summer's CBO's projections might look like in comparison with the past two summers is shown in the following graph of the federal debt as a percentage of GDP.



Some say we need to wait to start reducing government purchases because of the high unemployment and the fragile recovery. Some even say we need to increase spending before we start reducing it. But there is no convincing evidence that a gradual and credible reduction in government purchases as a share of GDP will increase unemployment. Indeed, the history of the past two decades shows that lower levels of government purchases as a share of GDP are associated with lower unemployment rates. The same history suggests that the surest way to reduce unemployment is to increase private investment as a share of GDP: Over the past two decades, when investment increased as a share of GDP, unemployment fell. In other words,

unemployment is inversely correlated with private investment, as the chart below shows. So reducing the share of government spending and focusing on increasing the share of private spending—at least over the ranges shown in the chart—is a proven way to create jobs and reduce unemployment.



Toward a Sound Monetary Policy

Just as the Congress and the President should lay out a plan for reducing the debt, the Federal Reserve should lay out an exit strategy for reducing the size of the its unusually large balance sheet. The exit strategy would be put into action when the time comes to begin raising interest rates, but specifying it now would reduce uncertainty.[3]

The exit should be to a more rules-based monetary policy of the kind characteristic of the 1980s and 1990s. QE1 and QE2 are part of the trend toward more discretionary and less rules-based monetary policy, which started with decisions to hold interest rates very low in 2003-2005. While the Federal Reserve deserves credit for helping to stop the panic in the fall of 2008, on balance, the discretionary actions have been harmful. Moreover, QE1 and the bailout of the creditors of several financial firms immersed the Fed into fiscal policy, including credit allocation and risk-taking, which circumvent the normal appropriations process. The Fed should be independent to make monetary policy decisions, but many Americans rightly question this independence when the Fed engages in fiscal policy.

[3] An example of such an exit strategy was proposed in my testimony "An Exit Rule for Monetary Policy," before the Committee on Financial Services, U.S. House of Representatives, March 25, 2010

Clarify the Objectives

In order to achieve a more predictable rules-based policy and bolster the Fed's independence in the monetary policy area, Section 2 of the Federal Reserve Act, which lays out objectives and reporting requirements for the Fed, should be amended. Section 2A calls for the Fed to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." It would be better for economic growth and job creation, if the Fed focused on the goal of "long run price stability within a clear framework of economic stability." Such a reform would not prevent the Fed from providing liquidity, serving as lender of last resort, and cutting the interest rate in a financial crisis or a recession; through the language "within a framework of economic stability" the legislation would make this clear.

Such a clear price stability goal would provide a foundation for strong employment growth. Too many goals blur responsibility and accountability for any organization, and they allow for changing the emphasis on one goal versus others over time. Recently the multiple objectives in Section 2A have been cited as a rationale for unconventional interventionist policies, such as QE2, an approach which was avoided during the 1980s and 1990s. But such interventions often have the unintended consequence of leading to higher unemployment as illustrated by the decisions to hold interest rates very low in 2003-2005 which may be responsible for the high unemployment rates in the United States today.

Restore Reporting and Accountability Requirements

Section 2B of the Federal Reserve Act should also be changed. During the 1980s and 1990s, the Federal Reserve Act required that the Fed report its ranges for the growth rates of the "money and credit aggregates" in writing and in public hearings before Congress. If the Fed deviated from those ranges, the Fed was required to be accountable by explaining the reason for the deviations, again in writing and in public hearings before Congress. However, these specific reporting and accountability requirements were removed from the Federal Reserve Act in 2000. They should be restored, but with some changes that reflect recent practical experience.

Rather than focusing on the monetary aggregates, they should require the Fed to report on the strategy (or rule) that the Fed plans to use for setting interest rates in order to achieve the goal of price stability. The Fed should establish and report its own strategy and not have one dictated by Congress. The strategy should be as simple as possible without being too simple and it should include a description of the quantitative responses of the interest rate to developments in the economy.

In addition to choosing its own strategy, the Fed should have the discretion to deviate from its strategy in a crisis or other unanticipated change in circumstances. However, if it does deviate it must report in writing and in public hearings the reasons for such deviations. This requirement provides a degree of accountability needed for an independent agency of government.

This approach would provide a degree of control of monetary policy by the American people through their representatives without interfering in day-to-day operations of policy. It would help restore the independence of the Fed by taking political pressure out of the day-to-day decisions. Such a reform will reverse the short-term focus of policy and restore credibility in sound monetary principles and help achieve strong economic growth and job creation now and in the years ahead.

Conclusion

In this testimony I have argued that proven economic principles and practical policy experience show that the best road forward to strengthen economic growth and create jobs is through sound fiscal policy and sound monetary policy. I have also given some recommendations of how to restore sound fiscal policy and sound monetary policy. While there are signs that the pendulum is already beginning to swing back toward such policies, bold legislative actions will be required to achieve them.

I thank you for the opportunity to testify, and I would be happy to answer any questions you may have.

January 26, 2011

The Honorable Spencer Bachus
Chairman
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20510

The Honorable Barney Frank
Ranking Member
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20510

Dear Chairman Bachus and Ranking Member Frank:

On behalf of Associated Builders and Contractors (ABC), a national association with 75 chapters representing more than 23,000 merit shop construction and construction-related firms with nearly two million employees, I am writing in regard to the full-committee hearing titled, "Promoting Economic Recovery and Job Creation: The Road Forward."

ABC commends the committee for holding a hearing on job creation. The economic hardships facing our nation have acutely impacted ABC members and their employees. With the construction industry unemployment rate at 20.7 percent, and a loss of nearly 1.9 million construction jobs since December 2007, creating jobs and invigorating the economy is a priority for ABC members.

ABC urges Congress to immediately address the near freeze on lending for private sector construction projects. Many ABC members have viable, low risk projects and/or contracts that simply need funding in order for work to commence. Additionally, many ABC members rely on community banks for capital. However, community banks are facing the toughest regulatory environment in decades. Federal banking agencies are overregulating the community banking sector and thus, jeopardizing lending for qualified small businesses that have received loans in the past. During this time of economic recovery, it is critical that construction firms have access to much-needed funds.

Additionally, small business owners, those who create the vast majority of jobs in America, often face costly regulations that impede their business' ability to compete and expand. Research from a 2010 study by the U.S. Small Business Administration's Office of Advocacy found that, on average, small businesses annually pay $10,585 per employee to comply with federal regulations. Furthermore, the outcomes of numerous federal regulations proposed during the last two years are currently unclear. This has created an environment of uncertainty in our industry that makes it difficult for firms to adequately plan for the future. Reducing the regulatory burdens placed on small businesses will enable them to expand, hire new employees, and invest in equipment or facilities.

It is clear that Americans are facing unprecedented economic challenges and immediate action is needed in order to create jobs. ABC believes the following issues must be addressed:

- Under the nation's current tax system, rates are too high and laws are too complex, thus inhibiting the growth of small businesses. ABC supports minimizing the tax burden on American citizens – and the construction industry in particular – to help increase the rate of capital formation, economic growth and job creation.

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- A comprehensive energy plan will benefit all Americans through less expensive, more stable energy supplies. The potential dividend for the construction industry is considerable. The nation's energy infrastructure is insufficient and crumbling; new construction and upgrades to plants and transmission infrastructure are desperately needed. ABC is committed to ensuring these new projects are built with open competition and without government mandated project labor agreements (PLAs).

- Davis-Bacon Act requirements on stimulus funds must be lifted. Many small and minority owned businesses are not equipped to navigate the maze of paperwork required to work on Davis-Bacon projects which means they simply will not bid on these projects.

- Any effort to stimulate the construction industry must use taxpayer dollars efficiently, and must award projects based solely on merit. Long-term economic success includes the participation of the entire construction workforce, regardless of union affiliation, on federal and/or federally funded construction projects. Federal agencies should be prohibited from requiring PLAs on these projects.

ABC members large and small are eager to take the lead in stimulating growth and spurring job creation. We look forward to working with you as you develop initiatives to put Americans back to work.

