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Statement by

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before the

Committee on Financial Services

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Chairman Frank, Ranking Member Bachus, and other members of the Committee, I appreciate this opportunity to review some of the activities to date of the Treasury's Troubled Asset Relief Program, or TARP, and to discuss how additional funding could be used to strengthen our financial system and promote economic recovery.

A well-functioning, stable financial system is essential for healthy economic growth. Unfortunately, as you know, after the collapse of a credit boom that encompassed both mortgage lending and other major credit markets, the financial systems of the United States and of a number of other industrialized countries came under severe strain. Banks and other key financial institutions have seen their capital depleted and their balance sheets clogged with poorly performing and hard-to-value assets. Securitization markets have largely shut down, and credit spreads have widened dramatically on balance. Together with the ongoing contraction of the housing sector, the worsening of credit conditions weighed heavily on economic growth throughout 2008.

The financial crisis intensified considerably more in September and manifested in many countries that it had not yet touched, which led to grave concerns about the stability of the global financial system itself. The shocks to confidence and to the availability of credit that followed the intensification of the crisis last fall have contributed to a substantial further weakening in global economic activity. However, although the economic impact of the worsening crisis has been severe indeed, an international financial collapse--which seemed a real possibility in early October--would unquestionably have led to economic outcomes far worse even than those we are currently experiencing. The first and most urgent priority of policy was thus to avert such a collapse. The existence of the TARP allowed the Treasury to react quickly by announcing, on October 14, a plan to inject \$250 billion in capital into U.S. financial institutions. Although the

Capital Purchase Program has been in place less than three months, many banks, both large and small, have applied for and received capital from this program. The Treasury's actions were complemented by the Federal Deposit Insurance Corporation's (FDIC) expansion of bank liability guarantees and by the Federal Reserve's measures to increase liquidity and support the functioning of key credit markets. Together, these actions helped to bolster confidence in our lending institutions, which enabled them to access funds and make loans. As contemplated by the enabling legislation, TARP funds have also been used on a targeted basis to prevent potentially disorderly failures of systemically critical financial institutions--failures that would have had highly adverse consequences for the system as a whole.

These actions, together with similar measures in other countries, have brought greater stability to our financial system. Moreover, injections of new capital are moderating the powerful pressures on the financial institutions that received the injections to deleverage by selling assets and pulling back from new lending. Stabilization and slowing the pace of deleveraging are critical first steps toward more-normal credit conditions. The federal banking regulators, pursuant to their joint November 12 statement, are working to help banks ensure that they are fully meeting the needs of creditworthy borrowers.[1] Bank lending to creditworthy borrowers is good for the economy, but it is also good for the profitability of banks and supports their safety and soundness. We have strongly encouraged our examiners to work constructively with banks as they perform the careful analysis needed to identify sound lending opportunities.

Regarding the future, the remaining TARP funds will play an essential role in further strengthening the financial system and restoring normal credit flows. An important use of these

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[1] See Board of Governors of the Federal Reserve System, FDIC, Office of the Comptroller of the Currency, Office of Thrift Supervision (2009), "Interagency Statement on Meeting the Needs of Creditworthy Borrowers," joint press release, November 12, www.federalreserve.gov/newsevents/press/bcreg/20081112a.htm.

funds will be to step up efforts to avoid preventable foreclosures. Preventable foreclosures harm not only the affected borrowers and their communities but also, through their effects on the housing market, the broader economy and the financial system as well. Although a number of efforts are underway to address the problem of preventable foreclosures, more needs to be done.

Generally speaking, the most attractive approaches to reducing preventable foreclosures fall into two main categories. The first category features highly streamlined re-underwriting processes with the goal of modifying large numbers of troubled mortgages quickly. Based partly on its experience working with troubled borrowers at IndyMac Federal Bank, F.S.B., the FDIC has proposed a plan of this type. To encourage an aggressive approach to loan modification, the FDIC plan would provide partial insurance against the losses stemming from borrower redefaults on modified loans and would also pay servicers $1,000 for each loan they modify. An alternative program in this same category would have the government share the cost when the servicer reduces the borrower's monthly payment.

