U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

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TESTIMONY BY SECRETARY HENRY M. PAULSON, JR. BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES HEARING ON TURMOIL IN U.S. CREDIT MARKETS: RECENT ACTIONS REGARDING GOVERNMENT SPONSORED ENTITIES, INVESTMENT BANKS AND OTHER FINANCIAL INSTITUTIONS

Washington, DC— Chairman Frank, Congressman Bachus, members of the committee, thank you for the opportunity to appear before you today. I appreciate that we are here to discuss an unprecedented program, but these are unprecedented times for the American people and our economy. I also appreciate that Congress and the Administration are working closely together so that we can help the American people by quickly enacting a program to stabilize our financial system.

We must do so in order to avoid a continuing series of financial institution failures and frozen credit markets that threaten American families' financial well-being, the viability of businesses both small and large, and the very health of our economy.

The events leading us here began many years ago, starting with bad lending practices by banks and financial institutions, and by borrowers taking out mortgages they couldn't afford. We've seen the results on homeowners – higher foreclosure rates affecting individuals and neighborhoods. And now we are seeing the impact on financial institutions.

These bad loans have created a chain reaction and last week our credit markets froze up – even some Main Street non-financial companies had trouble financing their normal business operations. If that situation were to persist, it would threaten all parts of our economy.

Every business in America relies on money flowing through the financial system smoothly every day – not only to borrow, expand and create jobs, but to finance their normal business operations and preserve existing jobs.

Since the housing correction began last summer, Treasury has examined many proposals as potential remedies for the turmoil that the correction has caused in our banking system. With the Federal Reserve, we have sought to address financial market stresses with as minimal exposure for the US taxpayer as possible. The Federal Reserve took bold steps to increase liquidity in the markets. And we worked together on a case-by-case basis – addressing problems at Fannie Mae and Freddie Mac, working with market participants to prepare for the failure of Lehman Brothers, and lending to AIG so it can sell some of its assets in an orderly manner.

We have also taken a number of powerful tactical steps to increase confidence in the system, including a temporary guaranty program for the U.S. money market mutual fund industry. These steps have been necessary but not sufficient. More is needed. We saw financial market turmoil reach a new level last week, and spill over into the rest of the economy. We must now take further, decisive action to fundamentally and comprehensively address the root cause of this turmoil.

And that root cause is the housing correction which has resulted in illiquid mortgage-related assets that are choking off the flow of credit which is so vitally important to our economy.
We must address this underlying problem, and restore confidence in our financial markets and financial institutions so they can perform their mission of supporting future prosperity and growth.

We have proposed a program to remove troubled assets from the system – a program we analyzed internally for months, and had hoped would never be necessary. Under our proposal, we would use market mechanisms available to small banks, credit unions, and thrifts, across the country – not just big banks. These mechanisms will help set values of complex, illiquid mortgage and mortgage-related securities to unclog our credit and capital markets, and make it easier for private investors to purchase these securities and for financial institutions to raise more capital.

This troubled asset purchase program has to be properly designed for immediate implementation and be sufficiently large to have maximum impact and restore market confidence. It must also protect the taxpayer to the maximum extent possible, and include provisions that ensure transparency and oversight while ensuring the program can be implemented quickly and run effectively, as it needs to get the job done.

I understand the view that I have heard from many of you on both sides of the aisle, urging that the taxpayer should share in the benefits of this plan to our financial system. Let me make clear – this entire proposal is about benefiting the American people, because today's fragile financial system puts their economic well-being at risk. When local banks and thrifts aren't able to function as they should, Americans' personal savings, and the ability of consumers and businesses to finance spending, investment and job creation are threatened.

The ultimate taxpayer protection will be stabilizing our system, so that all Americans can turn to financial institutions to meet their needs – financing a home improvement or a car or a college education, building retirement savings or starting a new business. The $700 billion program we have proposed is not a spending program. It is an asset purchase program, and the assets which are bought and held will ultimately be resold with the proceeds coming back to the government. Depending on the rate at which our housing market and economy recover, the loss to the taxpayers should be much less than the purchase price of the assets. And those purchases will be spread out over time, occurring as warranted by market conditions.

I am convinced that this bold approach will cost American families far less than the alternative – a continuing series of financial institution failures and frozen credit markets unable to fund everyday needs and economic expansion.

I understand that this is an extraordinary ask, but these are extraordinary times. I'm encouraged by the bipartisan consensus for an urgent legislative solution. We need to enact this bill quickly and cleanly, and avoid slowing it down with unrelated provisions or provisions that don't have broad support. This troubled asset purchase program on its own is the single most effective thing we can do to help homeowners, the American people and stimulate our economy.

Earlier this year, Congress and the Administration came together quickly and effectively to enact a stimulus package that has helped hard-working Americans and boosted our economy. We acted cooperatively and faster than anyone thought possible. Today we face a much more challenging situation that requires bipartisan discipline and urgency.

When we get through this difficult period, which we will, our next task must be to address the problems in our financial system through a reform program that fixes our outdated financial regulatory structure, and provides strong measures to address other flaws and excesses. I have already put forward my recommendations on this subject. Many of you also have strong views, and we must have that critical debate, but we must get through this period first.

Right now, all of us are focused on the immediate need to stabilize our financial system, and I believe we share the conviction that this is in the best interest of all Americans.

Now let's work together to get it done. Thank you.

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Statement of

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

September 24, 2008

Chairman Frank, Ranking Member Bachus, and members of the Committee, I appreciate this opportunity to discuss recent developments in financial markets and the economy. As you know, the U.S. economy continues to confront substantial challenges, including a weakening labor market and elevated inflation. Notably, stresses in financial markets have been high and have recently intensified significantly. If financial conditions fail to improve for a protracted period, the implications for the broader economy could be quite adverse.