Sincerely,

Geoffrey Burr
Vice President, Federal Affairs

Preserving the American Dream of Home Ownership Through Regulatory Reform
MHARR NEWS

FOR IMMEDIATE RELEASE

Contact: MHARR
(202) 783-4087

MHARR TESTIMONY URGES CONGRESSIONAL INTERVENTION TO REVIVE INDUSTRY

Washington, D.C., January 26, 2011 -- The Manufactured Housing Association for Regulatory Reform (MHARR) has submitted testimony to a key congressional committee detailing the drastic decline of the federally-regulated manufactured housing industry and urging Congress to intervene and conduct further oversight into the U.S. Department of Housing and Urban Development (HUD) programs responsible for regulating the industry and supporting manufactured home financing for millions of lower and moderate-income American consumers. (See, attached comprehensive package).

The January 26, 2011 House Financial Services Committee hearing, entitled "Promoting Economic Recovery and Job Creation: The Road Forward" is, according to the Committee, the first in a series of hearings to review the roadblocks that small businesses face, including "mixed messages" from federal regulators, "competitive disadvantages" created by government policies and a climate of "regulatory uncertainty." In announcing the hearing, Committee Chairman, Spencer Bachus (R-AL), noted, If we are to enjoy a full economic recovery, new job creation must come from the private sector...and this hearing is just the beginning of our work to ensure government is encouraging, not inhibiting, job creation and economic recovery."

As MHARR's testimony explains, however, it is government policies -- specifically HUD's failure to fully and properly implement the reforms of the Manufactured Housing Improvement Act of 2000 and other relevant consumer finance laws -- that lie at the root of a severe decade-plus decline that has cut manufactured home production by 87% and has led to the closure of nearly two-thirds of the industry's manufacturing plants, with huge job losses in the industry's production, retail and community development sectors, as well as related industries (e.g., component and product suppliers, installers, transporters and others).

This testimony is among the first steps by MHARR to implement a plan of action adopted by the Association in November 2010, based on the fundamental shift in the

political climate and priorities in Washington, D.C. growing out of the results of the November 2010 congressional elections. It documents and explains HUD's failure, since 2000, to fully and properly implement laws passed with overwhelming bi-partisan support by different Congresses, and the need to reverse these policies in order to revive the industry and ensure the availability of affordable non-subsidized home ownership for millions of lower and moderate-income families. As such, it is a key element of MHARR's broader program, which is designed to fully engage Congress on multiple fronts, including the deterioration of the federal program; continued discrimination against manufactured housing and particularly the industry's smaller businesses; investigation of the ways that regulators have undermined relevant laws; and an examination of the HUD program's runaway budget and appropriations, which have enabled a costly expansion of regulation by the Department and its contractors -- despite sharply reduced production -- at the expense of revenue-deprived state agencies that, by law, are the first line of protection for consumers.

In Washington, D.C., MHARR President, Danny D. Ghorbani, stated: "With major shifts in the Washington, D.C. political climate resulting from the November 2010 elections, including the Administration's sharp new focus on regulation and jobs, especially relating to small businesses, the manufactured housing industry has a golden opportunity to press for real reform of discrimination against the industry and consumers of affordable housing in the nation's capital, in ways that could lead to recovery from the alarming decline of the past twelve years." Ghorbani continued, "Real progress, though, is not going to come from the industry's boilerplate go-along-to-get-along approach in Washington, D.C., which has sacrificed the interests of the industry and American consumers for a feel-good atmosphere while the industry is at the brink and consumers cannot obtain the affordable home ownership that they need and want."

The Manufactured Housing Association for Regulatory Reform is a Washington, D.C.-based national trade association representing the views and interests of producers of federally-regulated manufactured housing.

Manufactured Housing Association for Regulatory Reform

1331 Pennsylvania Avenue, NW • Suite 508 • Washington, DC 20004 • 202-783-4087 • Fax 202-783-4075

January 26, 2011

VIA ELECTRONIC DELIVERY

Hon. Spencer Bachus
Chairman
House Financial Services Committee
Room 2246
Rayburn House Office Building
Independence Ave. & S. Capitol St., S.W.
Washington, D.C. 20515

Hon. Barney Frank
Ranking Member
House Financial Services Committee
Room 2252
Rayburn House Office Building
Independence Ave. & S. Capitol St., S.W.
Washington, D.C. 20515

Re: Financial Services Committee January 26, 2011 Hearing - "Promoting Economic Development and Economic Recovery -- The Road Forward"

Dear Chairman Bachus and Ranking Member Frank:

We ask that this letter and its attachments be included as part of the hearing record of the House Financial Services Committee's January 26, 2011 hearing, "Promoting Economic Development and Economic Recovery -- The Road Forward."

The Manufactured Housing Association for Regulatory Reform (MHARR) is a Washington, D.C.-based national trade organization representing the views and interests of producers of manufactured housing regulated by the Department of Housing and Urban Development (HUD) pursuant to the National Manufactured Housing Construction and Safety Standards Act of 1974, as amended by the Manufactured Housing Improvement Act of 2000 (2000 law). MHARR members are primarily small and medium-sized businesses, located throughout the United States.

Manufactured housing has historically been the nation's leading source of inherently affordable, non-subsidized home-ownership. It provides a quality home at a price that nearly every American can afford without government subsidies or risky financing schemes. Manufactured housing is also a uniquely American industry, that has historically provided hundreds of thousands of jobs in manufacturing plants, retail centers communities and related industries (e.g., suppliers, installers, insurers and others) throughout the nation's heartland.

But the manufactured housing industry -- a key part of the American housing market for over 70 years -- is today in danger of disappearing, with devastating

consequences for affordable housing, employment, and job creation, particularly in rural America. Over the past two years alone, industry production has declined by 40% -- to an estimated 49,199 homes in 2010 -- and is now 87% below peak production of nearly 400,000 homes in 1998. (See, Attachment 1, Sustained Decline of the Manufactured Housing Industry). During the same 12-year period, nearly two-thirds of the industry's production facilities have closed, from 430 active plants in 1998, down to fewer than 130 today. This translates into many thousands of jobs lost and even greater hardship for lower and moderate-income Americans who seek affordable home-ownership, but cannot obtain necessary financing for a new manufactured home. The industry's downturn, moreover, began long before the decline of the broader housing market over the last several years, and has been much more severe.

This dramatic deterioration, and its disconnect from the economy of the broader housing market, is a result of continuing -- and worsening -- regulatory and financing discrimination against manufactured housing and manufactured home-buyers. This discrimination flows directly from policy decisions by HUD, which not only comprehensively regulates the manufactured housing industry, but has also been charged by Congress with supporting manufactured home financing through the Federal Housing Administration's (FHA) Title I and II programs, which were updated and improved as part of the Housing and Economic Recovery Act of 2008 (HERA).

The policy decisions at issue relate to the implementation of the Manufactured Housing Improvement Act of 2000. That watershed law, enacted by Congress via unanimous consent and with full bi-partisan support, was designed to modernize and reform the HUD manufactured housing program, and to complete the transition of manufactured housing from the "trailers" of the post-war era to legitimate, full-fledged "housing," to be treated equally, for all purposes, with other types of housing. As is shown by the attached documents, however, HUD regulators, instead of implementing this legislation, fully and in accordance with its purposes, have either ignored or made a mockery of its most important reforms (see, Attachment 2, MHARR's December 3, 2010 letter to HUD manufactured housing program Administrator Teresa Payne), while at the same time directly contravening Administration regulatory policy as set forth in President's Executive Order of January 18, 2011 (see, Attachment 3, MHARR's January 19, 2011 letter to HUD Assistant Secretary David Stevens and Attachment 4, Executive Order of January 18, 2011).