The second category of foreclosure prevention plans takes a less streamlined but more deliberate approach, with the goal of increasing the proportion of loan modifications that borrowers will be able to sustain over the longer term. The tradeoff is that the more deliberate approach would likely result in relatively fewer mortgages being modified. One example of a plan that puts greater emphasis on achieving sustainability would have the Treasury use TARP funds as working capital to buy delinquent mortgages from lenders and investors at steep discounts to their remaining balances, through negotiations or through reverse auctions. The acquired mortgages would then be re-underwritten and modified as appropriate to meet the criteria for refinancing into Hope for Homeowners (H4H) or other government programs.

Especially if the Congress moves forward on a plan of this type, it should examine the possibility of enhancing the H4H program to make it a more effective vehicle for this effort.

A second broad use of new TARP funding, besides foreclosure mitigation, would be to support programs to help restart key credit markets. The Treasury and the Federal Reserve recently announced such a program, the Term Asset-Backed Securities Loan Facility, which is designed to stimulate securitization activity in the market for asset-backed securities collateralized by a range of consumer and small business loans.[2] Under this program, which is expected to begin operation next month, the Federal Reserve will lend for up to three years on a nonrecourse basis against asset-backed securities. By providing this financing, the program should increase the availability of credit to households and small businesses. The Federal Reserve will be protected from credit losses by lending amounts less than the market value of the financed security--that is, by applying a "haircut"--and by the $20 billion of capital provided by the TARP. If the program is successful, the program could be increased in size or expanded in scope to provide financing for additional types of securities, such as commercial mortgage-backed securities, for which the markets are currently distressed.

Finally, I would expect the bulk of the remaining TARP funding to be devoted to strengthening financial institutions, thereby supporting the normalization of credit markets and the flow of new credit. Some of this support might take the form of additional capital injections, both to offset additional credit losses and to further expand lending capacity. Consideration should be given to whether it is feasible for some capital injections to be made on a matching

[2] See Board of Governors of the Federal Reserve System (2008), "Federal Reserve Announces the Creation of the Term Asset-Backed Securities Loan Facility (TALF)," press release, November 25, www.federalreserve.gov/newsevents/press/monetary/20081125a.htm; and U.S. Department of the Treasury (2008), "Secretary Paulson Remarks on Consumer ABS Lending Facility," press release, November 25, www.treas.gov/press/releases/hp1293.htm.

basis with private capital raises, thereby providing a market test for those injections. In addition, prudence requires that funds be held in reserve as needed to address urgent contingencies, such as averting the disorderly failure of a systemically important financial institution.

A continuing barrier to private investment in financial institutions is the large quantity of troubled, hard-to-value assets that remain on institutions' balance sheets. The presence of these assets significantly increases uncertainty about the underlying value of these institutions and may inhibit private investment and new lending. The Treasury may thus wish to consider whether to supplement injections of capital with steps to reduce the uncertainty about the values of assets held by financial institutions. This objective could be accomplished in several ways, including by directly purchasing troubled assets, by setting up and capitalizing special banks that would purchase assets from financial institutions in exchange for cash and shares of capital in the special bank, or by making available to banks insurance that would pay off under very adverse conditions. Each approach could build on the infrastructure that the Treasury developed when it was planning to purchase troubled assets directly. Moreover, as I noted earlier, purchases that include residential mortgages could be combined with steps to restructure some mortgages as needed to avert preventable foreclosures.

As you know, the ultimate cost of the TARP program to the taxpayer is likely to be far less than the total amount allocated, because the funds are not simply spent but are used to acquire financial assets, such as preferred shares in banks. Even so, the public is understandably concerned about the cost of this program, particularly as most other industries experiencing distress are not receiving comparable assistance. History clearly shows, and recent experience confirms, that--because of the dependence of modern economies on the flow of credit--serious financial instability imposes disproportionately large costs on the broader economy. The rationale for public investment in the financial industry is not, therefore, any special regard for managers, workers, or investors in that industry over others, but rather the need to prevent a further deterioration in financial conditions that would destroy jobs and incomes in all industries and regions. That said, the public is entitled to demand that policymakers take near-term, concrete actions to ensure that we do not face a similar crisis in the future. An important part of those actions should be to create a stronger supervisory and regulatory system in which gaps and unnecessary duplication in coverage are eliminated, lines of supervisory authority and responsibility are clear, and oversight powers are sufficient to curb excessive leverage and risk-taking, particularly in systemically critical institutions. The Federal Reserve stands ready to work closely with the Congress to achieve meaningful and effective regulatory reform.

Thank you. I would be pleased to take your questions.