The downturn in the housing market has been a key factor underlying both the strained condition of financial markets and the slowdown of the broader economy. In the financial sphere, falling home prices and rising mortgage delinquencies have led to major losses at many financial institutions, losses only partially replaced by the raising of new capital. Investor concerns about financial institutions increased over the summer, as mortgage-related assets deteriorated further and economic activity weakened. Among the firms under the greatest pressure were Fannie Mae and Freddie Mac, Lehman Brothers, and, more recently, American International Group (AIG). As investors lost confidence in them, these companies saw their access to liquidity and capital markets increasingly impaired and their stock prices drop sharply.

The Federal Reserve believes that, whenever possible, such difficulties should be addressed through private-sector arrangements--for example, by raising new equity capital, by negotiations leading to a merger or acquisition, or by an orderly wind-down. Government assistance should be given with the greatest of reluctance and only when the stability of the financial system, and, consequently, the health of the broader economy, is at risk. In the cases of Fannie Mae and Freddie Mac, however, capital raises of sufficient size appeared infeasible and the size and government-sponsored status of the two companies precluded a merger with or acquisition by another company. To avoid unacceptably large dislocations in the financial sector, the housing market, and the economy as a whole, the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac into conservatorship, and the Treasury used its authority, granted by the Congress in July, to make available financial support to the two firms. The Federal Reserve, with which FHFA consulted on the conservatorship decision as specified in the July legislation, supported these steps as necessary and appropriate. We have seen benefits of this action in the form of lower mortgage rates, which should help the housing market.

The Federal Reserve and the Treasury attempted to identify private-sector approaches to avoid the imminent failures of AIG and Lehman Brothers, but none was forthcoming. In the case of AIG, the Federal Reserve, with the support of the Treasury, provided an emergency credit line to facilitate an orderly resolution. The Federal Reserve took this action because it judged that, in light of the prevailing market conditions and the size and composition of AIG's obligations, a disorderly failure of AIG would have severely threatened global financial stability and, consequently, the performance of the U.S. economy. To mitigate concerns that this action would exacerbate moral hazard and encourage inappropriate risk-taking in the future, the Federal Reserve ensured that the terms of the credit extended to AIG imposed significant costs and constraints on the firm's owners, managers, and creditors. The chief executive officer has been replaced. The collateral for the loan is the company itself, together with its subsidiaries.[1] (Insurance policyholders and holders of AIG investment products are, however, fully protected.) Interest will accrue on the outstanding balance of the loan at a rate of three-month Libor plus 850 basis points, implying a current interest rate over 11 percent. In addition, the U.S. government will receive equity participation rights corresponding to a 79.9 percent equity interest in AIG and

[1] Specifically, the loan is collateralized by all of the assets of the company and its primary non-regulated subsidiaries. These assets include the equity of substantially all of AIG's regulated subsidiaries.

has the right to veto the payment of dividends to common and preferred shareholders, among other things.

In the case of Lehman Brothers, a major investment bank, the Federal Reserve and the Treasury declined to commit public funds to support the institution. The failure of Lehman posed risks. But the troubles at Lehman had been well known for some time, and investors clearly recognized--as evidenced, for example, by the high cost of insuring Lehman's debt in the market for credit default swaps--that the failure of the firm was a significant possibility. Thus, we judged that investors and counterparties had had time to take precautionary measures.

While perhaps manageable in itself, Lehman's default was combined with the unexpectedly rapid collapse of AIG, which together contributed to the development last week of extraordinarily turbulent conditions in global financial markets. These conditions caused equity prices to fall sharply, the cost of short-term credit--where available--to spike upward, and liquidity to dry up in many markets. Losses at a large money market mutual fund sparked extensive withdrawals from a number of such funds. A marked increase in the demand for safe assets--a flight to quality--sent the yield on Treasury bills down to a few hundredths of a percent. By further reducing asset values and potentially restricting the flow of credit to households and businesses, these developments pose a direct threat to economic growth.

The Federal Reserve took a number of actions to increase liquidity and stabilize markets. Notably, to address dollar funding pressures worldwide, we announced a significant expansion of reciprocal currency arrangements with foreign central banks, including an approximate doubling of the existing swap lines with the European Central Bank and the Swiss National Bank and the authorization of new swap facilities with the Bank of Japan, the Bank of England, and the Bank of Canada. We will continue to work closely with colleagues at other central banks to address ongoing liquidity pressures. The Federal Reserve also announced initiatives to assist money market mutual funds facing heavy redemptions and to increase liquidity in short-term credit markets.

Despite the efforts of the Federal Reserve, the Treasury, and other agencies, global financial markets remain under extraordinary stress. Action by the Congress is urgently required to stabilize the situation and avert what otherwise could be very serious consequences for our financial markets and for our economy. In this regard, the Federal Reserve supports the Treasury's proposal to buy illiquid assets from financial institutions. Purchasing impaired assets will create liquidity and promote price discovery in the markets for these assets, while reducing investor uncertainty about the current value and prospects of financial institutions. More generally, removing these assets from institutions' balance sheets will help to restore confidence in our financial markets and enable banks and other institutions to raise capital and to expand credit to support economic growth.

At this juncture, in light of the fast-moving developments in financial markets, it is essential to deal with the crisis at hand. Certainly, the shortcomings and weaknesses of our financial markets and regulatory system must be addressed if we are to avoid a repetition of what has transpired in our financial markets over the past year. However, the development of a comprehensive proposal for reform would require careful and extensive analysis that would be difficult to compress into a short legislative timeframe now available. Looking forward, the Federal Reserve is committed to working closely with the Congress, the Administration, other federal regulators, and other stakeholders in developing a stronger, more resilient, and better regulated financial system.