By failing to fully and properly implement the 2000 law and by failing to achieve or even pursue its fundamental purpose of ensuring the status of manufactured homes as legitimate housing for all purposes, HUD has placed the manufactured housing industry and its consumers in a no-win position. Effectively, HUD, through FHA, is refusing to finance manufactured homes on an equal footing because it views them as "trailers," but, at the same time, it refuses to fully and properly implement the 2000 law, that was designed to change that. Thus, discrimination against affordable manufactured housing has grown and is still mounting, the affordability of manufactured housing is being undermined by unnecessary and unnecessarily costly expansions of regulation, and modern manufactured homes, despite of state-of-the-art construction and high quality are

treated and penalized, by FHA and the Government Sponsored Enterprises (based on HUD's policies), as "trailers" for purposes of both public and private financing. The same policies moreover, either knowingly or unknowingly, by disproportionately increasing regulatory burdens, compliance costs and financing difficulties for smaller businesses, are destroying competition and underwriting the domination of the manufactured housing market by one or two large conglomerates to the detriment of smaller businesses and consumers.

Therefore, we ask that both Houses of Congress intervene by initiating a complete investigation of the HUD program, which is responsible for a significant portion of the nation's supply of affordable housing, and hold oversight hearings focusing on the decline of the industry and its relationship to HUD's failure to comply with relevant law, including the 2000 law and the FHA-related provisions of HERA. By holding HUD accountable for the full and proper implementation of these laws, Congress could help change the course of the past 12 years and place the industry on a path toward economic recovery, while simultaneously benefiting consumers of affordable housing.

Thank you for the opportunity to apprise the Committee of this important matter and we look forward to working with you to halt and reverse the decline of the federal program and the nation's manufactured housing industry.

Sincerely,

Danny D. Ghorbani
President

cc: Hon. Judy Biggert, Chairwoman, Housing Subcommittee
Hon. Luis Gutierez, Ranking Member, Housing Subcommittee

ATTACHMENT 1

SUSTAINED DECLINE OF MANUFACTURED HOUSING INDUSTRY

YEAR	MANUFACTURED HOMES PRODUCED
1998	374,000 homes
1999	348,000 homes
2000	250,000 homes
2001	193,000 homes
2002	165,000 homes
2003	130,000 homes
2004	130,000 homes
2005	146,000 homes (includes emergency relief homes for Gulf Coast hurricane victims)
2006	117,000 homes
2007	95,000 homes (fewer than 100,000 homes for first time since 1961)
2008	81,000 homes
2009	49,683 homes
2010	49,000+ homes (projected)

ATTACHMENT 2

Manufactured Housing Association for Regulatory Reform

1331 Pennsylvania Avenue, NW • Suite 508 • Washington, DC 20004 • 202-783-4087 • Fax 202-783-4075

December 3, 2010

VIA FEDERAL EXPRESS

Ms. Teresa B. Payne
Administrator, Federal Manufactured Housing Program
U.S. Department of Housing and Urban Development
451 Seventh Street, S.W.
Washington, D.C. 20410

Re: HUD Manufactured Housing Program Issues -- Alarming State of the Industry

Dear Ms. Payne:

As MHARR officials promised you on November 23, 2010, we are writing to explain, in greater detail, the very serious concerns that members of the manufactured housing industry share regarding the direction of the federal Title VI manufactured housing program including, most particularly, HUD's ongoing failure to properly implement key reforms of the Manufactured Housing Improvement Act of 2000 (2000 law), and the harm this is causing to the manufactured housing industry and the millions of lower and moderate-income American families that rely on unsubsidized, affordable manufactured housing. This detail is unavoidably lengthy given the complexity of the issues involved and the need for full congressional engagement in these issues for the first time since the 2000 law was unanimously enacted by both houses of Congress.

The 2000 law was a major watershed for both the manufactured housing industry and consumers. It made significant changes to the original Manufactured Housing Construction and Safety Standards Act of 1974, based on decades of experience and the recommendations of a congressional commission (the National Commission on Manufactured Housing), which showed that the orientation and practices of the HUD regulatory program were impairing the growth, evolution and transition of manufactured housing as a crucial source of affordable housing -- in part through an anachronistic "trailer"-based view of manufactured homes, and in part through closed-door procedures that undermined the accountability, transparency and legitimacy of the program, while resulting in unnecessary and unnecessarily costly regulation.

Ten years later, the fundamental promise and purpose of the 2000 law -- to complete the transition of manufactured housing from the "trailers" of the post-war era to legitimate housing for all purposes -- remains unfulfilled, as the most important reforms enacted by Congress have either been ignored by the Department or circumvented through "interpretations" that have undermined their content, meaning and intended effect. The impact of HUD's failure to properly implement the reforms of the 2000 law and thereby establish the legitimate parity of manufactured homes with other types of residential housing is far-reaching and has been extremely damaging, as it affects the treatment of manufactured housing by government at all levels (as well as the private sector), in matters as diverse as zoning, placement and financing.

Indeed, financing discrimination against manufactured homes and manufactured home buyers has actually worsened over the past decade, as it has become apparent that the HUD program would continue to treat manufactured homes as "trailers" and HUD itself has acted to restrict the availability of manufactured home financing.

Accordingly, and based on our recent discussions, and as explained in greater detail below, the following are major issues that are harming the industry and consumers and need to be resolved before the industry looses critical mass and disappears as a significant source of affordable, non-subsidized housing.

EXPANDED IN-PLANT REGULATION

The ongoing effort to expand in-plant regulation and prescriptively control the production process, without any justification whatsoever based on consumer complaints or any evidence of systemic deficiencies in the current system -- outside of one California plant of a producer that subsequently went bankrupt and was acquired by another company -- is the premier illustration of the program's failure to implement the most important program reforms of the 2000 law.

Originally termed "voluntary" by HUD, this regulatory expansion has since been characterized as "not optional" and is now on the verge of mandatory enforcement through extremely costly multi-day in-plant "audits" by HUD's monitoring contractor, even though, again, statistics from HUD's own dispute resolution program show a minimal level of consumer complaints regarding manufactured homes. And although this program is based on "enhanced" inspection criteria and a "Standard Operating Procedure" that impose requirements not contained in the existing program regulations and materially change the entire focus of in-plant regulation, as HUD itself has acknowledged, none of these new de facto regulations have been brought to the Manufactured Housing Consensus Committee (MHCC) for consensus review and input to the Secretary, nor have they been published for public notice and comment, as required by the 2000 law.

While such a change in the entire focus of in-plant regulation falls squarely within the scope of section 604(b) of the 2000 law and, particularly, section 604(b)(6) -- a catchall provision which requires all changes to "policies, practices, or procedures relating to ... inspections, monitoring or other enforcement activities" to be presented to the MHCC and put through rulemaking or be deemed "void" -- the program circumvented this reform by unilaterally issuing an interpretive rule in February 2010 (without opportunity for public comment), that effectively reads this section out of the law by limiting its scope to actions that would be deemed "rules" under the Administrative Procedure Act (APA). But a "rule" for purposes of the APA would be subject to notice and comment procedures anyway, under that law, leaving section 604(b)(6) devoid of any content.

Thus, a key reform of the 2000 law, designed to prevent the development of new de facto regulations and standards behind closed doors -- as occurred regularly in the 1980's and 1990's -- has simply been disavowed by HUD. This has allowed HUD to expand in-plant regulation without showing any justification for those changes or determining and justifying their regulatory compliance cost-impact on consumers -- both of which are required by the 2000 law as part of the MHCC review procedure. This has paved the way for the development of this entire program of costly expanded in-plant regulation and enforcement behind closed doors, beginning with meetings in 2008 between HUD program personnel, selected third-party inspection agencies and manufacturers (details of which HUD continues to withhold notwithstanding an MHARR

Freedom of Information Act request filed in September 2009), and continuing, just two weeks ago, in a closed-door meeting of HUD, monitoring contractor and third-party personnel, where an elaborate and costly new scheme for the enforcement of these supposedly "voluntary" changes was unveiled and developed.

The 2000 law was designed by Congress to bring the development of new or changed standards, regulations and interpretations into the open, through a transparent consensus process that would assure reasonable, cost-effective regulation and broad-based acceptance of those actions by program stakeholders, thereby avoiding unnecessary disputes and litigation. HUD's expansion of in-plant regulation, however, entails an unacceptable regression of the program back to the types of abuses that led to the reforms of the 2000 law in the first place.

