SYSTEMIC RISK AND THE FINANCIAL MARKETS

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COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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SYSTEMIC RISK AND THE FINANCIAL MARKETS

Thursday, July 10, 2008

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. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Waters, Maloney, Watt, Ackerman, Sherman, Moore of Kansas, Capuano, Hinojosa, McCarthy of New York, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Davis, Hodes, Ellison, Perlmutter, Donnelly, Speier, Childers; Bachus, Castle, Royce, Paul, Manzullo, Biggert, Shays, Feeney, Hensarling, Garrett, Neugebauer, Campbell, Bachmann, Roskam, Marchant, and Heller.

The CHAIRMAN. The hearing will begin. We have an overflow room, I believe. Is that true?

The CLERK. Yes, sir.

The CHAIRMAN. Okay, so there is an overflow room for people who can't find seats. We have gotten the agreement of the Chairman and the Secretary, preliminary to any opening statements, to stay until 1 p.m. We will probably have some votes, so we will maximize our time.

Let me remind the members that Chairman Bernanke will be before this committee next week for the Humphrey-Hawkins hearing on the economy. Members are obviously free to raise anything they want today, but it is my hope that we would focus on these very important questions of financial regulation. I know there are members who want to review what happened with Bear Stearns and then what we do going forward, but I personally believe the best use of the committee's time today would be to focus on those structural questions and regulatory questions.

We will have the Chairman before us for 3 more hours next week to talk about the economy and Humphrey-Hawkins; and, again, I would urge members to do that. All members are free, as we know, to bring up whatever they want, but that would be our hope, because I did note that some of the members of the committee had asked previously for a hearing to look into what happened with Bear Stearns. And I said at the time that I thought that was very important. I believed it was best to do that in this broader context. Members want to get a new context because the experience regarding Bear Stearns is clearly the context in which much of this hear-

ing is and much of what we will be talking about is what happens if that should occur. So those are the parameters.

Given the importance of this, and given the interest of members in speaking, we are going to hold pretty firmly to the 5-minute rule. And, obviously, we are not going to completely finish in 5 minutes, but no question can be asked after the 5 minutes have expired. We will allow the answers to conclude. But I am going to have to restrain myself and others from asking any questions after the 5 minutes.

Under the rules that apply when we have cabinet and cabinet-level officials, there are two opening statements on each side, the chairs and ranking members of the appropriate subcommittees. In this case, it seems clear to me that it is the Financial Institutions Subcommittee that is the developing subcommittee so that is how we will proceed. The official part of the hearing will now begin and I will recognize myself for a fairly strict 5 minutes.

When I was about to become chairman of this committee in 2006, I was told by a wide range of people that our agenda should be that of further deregulating. I was told that the excess regulation in America from Sarbanes-Oxley and other acts was putting American investment companies and financial institutions at a competitive disadvantage and that people much prefer the softer touch of the financial services authority to the harshness of the American regulatory structure. Things have changed.

Where there was a strong argument as recently as November of 2006 that we had been over-regulating the financial system, I believe the evidence is now clear that we are in one of the most serious economic troubles that we have seen recently, in part because of an inadequacy of regulation.

Clearly, that has been the case with regard to subprime mortgages, but what has been striking is not simply that we had the problems with subprime mortgages, but that those problems infected so much of the financial system, including, I must say, many in Europe. One of the things though that I do take away from that set of conversations, and then it's a fairly clear one is that what we do, and I believe there is a consensus now among people in the Administration, among many of us in Congress, and among people in the financial industry, that an increase in regulation is required. It must be done sensibly. It must be market sensitive.

But I believe we have seen a significant shift from the notion that the most important issue was to deregulate further to one recognizing the need for more sensible regulation, but more regulation. It is clear that this needs to be done in the context of international cooperation, and I am encouraged to believe, and the first trip this committee took when I became chairman was to Belgium and London to meet with people from the European Union and Great Britain in terms of their financial regulation. This needs to be done with international cooperation and I think the prospects of that are very good. I think there was a broad international recognition that some form of increased regulation was necessary. And the form we are talking about is regulation of risk-taking outside the very narrowly defined commercial banking. Innovation is very important, and an innovation that has brought a great deal of benefit during the last few decades is securitization.