RESTORING THE ROLE AND AUTHORITY OF THE MHCC

The MHCC is the centerpiece reform of the 2000 law. For more than two years, however, the HUD program has done everything in its power to undermine the role, authority, independence and functionality of the MHCC.

HUD has sought to unilaterally strip the MHCC of half of its authority -- to review and provide recommendations to the Secretary on regulations and enforcement-related matters. First it issued its February 2010 "interpretive" rule, which is designed to eliminate MHCC review of virtually all matters relating to enforcement. Now, it is evident that HUD is also attempting to skirt the entirety of section 604(b) of the 2000 law as well, which requires HUD to comply with the MHCC consensus process for new or modified regulations of any type. For example, even though HUD and its contractors are engineering an unprecedented expansion of in-plant regulation, none of this expansion is being brought to the MHCC, even though new elements are still evolving, such as an undefined "continuous improvement process" for manufacturer quality control and related auditing, which was discussed at a September 2010 meeting between HUD and the State Administrative Agencies (SAAs), but has never been brought before the MHCC.

HUD has also maneuvered to take complete control of the MHCC through a new Charter and Bylaws, imposed without MHCC involvement or consent. HUD has claimed that changes in both documents are required by the Federal Advisory Committees Act (FACA), but changes designed to undermine the MHCC go far beyond anything required by either FACA or the 2000 law that created the MHCC. For example: (1) the new Charter attempts to give HUD complete control over the subjects the MHCC can consider by empowering the Designated Federal Officer (DFO) -- a HUD program official (career staff) -- to "prepare" all meeting agendas. The new Bylaws similarly abolish the former Planning and Prioritization Subcommittee. There is no such requirement or authority contained in FACA; (2) the new Charter gives the Secretary (or his "designee") "exclusive authority to create subcommittees." Nothing in FACA or the 2000 law gives HUD this power, "exclusively" or otherwise; (3) the new Charter and Bylaws say nothing about public participation in MHCC meetings and do not guarantee such participation, even though the 2000 law specifically requires "a fair opportunity for the expression and consideration of various positions and public participation;" (4) the new purported Bylaws require three of the seven members of the "general interest" group to be "public officials." Nothing in the 2000 law or FACA requires this or authorizes HUD to unilaterally change the law as enacted by Congress.

Moreover, even if FACA did contain such requirements, FACA itself states, as MHARR has previously pointed out, that it applies "except to the extent that" an "Act of Congress establishing any such advisory specifically provides otherwise," as is the case with the 2000 law,

which spells out, in detail, the role, authority and procedures of the MHCC. Accordingly, HUD is improperly attempting to use FACA to emasculate the MHCC.

Further, HUD has also sought to exclude from the MHCC the collective representation of the industry, thereby depriving the industry of the benefit of the many decades of collective knowledge, know-how, expertise and institutional memory that it has assembled in Washington, D.C. in order to make certain that the MHCC functions in full compliance with law. In doing so, the Department has improperly extended a ban on registered lobbyists to include non-lobbyist association staff members as well. And while the Department has appointed individual manufacturers to the MHCC, this role cannot be properly filled by representatives of individual companies subject to regulation (and potential reprisal) by HUD that have, instead, entrusted such functions to their collective industry representatives in Washington, D.C. for decades.

ENHANCED PREEMPTION

Federal preemption is key to maintaining the affordability of manufactured housing insofar as, properly applied, it ensures the uniformity of both the standards applied to manufactured housing and the enforcement of those standards. The 2000 law expanded the federal preemption of the original 1974 law in three ways: (1) it told HUD to apply preemption "broadly and liberally;" (2) it extended preemption to state "requirements" that are not necessarily standards; and (3) it expanded the basis for preemption to include interference with the comprehensive federal "superintendence" of the industry. As a result, preemption is no longer limited to the old, narrow, "same aspect of performance" test that HUD routinely cited as an excuse in the past not to enforce federal preemption.

Despite this major enhancement of federal preemption HUD, in the ten years since the enactment of the 2000 law, has not changed any of its previously-stated positions concerning preemption. HUD has not only failed to reevaluate and reassess all aspects of the program to determine where such enhanced preemption would be applicable (and beneficial to consumers), it has not even retracted outdated and highly restrictive internal guidance and policy statements regarding preemption that were issued before the 2000 reform law, leading to confusion that could result in erroneous decisions by courts as well as state and local governments.

Nowhere is this failure to implement the enhanced preemption of the 2000 law more evident than in the case of fire sprinklers. Despite the fact that HUD currently has "fire safety" standards designed to assure "reasonable fire safety" for manufactured home residents -- that have been proven both effective and cost-efficient -- HUD continues to maintain that state and local fire sprinkler requirements are not preempted. This despite the fact that HUD at one time, prior to the 2000 enhancement of preemption (i.e., under much weaker preemption language) concluded that such state and local standards were preempted. Congress, therefore, based largely on HUD complaints that the preemption of the original 1974 law was too narrow, went to the trouble of providing enhanced preemption in the 2000 law, but HUD still refuses to use that power for the benefit of manufactured housing consumers, even in a simple and straightforward case like fire sprinklers.

NEW MONITORING CONTRACTOR

The federal program has had the same monitoring contractor (notwithstanding changes in the name of that entity) since the inception of federal regulation in 1976. Although the

monitoring contract is subject, officially, to competitive bidding, the contract is a de facto sole source procurement because solicitations are consistently based on award factors that track the experience and performance of the existing contractor -- experience that cannot be duplicated by other bidders due to the unique character of the HUD program as the only federal building code and national enforcement program -- effectively preventing any other bidder from successfully competing for the contract. And, in the one rare case where the solicitation did result in a competing bidder, HUD requested a second round of proposals and ultimately awarded the contract to the entrenched incumbent, even though its initial proposal was priced higher than the competing bidder.

This practice has had a dire impact on the industry and on consumers of affordable manufactured housing by depriving the program of the new blood and fresh thinking that it needs to progress and grow. With the same contractor for 34 years, the program remains mired in the 1970's "trailer" era and has not evolved along with the industry. This is one of the primary reasons that the program, governments at all levels, and others, continue to view and treat manufactured homes as "trailers," causing untold problems for the industry and consumers, including financing, placement and other issues.

Moreover, the 2000 law was designed to assure a balance of reasonable consumer protection and affordability. But the HUD program and its contractor have a history of constantly ratcheting-up regulation, with more detailed, intricate and costly procedures, inspections, record-keeping, reports and red-tape -- demands that never end and cannot reasonable be met by anyone -- despite the fact that consumer complaints, as shown by HUD's own data are minimal. This cycle must be broken, and the program must be brought into compliance with the objectives and focus of the 2000 law. It is thus essential that the program ensure that there is full and open competition for the monitoring contract when the next solicitation occurs in 2012, and that a new contractor, with a new, more modern, more cost-effective and less damaging approach to the monitoring function is ultimately retained.

RE-CODIFICATION OF INSTALLATION

Congress, in the 2000 law, created two new programs -- installation and dispute resolution -- designed to close the loop on consumer protection and ensure that manufactured homes are not only safe and properly constructed, but are also installed properly and perform as intended once installed. In establishing the new installation program, in particular, Congress was following a recommendation of the National Commission on Manufactured Housing (National Commission) that the federal installation standards be adopted and included within the existing Part 3280 construction and safety standards, so that they would be preemptive of potentially discriminatory local standards and less stringent state installation standards. HUD, however, citing the "structure" of the 2000 law, has re-codified installation outside of the Part 3280 standards, leading to chaos, confusion and difficulties for the industry and consumers that Congress did not intend.

HUD maintains that because installation is addressed in section 605 of the 2000 law, separately from the development of Part 3280 construction and safety standards in section 604, that it is appropriate to codify the installation standards outside of the Part 3280 construction and safety standards. But this flies in the face of the specific recommendation of the National Commission and also ignores the simple reality that when Congress disbanded the National Manufactured Housing Advisory Council, section 605 was left without any content and, in order to avoid a renumbering of the law, Congress simply inserted the new installation mandate as the

new section 605, without intending that the resulting installation standards would be anything other than Part 3280 standards.

This re-codification of installation outside of the Part 3280 standards is causing significant problems that are only likely to get worse. First, the re-codification of these new programs mandated by the 2000 Act strips the MHCC of any statutory authority to review or propose changes. Second, and more importantly, the artificial distinction between construction and installation that re-codification is based upon, gives carte blanch to state and local officials to discriminate against manufactured housing with "installation" standards that are actually designed to restrict its placement or eliminate it altogether, and exposes manufactured homes to varying local installation standards (in states without compliant installation programs) that should be clearly preempted, but have been left in limbo because "installation" matters are not subject to federal preemption under re-codification.

This again, will bring about needless disputes and confusion that will negatively impact the affordability, availability and utilization of manufactured housing, particularly when the federal installation program is fully implemented.

APPOINTMENT OF A NON-CAREER PROGRAM ADMINISTRATOR

While MHARR will continue to work with you as the career Administrator of the federal program, this remains a key reform of the 2000 law that HUD has failed to implement. The appointment of a non-career Administrator for the federal manufactured housing program is essential, because the fundamental character and focus of the federal program will not change in the absence of an appointed policy-level official to act as a full-time liaison between the highest policy-making levels of HUD and the Administration, and the federal program and its stakeholders. Notwithstanding the positive change in tone that you have brought to the program, it has been -- and remains -- cut-off from mainstream policy-making within HUD. This isolates manufactured housing from initiatives that could benefit the industry and consumers, allows continuing discrimination against manufactured housing and its consumers and leaves manufactured housing in perpetual "second-class" status at HUD and elsewhere within the government.

Furthermore, an appointed non-career Administrator is essential to ensuring full and proper accountability for the actions of the program and specifically for compliance with the 2000 law. It is noteworthy that the rapid deterioration of the program began when the program Administrator position was converted from non-career to career status approximately five years ago and, as detailed above, has accelerated ever since.

While HUD has maintained that the 2000 reform law "contains no express or implied requirement for the Secretary to appoint a non-career Administrator," this represents a misreading of the 2000 law. Section 620(a), as amended by the 2000 reform law does, in fact, give the Secretary discretion in whether or not to establish a user fee to fund the program, but once that fee is established -- as it has been -- those funds are to be used "to offset the expenses incurred ... carrying out the <u>responsibilities</u> of the Secretary," including "funding for a non-career administrator within the Department to administer the manufactured housing program." Thus, while the establishment of the label fee is permissive, once that fee is established, it is to be used to offset the Secretary's non-discretionary "responsibilities" including the appointment of a non-career program Administrator.

CONSUMER FINANCING

While HUD has maintained, such as in a January 2010 letter to Congressman Travis Childers (D-MI), that the scarcity of manufactured home financing is attributable to the performance of manufactured homes (stating, e.g., that that improvements to producer "quality control" would "attract lenders back to manufactured housing"), the reality is that HUD itself, by failing to fully and properly implement the 2000 law and by failing to achieve or even pursue its fundamental purpose of completing the transition of manufactured homes from the "trailers" of yesteryear to legitimate housing and ensuring the status of manufactured homes as legitimate housing for all purposes, has placed the industry and its consumers in a no-win position where modern manufactured homes, despite of state-of-the-art construction and high quality are perceived, treated and penalized as -- "trailers" for purposes of financing and a host of other matters.

Thus, it is not surprising that the Government National Mortgage Association (GNMA) -- a wholly-owned government corporation established within HUD -- earlier this year, announced requirements for the securitization of Federal Housing Administration (FHA) Title I program manufactured housing loans that significantly exceed those for originators of all other types of FHA-insured housing loans and, because they require disproportionately large assets, effectively limit the Title I program to one large finance company affiliated with the industry's largest manufacturer -- at the expense of the industry's smaller businesses and consumers.

Nor is it surprising, given HUD's failure to fully and properly implement the 2000 law in accordance with its fundamental transformative purpose, that the Government Sponsored Enterprises -- Fannie Mae and Freddie Mac -- continue to discriminate against manufactured homes and manufactured home buyers, and that the Federal Housing Finance Agency (FHFA) is proposing to exclude nearly two-thirds of all manufactured home loans (financed as personal property -- the most affordable manufactured homes) from the "duty to serve" mandate of the Housing and Economic Recovery Act of 2008 (HERA).

Indeed, as the guardian of this unique federal-state program, HUD has an obligation -- beginning, but not ending with its statutory obligation under the 2000 law to "facilitate[e] the acceptance of ... manufactured housing within the Department" -- to ensure that the reforms of thee 2000 law and the vision of the federal program set forth in that law are fully and properly implemented, not only to ensure that the health and safety of consumers are protected, but to support, as well, their ability to purchase and finance affordable manufactured homes.

Accordingly, the scarcity of manufactured home financing is not a product of insufficient HUD regulation. It is a product of HUD regulation and a HUD regulatory program that continue to treat manufactured homes as "trailers" even though Congress has instructed the Department to treat manufactured homes as "housing."

Predictably, then, HUD's failure to implement the 2000 law, together with its outdated approach to manufactured housing, has had a devastating impact on both the industry and American consumers of affordable housing. In the ten years since the 2000 law was enacted, production and sales of HUD-regulated manufactured homes have declined by more than 90% -- from a high of nearly 400,000 homes in 1998 to just 49,683 homes in 2009 -- the lowest level in over four decades. Between 2008 and 2009 alone, production and sales fell by 40% and a further decline is currently projected for 2010, with expected production of just 49,199 homes. Moreover, this prolonged decline began long before the decline of the broader housing market

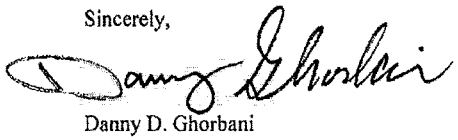
and is continuing even after the broader housing market has stabilized and begun a modest recovery. Yet, the program, instead of changing course, has actually accelerated its efforts to effectively neutralize the reforms of the 2000 law and Congress' objectives for the program, the industry and consumers.

All of these matters lie at the heart of the alarming decline of the manufactured housing industry.

While MHARR and its members understand that you personally did not initiate these policies and appreciate the positive change in tone that you have brought to the HUD program since your appointment as its career Administrator in April 2010, the substantive direction of the program remains seriously misguided -- as it has been for years -- and must be changed. Given the fact that HUD continues to downgrade the reforms of the 2000 law, the industry, in order to return the program to the course and purposes set out by Congress in the 2000 law, is left with no alternative but to seek congressional engagement, oversight and intervention for the purpose of reassessing and ultimately reversing the positions that HUD has taken regarding key reforms under the 2000 law, beginning with the urgent matters set forth above.

We thank you again for the time and counsel that you have afforded the industry under difficult circumstances. But given the fact that ten years after the 2000 law, the federal program continues to be diminished and degraded, we strongly believe that in order to slow and reverse the harm that has been done and put the program back on the correct track, it is time for Congress to become engaged in this matter and undertake appropriate oversight and intervention.

Sincerely,



Danny D. Ghorbani
President

cc: Hon. Tim Johnson, Senate Banking Committee
Hon. Richard Shelby, Senate Banking Committee
Hon. Robert Menendez, Senate Housing and Transportation Subcommittee
Hon. David Vitter, Senate Housing and Transportation Subcommittee
Hon. Barney Frank, House Financial Services Committee
Hon. Spencer Bachus, House Financial Services Committee
Hon. Maxine Waters, House Housing and Community Opportunity Subcommittee
Hon. Shelly Moore Capito, House Housing and Community Opportunity Subcommittee
Hon. Shawn Donovan, HUD Secretary
Hon. David Stevens, HUD Assistant Secretary

ATTACHMENT 3

Manufactured Housing Association for Regulatory Reform

1331 Pennsylvania Avenue, NW • Suite 508 • Washington, DC 20004 • 202-783-4087 • Fax 202-783-4075

January 19, 2011

VIA FEDERAL EXPRESS

Hon. David H. Stevens
Assistant Secretary for Housing -
Federal Housing Commissioner
U.S. Department of Housing and Urban Development
Room 9100
451 Seventh Street, S.W.
Washington, D.C. 20410

Re: HUD Opportunity to Fully Comply with President Obama's January 18, 2011 Regulatory Executive Order

Dear Secretary Stevens:

To begin, please accept our wishes for a Happy New Year and all the best in 2011.