Securitization replaces the lender-borrower relationship and the discipline that you have in the lender-borrower relationship. A very large part of our problem is that we have not yet found sufficient replacement for the discipline of a lender not lending to a borrower unless the lender is sure that the borrower will be able to repay. Something that simple causes problems in subprime, and it has caused problems elsewhere.

We have had too many loans made without sufficient attention to whether or not the loans could be repaid. And, what we now have is a contagion, because people who bought loans in various forms that they shouldn't have bought are now resistant to buying things that they should buy.

That is why I believe regulation properly done, regulation of risk that is too unconstrained today, because the various risk management techniques that were supposed to replace the lender-borrower relationship have not been successful. Diversification and quantitative models and the rating agencies, we have not yet replaced them. Some form of regulatory authority is necessary. If properly done, a market sensitive regulatory authority not only prevents some of the problems, but is pro-market, because we have investors now who are unwilling to invest even in things they should.

Many of our nonprofit institutions and our State and local governments have been the victims of this. So our job, I believe—and I congratulate the officials of this Administration for having done a good job in the current legal context of dealing with these problems—is to look at what happened, to look at what is now going on, and to decide what should be done to provide a better statutory framework for the increase in regulation that I believe people agree should happen.

The gentleman from Alabama.

Mr. BACHUS. I thank the chairman for holding this hearing on systemic risk and the appropriate regulatory responses to managing that risk and I know there will be short-term responses, and at some time in the future maybe a new regulatory structure which will take time.

The two public servants before us today I think are eminently qualified to speak to these issues and we welcome Secretary Paulson and Chairman Bernanke. They had agencies whose mandates and responsibilities are broad and are deep, but the issue of systemic risk also requires the involvement of other significant and capable regulators, including particularly the SEC and the Federal banking regulators.

It is my expectation that the leaders of these agencies will appear at a subsequent hearing with their comments and that will supplement our understanding and the testimony we gather today on this difficult issue, and I trust that Secretary Paulson and Chairman Bernanke agree that a collaborative effort that includes these agencies is going to be needed if we are to have a successful outcome.

To say we are living through interesting times in our financial markets is to state the painfully obvious. We have seen a run on what was then the Nation's 5th largest investment bank, Bear Stearns. We have seen the Federal Reserve intervene in order to avoid a cascading effect from Bear Stearns's collapse that could

have spread throughout the financial system with what I believe would have been decidedly negative implications for the larger economy.

And we have seen the Federal Reserve take steps or a series of steps that in the short term at least have brought a measure of confidence and stability to the financial markets. But now that the immediate crisis created by the run on Bear Stearns has passed, we face some difficult, long-term policy questions.

Perhaps the most critical question is, have we arrived at the place where virtually every primary dealer is considered too big or too interconnected to fail? The logical extension of this too big to fail perception is that markets no longer work and that the government must not only exercise greater control of our capital markets, but also be the ultimate guarantor of financial solvency; that would be a conclusion I could not endorse.

And in reading over the remarks of Secretary Paulson in London, I see that you did not endorse it, either. A far better alternative is to restore market discipline within appropriate regulatory bounds. I believe we have reached a consensus that we must establish a modern, regulatory structure to strengthen the safety and soundness of our institutions and discourage unsound practices and conduct. However, these regulations should not and cannot ensure that institutions will never fail. And if one does fail, we must ensure that taxpayers are not left holding the bag.

Thanks to the fast action of the Federal Reserve in cooperation with the SEC and the Treasury, we dodged a bullet when Bear Stearns collapsed. We may not be so lucky next time. For that reason, I look forward to hearing from today's witnesses about what we can do to provide for an orderly resolution in the event a large financial institution fails.