As you know, since you and Secretary Donovan arrived at HUD, MHARR has been warning that the federal manufactured housing program is in dire need of a shake-up and change of direction to fully comply with the Manufactured Housing Improvement Act of 2000. The urgent need for change is proven by the fact that industry production has declined by 40% over the past two years alone, and is now 87% below peak production in 1998 -- a sharp downturn that began long before the decline of the broader housing market over the last few years, and has been much more severe. And now, President Obama has issued an Executive Order, "Improving Regulation and Regulatory Review" (January 18, 2011) that both validates and reinforces the points that MHARR has raised with you, the Secretary and program officials.

In particular, MHARR has maintained that a real change of direction can only be accomplished through the appointment of a non-career program Administrator, as provided by the 2000 reform law. However, for the reasons set out in your June 22, 2010 letter to Rep. Bennie Thompson, you decided to continue the administration of the program at the career level, and named Ms. Payne to that position. While MHARR continues to disagree with HUD regarding its interpretation of the 2000 law on this matter, we nevertheless have worked with Ms. Payne, and commend her for the change in tone that she has brought to the program and the break that she has brought from the chaos and confusion that prevailed prior to her arrival.

That said, however, the substantive direction of the program and particularly its continued defiance of basic transparency and due process reforms required by the 2000 law has not changed -- and has, indeed, gotten worse -- and continues to impact the industry and

consumers of affordable housing in an extremely negative way, as shown by the industry's continued decline. All of this is detailed in our December 3, 2010 letter to Ms. Payne, which was copied to you as well. And, while MHARR has begun to address these HUD policy matters on several fronts with the 112th Congress, in order to seek their reform, we also continue to look to you, as the highest-ranking HUD appointed official with direct responsibility for the manufactured housing program and public consumer financing, to ensure that the routine procedural aspects of these programs are, at the very least, fair and reasonable and maintain some semblance of consistency with applicable law and regulations, particularly with respect to the industry's smaller businesses.

Specifically, a major issue for the industry, and particularly its small businesses, is the ongoing effort by program regulators and contractors to significantly expand the scope of in-plant regulation. What began as an innocuous push for "voluntary cooperation" to update manufacturer quality control systems, has now evolved, bit-by-bit, into a full-blown, unnecessary and unnecessarily costly, de facto regulation -- all without review and comment by the Manufactured Housing Consensus Committee (MHCC), or notice and comment rulemaking procedures.

The most recent step in this progression was a November 2010 meeting convened by HUD, which was open only to monitoring contractor personnel and other third-party contractors. Upon learning of this planned meeting, MHARR's Senior Vice President, Mark Weiss, specifically requested, in both verbal and written communications with assistant program Administrator Ms. Liz Cocke, that the meeting be open to individual and collective representatives of HUD Code manufacturers. This request, however, was denied.

Now, though, information regarding this meeting is emerging piecemeal, through word-of-mouth and otherwise, creating uncertainty and confusion among small businesses that are using all their resources just to keep their plants open, avoid layoffs, and continue supplying affordable homes for American consumers. For example, a "Pilot Audit Process Structure" apparently presented at the November meeting includes extremely costly requirements, as follow, that either exceed current regulations or lack any objective standard for determining compliance:

- Reviewing training records to verify that an employee's "training *is appropriate* for the task assigned;"
- Reviewing material inspection records and information to verify that "inspections of materials *are appropriate*;"
- Determining if employees are "*technically knowledgeable* to fulfill their responsibilities;"
- Auditors must evaluate Quality System Issues as described in "Guidelines for the Investigation and Reporting of Quality System Issues (QSI)," developed by the monitoring contractor. This document is neither a regulation or standard;
- Auditors must conduct inspection for "compliance with CCI items." CCI, or Computer Coded Items, were developed by the monitoring contractor and are neither a standard or regulation.
- Auditors must "inspect a recently labeled home for failures to conform" at a retailer lot within 50 miles of the plant. (This item would specifically target retailers for costly and unnecessary regulation).

Other elements of expanded regulation addressed at the November meeting will require IPIAs to conduct retailer lot inspections if a non-compliance is found in a production facility, as well as other activities that will significantly expand their Subpart I involvement and manufacturers' Subpart I compliance costs, again without consensus review and required

rulemaking. Thus, a document entitled "IPR Functional Category Checklist Level I, II & III Evaluation Criteria" requires that IPIAs be evaluated by the "monitoring" contractor based, in part on whether:

- The IPIA Inspector has identified and inspected homes released by the plant, but not yet sold, which either the IPIA's records or records of the manufacturer indicate may not conform to the design or the standards;
- The IPIA Inspector has made inspections of manufactured homes at locations other than the factory.

These are just some examples of multiple new unnecessary and unnecessarily costly requirements that, under the 2000 law, should have -- but have not -- been reviewed and addressed by the MHCC and followed by notice and comment rulemaking, and HUD's failure to do so, based on its selective avoidance of section 604(b) of that law and its February 5, 2010 "Interpretive Rule," effectively reading section 604(b)(6) out of the law, as noted above, is simply unacceptable to small industry businesses struggling to survive. But with the publication of the President's January 18, 2011 Executive Order, these actions now specifically contravene Administration policy regarding both new and existing agency action, in that they have not been shown to be necessary or cost effective (Section 1(b)), would undermine competitiveness and job creation (Section 1(a)) and have not been enacted through a process "that involves public participation" (Section 2(a)), among other provisions.

To continue with the closed-door process that has been used to date would not only violate this Executive Order, but would discriminate against the HUD Code industry and its consumers, by singling them out for disparate regulatory treatment. This would compound existing HUD discrimination against the industry, and particularly its small businesses, as reflected by its refusal, for a year-and-a-half to respond to a routine MHARR Freedom of Information Act (FOIA) request concerning this regulatory expansion, contrary to the FOIA law itself, HUD's own regulations, and the Attorney General's March 19, 2009 Memorandum to agency heads establishing a "presumption of openness" in addressing FOIA requests.

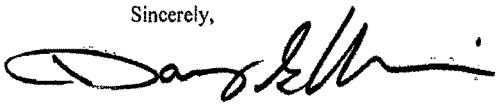
To be fair, the perception of many in the industry is that this and other recent HUD actions may be a byproduct of misunderstanding and miscalculation by program regulators, due to their cozy relationship with the industry establishment. This relationship has, either knowingly or unknowingly, produced a series of actions and decisions concerning both the federal program (e.g., the current expansion of in-plant regulation, MHCC-related matters, not triggering enhanced preemption, etc.) and consumer financing ((e.g., FHA Title I program restrictions contained in the June 1, 2010 and November 1, 2010 Ginnie Mae Mortgagee Letters) that have benefited a few industry conglomerates at the expense of the industry's smaller businesses and consumers of affordable housing. (See, MHARR's letter of December 3, 2010 for further detail).

A particularly glaring example of the impact of this relationship concerns fire sprinklers. On this issue, HUD regulators have aligned with the industry establishment in advancing a conditional "as needed/required" federal sprinkler standard that would benefit a few large manufacturers, despite knowing full well that a conditional standard is not authorized by relevant law and that the Secretary would ultimately be obliged to enforce such a standard against the entire industry (upon petition by an interested party or any member of the public), thereby saddling the industry and consumers with an extremely costly yet unnecessary new standard, given the proven effectiveness of the existing HUD standards and the widespread rejection of sprinkler mandates by state and local authorities. Program regulators, in conjunction with the industry establishment, are continuing to press this matter before the MHCC, after conveniently

shifting the balance of the Committee membership against the industry's smaller businesses.

Based on all of this, MHARR requests that you take action to halt all activity on expanded in-plant regulation, as this entire matter should be reviewed in light of the President's January 18, 2011 Executive Order. Afterward, if HUD still believes that this expansion is consistent with Administration policy, it should bring this matter to the MHCC and proceed via rulemaking thereafter, in full compliance with the 2000 law.

Sincerely,



Danny D. Ghorbani
President

cc: Hon. Shaun Donovan
Hon. Peter Kovar
Ms. Teresa Payne
HUD Code Manufacturers and Retailers

ATTACHMENT 4

The White House

Office of the Press Secretary
For Immediate Release
January 18, 2011
Improving Regulation and Regulatory Review - Executive Order

By the authority vested in me as President by the Constitution and the laws of the United States of America, and in order to improve regulation and regulatory review, it is hereby ordered as follows:

Section 1. General Principles of Regulation. (a) Our regulatory system must protect public health, welfare, safety, and our environment while promoting economic growth, innovation, competitiveness, and job creation. It must be based on the best available science. It must allow for public participation and an open exchange of ideas. It must promote predictability and reduce uncertainty. It must identify and use the best, most innovative, and least burdensome tools for achieving regulatory ends. It must take into account benefits and costs, both quantitative and qualitative. It must ensure that regulations are accessible, consistent, written in plain language, and easy to understand. It must measure, and seek to improve, the actual results of regulatory requirements.

(b) This order is supplemental to and reaffirms the principles, structures, and definitions governing contemporary regulatory review that were established in Executive Order 12866 of September 30, 1993. As stated in that Executive Order and to the extent permitted by law, each agency must, among other things: (1) propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs (recognizing that some benefits and costs are difficult to quantify); (2) tailor its regulations to impose the least burden on society, consistent with obtaining regulatory objectives, taking into account, among other things, and to the extent practicable, the costs of cumulative regulations; (3) select, in choosing among alternative regulatory approaches, those approaches that maximize net benefits (including potential economic, environmental, public health and safety, and other advantages; distributive impacts; and equity); (4) to the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated entities must adopt; and (5) identify and assess available alternatives to direct regulation, including providing economic incentives to encourage the desired behavior, such as user fees or marketable permits, or providing information upon which choices can be made by the public.

(c) In applying these principles, each agency is directed to use the best available techniques to quantify anticipated present and future benefits and costs as accurately as possible. Where appropriate and permitted by law, each agency may consider (and discuss qualitatively) values that are difficult or impossible to quantify, including equity, human dignity, fairness, and distributive impacts.

Sec. 2. Public Participation. (a) Regulations shall be adopted through a process that involves public participation. To that end, regulations shall be based, to the extent

feasible and consistent with law, on the open exchange of information and perspectives among State, local, and tribal officials, experts in relevant disciplines, affected stakeholders in the private sector, and the public as a whole.

(b) To promote that open exchange, each agency, consistent with Executive Order 12866 and other applicable legal requirements, shall endeavor to provide the public with an opportunity to participate in the regulatory process. To the extent feasible and permitted by law, each agency shall afford the public a meaningful opportunity to comment through the Internet on any proposed regulation, with a comment period that should generally be at least 60 days. To the extent feasible and permitted by law, each agency shall also provide, for both proposed and final rules, timely online access to the rulemaking docket on regulations.gov, including relevant scientific and technical findings, in an open format that can be easily searched and downloaded. For proposed rules, such access shall include, to the extent feasible and permitted by law, an opportunity for public comment on all pertinent parts of the rulemaking docket, including relevant scientific and technical findings.

(c) Before issuing a notice of proposed rulemaking, each agency, where feasible and appropriate, shall seek the views of those who are likely to be affected, including those who are likely to benefit from and those who are potentially subject to such rulemaking.

Sec. 3. Integration and Innovation. Some sectors and industries face a significant number of regulatory requirements, some of which may be redundant, inconsistent, or overlapping. Greater coordination across agencies could reduce these requirements, thus reducing costs and simplifying and harmonizing rules. In developing regulatory actions and identifying appropriate approaches, each agency shall attempt to promote such coordination, simplification, and harmonization. Each agency shall also seek to identify, as appropriate, means to achieve regulatory goals that are designed to promote innovation.

Sec. 4. Flexible Approaches. Where relevant, feasible, and consistent with regulatory objectives, and to the extent permitted by law, each agency shall identify and consider regulatory approaches that reduce burdens and maintain flexibility and freedom of choice for the public. These approaches include warnings, appropriate default rules, and disclosure requirements as well as provision of information to the public in a form that is clear and intelligible.

Sec. 5. Science. Consistent with the President's Memorandum for the Heads of Executive Departments and Agencies, "Scientific Integrity" (March 9, 2009), and its implementing guidance, each agency shall ensure the objectivity of any scientific and technological information and processes used to support the agency's regulatory actions.

Sec. 6. Retrospective Analyses of Existing Rules. (a) To facilitate the periodic review of existing significant regulations, agencies shall consider how best to promote retrospective analysis of rules that may be outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them in accordance

with what has been learned. Such retrospective analyses, including supporting data, should be released online whenever possible.

(b) Within 120 days of the date of this order, each agency shall develop and submit to the Office of Information and Regulatory Affairs a preliminary plan, consistent with law and its resources and regulatory priorities, under which the agency will periodically review its existing significant regulations to determine whether any such regulations should be modified, streamlined, expanded, or repealed so as to make the agency's regulatory program more effective or less burdensome in achieving the regulatory objectives.

Sec. 7. General Provisions. (a) For purposes of this order, "agency" shall have the meaning set forth in section 3(b) of Executive Order 12866.

(b) Nothing in this order shall be construed to impair or otherwise affect:

(i) authority granted by law to a department or agency, or the head thereof; or

(ii) functions of the Director of the Office of Management and Budget relating to budgetary, administrative, or legislative proposals.

(c) This order shall be implemented consistent with applicable law and subject to the availability of appropriations.

(d) This order is not intended to, and does not, create any right or benefit, substantive or procedural, enforceable at law or in equity by any party against the United States, its departments, agencies, or entities, its officers, employees, or agents, or any other person.

BARACK OBAMA

THE WHITE HOUSE,
January 18, 2011.

National Association of Federal Credit Unions
3138 10th Street North • Arlington, Virginia • 22201-2149
703-522-4770 • 800-336-4644 • 703-522-0594

B. Dan Berger
Executive Vice President
Government Affairs

January 25, 2011

The Honorable Spencer Bachus
Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Barney Frank
Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Re: Raise the Arbitrary Credit Union Member Business Lending Cap

Dear Chairman Bachus and Ranking Member Frank:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the interests of our nation's federal credit unions, I am writing to you regarding tomorrow's hearing "Economic Recovery and Job Creation Strategies." One strategy that NAFCU believes will help to create jobs would be the lifting of the outdated and arbitrary member business lending cap of 12.25% of assets that credit unions currently face. This is one of the most crucial ways that Congress can enable credit unions to continue to assist in the creation of jobs and flow of credit.

By artificially restricting the ability of credit unions to lend, the strength of the overall economy and health and well being of small businesses suffer. While there are a number of credit unions at or approaching the cap, many more have capital to lend but have not fully developed their business lending models because the very existence of this arbitrary ceiling. It is important to note that the National Credit Union Administration (NCUA), credit unions prudential regulator, has endorsed lifting the member business lending cap stating that NCUA would "take every appropriate step to enhance regulatory safeguards and assure that member business lending is done in a prudent and safe manner." In addition, the Treasury Department has also signed off on an approach to lifting the cap that they can support.

In short, credit unions stand ready and willing to do their part in assisting the 92 million credit union members across the country during the fragile economic recovery ahead. NAFCU strongly urges the committee to consider additional discussion of the credit union member business lending cap at tomorrow's hearing and beyond.

If my staff or I can be of assistance to you, or if you have any questions regarding this issue, please feel free to contact myself, or NAFCU's Director of Legislative Affairs, Brad Thaler, at (703) 842-2204.