The regulatory regime we establish and follow must accomplish three things: ensure market discipline; provide a shock absorber against systemic risk; and, first and foremost, protect the taxpayer. To preserve market discipline and discourage moral hazard, we must see to it that no firm should be considered too big or interconnected to fail. To protect against systemic risk, we must ensure that when a firm fails, it does not bring down the entire financial system with it, i.e., an orderly liquidation. And to protect the taxpayer, we have to make sure that the cost of that failure is borne by the firm's shareholders and creditors, and not passed on to the taxpaying public.

In conclusion, of necessity we have to plan for how to handle the failure of a major institution. It is important, however, that we create a system focused not on failure, but on success. In doing so, we must also resist the temptation to over-regulate in our zeal to discourage practices such as overleveraging an excessive risk-taking that put institutions at risk of failure. This is a tall order.

Thank you, Mr. Chairman, for holding this hearing, and thank you to our witnesses.

The CHAIRMAN. The gentleman from Pennsylvania is now recognized and will temporarily preside.

Mr. KANJORSKI. Mr. Chairman, this hearing comes at a critical juncture. As the economy reels from a widespread, far-reaching financial crisis that continues to wreak havoc on everything from the

housing market to student loans, while we remain focused on many current economic difficulties average Americans face, we must simultaneously look to the future to determine how to prevent or at least mitigate future crises.

Financial innovation and the proliferation of complex and exotic financial instruments are probably inevitably going to occur under our capitalist system. But we must develop innovative, regulatory and oversight responses to keep pace as these market transactions evolve. One such proposal worth considering is the Systemic Risk Reduction Act of 2008 put forth by the Financial Services Roundtable.

This bill seeks to make regulation more efficient by closing gaps in our regulatory structure and by promoting consolidation and cooperation among regulatory agencies. Their proposal includes a provision of particular interest to me; namely, it proposes establishing a bureau similar in concept to the Office of Insurance Information which passed the Capital Markets Subcommittee yesterday.

Without a Federal repository to collect and analyze information on insurance issues, we cannot fully understand and control systemic risk. The Roundtable proposal would also expand the authority of the Federal Reserve so that investment banks who borrow from the Fed's discount window in various facilities do not get a free pass.

No one else can borrow money without conditions, and the American people do not expect that the investment bank be allowed to do so.

Chairman Bernanke spoke 2 days ago and raised many of these issues and offered ideas for consideration, noting that the financial turmoil since August underscores the need to find ways to make the financial system more resilient and more stable. I wholeheartedly agree. He further stated that the Fed's powers and responsibilities should be commensurate.

It is the job of Congress to strike that proper balance. While many concur that the Federal Reserve's move to bail out Bear Stearns in March of this year was necessary to prevent a financial meltdown, most also agree that we should be concerned about setting precedents with broad ramifications down the road. Taxpayers cannot be asked to bail out financial institutions, and we should look for ways to prevent such dire situations from arising in the future.

Another area germane to today's discussion is speculation. Specifically, we must determine to what extent speculation in commodities futures has hurt American consumers by artificially inflating the price of oil, energy, and other goods. I appreciate the ongoing debate on speculation with economists, traders, pundits, and politicians staking out various positions on the issue. To the extent that we can glean further insight from our panelists today, that would be of tremendous help, for it is true that speculators bear blame. Then congressional action in the form of increased oversight in authority is warranted.

on a related note, I am very interested in consolidating the regulation of our securities and commodities markets. While the CFTC currently has jurisdiction of this market, the Treasury's rec-

ommendation to merge SEC and FCTC seems a sensible course of action for Congress.

We need to take this action now and I look forward to working with the Administration.

The CHAIRMAN. The gentlewoman from Illinois.

Mrs. BIGGERT. Thank you, Mr. Chairman, and thank you for holding today's hearing on systemic risk.

Your responsiveness to the letter submitted in April by Mr. Garrett, Ranking Member Bachus, and more than a dozen of us on this side of the aisle is very much appreciated, and I would also like to thank Congressman Garrett for his leadership on this issue.