Sincerely,

B. Dan Berger
Executive Vice President, Government Affairs

cc: Members of the House Financial Services Committee

E-mail: dberger@nafcu.org • **Web site:** www.nafcu.org

CUNA
Credit Union National Association
cuna.org

BILL CHENEY
President & CEO

601 Pennsylvania Ave., NW | South Building, Suite 600 | Washington, DC 20004-2601 | PHONE: 202-508-6745 | FAX: 202-638-3389

January 26, 2011

The Honorable Spencer Bachus
Chairman
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable Barney Frank
Ranking Member
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Dear Chairman Bachus and Ranking Member Frank:

On behalf of the Credit Union National Association (CUNA), I am writing regarding today's hearing entitled, "Promoting Economic Recovery and Job Creation: The Road Forward." CUNA is the largest credit union advocacy organization in the United States, representing nearly 90% of America's 7,700 state and federally chartered credit unions and their 93 million members.

Since their founding in the United States over 100 years ago, credit unions have been serving the credit needs of their small business-owning members. While small business lending does not make up the largest portion of credit union lending, it is the fastest growing segment by a significant margin. In fact, as banks have reduced credit availability to small businesses over the last several years, credit union business lending has expanded. And, credit unions have proven the ability to do small business lending safely and soundly, demonstrating remarkably lower charge-off and delinquency rates than banks making business loans.

Unfortunately, since 1998, credit unions have been subject to a statutory cap on business lending of 12.25% of a credit union's total assets; as a result, today, many credit unions are rapidly approaching the cap while others choose not to engage in business lending because of the cap. In an effort to promote economic recovery and job creation, we strongly urge Congress to increase the credit union member business lending cap.

Last year, the administration gave its strong support to legislation to increase the credit union business lending cap to 27.5% of total assets, and worked with the National Credit Union Administration to shape this legislation. We estimate that if this bill became law, credit unions could lend an additional $10 billion to small businesses in the first year after implementation, helping them to create over 100,000 new jobs. Unlike the recently enacted Small Business Lending Fund Act, which gave community banks $30 billion of taxpayer money as an incentive to lend to small businesses, increasing the credit union business lending cap could be done without spending a dime of taxpayer money and without increasing the size of government. Credit unions do not need taxpayer money to lend to small businesses: they need the authority from Congress to do so.

America's credit unions and their 93 million members stand ready to be part of the solution to the economic problems our nation faces. To that end, we encourage you to make increasing the credit union member business lending cap a key part of the Committee's plan to promote economic recovery and job creation.

Best Regards,

Bill Cheney
President & CEO

AMERICA'S CREDIT UNIONS

PO Box 431 | Madison, WI 53701-0431 | 5710 Mineral Point Road | Madison, WI 53705-4454 | PHONE: 608-231-4000

Testimony of the
National Low Income Housing Coalition
Submitted to
Committee on Financial Services
U.S. House of Representatives
January 26, 2011

The National Low Income Housing Coalition (NLIHC) is pleased to offer this testimony to the Committee on Financial Services in connection with the January 26, 2011 hearing titled "Promoting Economic Recovery and Job Creation: The Road Forward."

NLIHC is a membership organization dedicated solely to achieving socially just public policy that assures people with the lowest incomes in the United States have affordable and decent homes. Our members include residents of public and assisted housing and their organizations, state and local housing coalitions, nonprofit housing providers, homeless service providers, fair housing organizations, housing researchers, public housing agencies, private developers and property owners, local and state government agencies, faith-based organizations, and concerned citizens. While our members include the wide spectrum of housing interests, we do not represent any segment of the housing industry. Rather, we focus exclusively on what is in the best interests of people who receive and those who are in need of federal housing assistance.

With unemployment at about 9.4%, job creation must be a major focus of policymakers in Congress. Getting people back to work will strengthen our economy, help lower the deficit, and help promote the recovery of the housing market.

One proven way to create jobs is to invest in housing production, preservation, and rehabilitation. Today, there are over 1.7 million unemployed workers whose last job was in construction. With a 20% unemployment rate, the construction industry has the highest rate of people looking for work of any industry.

Construction is probably the sector most affected by the recession. Employment in the sector has shrunk by 38% since its peak in the spring of 2006 and 25% since the recession formally began in 2007. The loss of employment in the non-farm economy generally during the recession is in the range of 6%.

The decline of this sector has a direct impact on the economy. For much of the last four decades housing construction (residential fixed investment) has contributed over 5% to the nation's GDP. While housing construction grew to over 6% of GDP during the housing bubble, by 2009 it had fallen to 2.7%. It fell further still to 2.4% in the third quarter of 2010. The industry clearly has room to grow.

While there may be an oversupply of luxury housing built during the bubble, the housing boom actually exacerbated the deficit of modest housing affordable to the lowest income households in

this country. With falling incomes and high unemployment the need for this affordable housing has only grown. Any comprehensive recovery plan must address the housing construction sector and the long standing deficit of affordable housing. We have an unprecedented opportunity to build and repurpose existing vacant and underutilized units of affordable housing with a hungry labor force and primed industry.

Congress could immediately create much needed construction jobs by funding the National Housing Trust Fund (NHTF), which was established in the Housing and Economic Recovery Act of 2008 (HERA). The NHTF is administered by HUD, which is now finalizing the regulations that will govern the operation of the program. The purpose of the NHTF is to produce and preserve rental homes that are affordable to extremely low income (ELI) households, those with incomes at or below 30% of the area median or the federal poverty level, whichever is higher. This is the *only income group* for whom there is a nationwide shortage of affordable homes.

The National Low Income Housing Coalition's most recent analysis of data from the American Housing Survey (AHS) shows that the shortage of rental homes that ELI families can afford grew substantially between 2007 and 2009. The absolute shortage increased from 2.1 million units to 3.4 million units. The number of rental units affordable to ELI families decreased by 600,000, while the population needing these homes increased by 700,000. Because many rental homes that ELI households can afford are rented by higher income people, the shortage for ELI households is actually much worse. The shortage of rental homes both *affordable and available* for ELI households grew from 5.2 to 6 million in those two years.

Our analysis of the AHS further shows that over half (51%) of the ELI households that will benefit from the NHTF are the elderly or disabled. Nationwide, there are 1.6 million ELI households composed of people who are elderly or disabled who receive no housing assistance, who pay more than half of their income for housing, or who live in severely substandard housing. These very vulnerable people will be the primary beneficiaries of the NHTF.

Funding the NHTF will not only address this critical housing shortage, it will also produce much needed jobs in several ways. First, because NHTF funds will be used to build or rehabilitate affordable housing, it will create jobs in the construction field in the same way building other housing creates jobs. The National Association of Homebuilders (NAHB) latest estimate is that for every 100 units built using the Low Income Housing Tax Credit, 122 jobs are created during that construction. In addition, the NAHB estimates that new residents of these units will continue to support about 30 jobs in other areas such as education and retail. Using the NAHB methodology and assumptions, NLIHC estimates that for every $1 billion allocated to the NHTF, 12,200 jobs are created during construction and 3,000 ongoing jobs will be created.

Funding the NHTF will also help support state and local governments because NHTF-funded housing will generate funds through additional fees for permitting, zoning and utilities and increased revenue from sales and property taxes.

Creating more affordable housing, such as that funded through the NHTF, also gives the families who live there more money to spend on other necessities. The Center for Housing Policy recently reported that access to affordable homes increases the amount of disposable family income by

$500 (or more in some cases), and that lower income families are more likely than others to spend these additional funds on food, clothing, health care, and transportation. These additional expenditures support the economy and multiply the job creating effects of NHTF dollars.

HERA provided that the NHTF be capitalized in part with contributions from Fannie Mae and Freddie Mac. Unfortunately, soon after HERA was enacted Fannie and Freddie's financial problems were identified and they were placed in conservatorship by their regulator, the Federal Housing Finance Agency (FHFA). FHFA suspended the contributions to the NHTF and that status continues today.

In a recent letter to the White House, 33 national organizations urged that funding for the NHTF be included in the Administration's proposal to reform Freddie and Fannie (a copy of this letter is attached). Funding the NHTF, whether through the next iteration of the secondary mortgage market or other mechanisms, will create jobs and address critical housing shortages.

The National Low Income Housing Coalition urges the Committee to consider the job creation promise of the NHTF as you develop policies to put Americans back to work.

Thank you for the opportunity to provide this testimony.

O