I welcome our distinguished witnesses today: Federal Reserve Chairman Bernanke; and Treasury Secretary Paulson. Your steady leadership is helping us weather the storm that our markets and our economy are experiencing. As a side, Secretary Paulson, I would like to specifically thank you and your staff, as well as the public and private sector partners for organizing the HOPE NOW Alliance, which has helped to keep hundreds of thousands of families in their homes.

And Chairman Bernanke, the Federal Reserve's actions continue to help preserve confidence and bring stability to our financial markets and institutions. Infusing liquidity into the marketplace has prevented the credit crunch from seizing the system, and facilitating the sale of Bear Stearns to J.P. Morgan is viewed by many as having been the lynchpin that prevented a run-on-the-bank type crises which could have spread throughout our financial system and caused irreparable harm.

What brought us here today are these specifically and the latter actions on the part of the Fed, actions that begged the question, what can the Federal Government do to prevent future, similar bailouts that can put taxpayer dollars at risk? Is the Federal Government prepared for another Bear Stearns? Can a Federal regulator or regulators monitor specific indicators that will flag weaknesses within individual, financial institutions and prevent another Bear Stearns? And can they do so without unnecessarily increasing regulatory burdens that would diminish the competitiveness of the U.S. financial institutions in the global marketplace?

It is vital that we closely examine the capacity of the Federal Government to monitor the large financial institutions like Bear Stearns, which represent not only American innovation and financial strength, but also our great vulnerability with respect to systematic risk in the financial system.

I think without delay, we need to strike the right balance and create a simpler, stronger, regulatory system that preserves the resilience of our economy, protects taxpayers, and maintains the position of our financial system as the envy of the world.

I look forward to the testimony and I yield back.

The CHAIRMAN. I think the gentlewoman.

We will now go to the opening statements, and a subject to which I sometimes pay insufficient attention is protocol. We don't usually have two such distinguished witnesses. The question is, who goes first?

I think the order, certainly, of succession to the Presidency is which Department was established first. And, I think, Mr. Paulson,

that you have about 125 years on Mr. Bernanke, so we will begin with you.

STATEMENT OF THE HONORABLE HENRY M. PAULSON, JR., SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary PAULSON. Mr. Chairman, Ranking Member Bachus, thank you very much for holding this hearing and for your leadership on these very important issues.

As you know, our financial markets have been experiencing turmoil since last August. It will take additional time to work through these challenges. Progress has not come in a straight line, but much has been accomplished. Our financial institutions are repricing risk, de-leveraging, recognizing losses, raising capital, and improving their financial position. Their ability to raise capital even during times of stress is a testament to our financial institutions and to our financial system.

Fannie Mae and Freddie Mac are also working through this challenging period. They play an important and vital role in our economy and housing markets today, and they need to continue to play an important role in the future. Their regulator has made clear that they are adequately capitalized.

Market practices and discipline on the part of financial institutions and investors are also improving. Our regulators are shining a light on our challenges. Through the President's Working Group on Financial Markets, we have issued a report analyzing the causes of the turmoil and recommending a comprehensive policy response, implementation of which is well underway.

Regulators are enhancing guidance, issuing new rules, and communicating more effectively across agencies domestically and internationally.

Although our regulatory architecture and authorities are outdated and less than optimal, we have been working together; while respecting our different authorities or responsibilities, we have been working together to ensure the stability of the financial system, because it is in the interest of the American people that we do so.

Today this is by far our most important priority. And our seamless cooperation to achieve it is made possible by the leadership and support provided by this committee and by other leaders in Congress. I have confidence in our regulators and markets. We need to remain focused and continue to address challenges with your support and with your help. But we will ultimately emerge with strong capital markets, which will in turn enable our economy to continue to grow.

Now looking beyond this period of market stress, which will eventually pass as these situations always do, I have presented my ideas for improving our regulatory structure and expanding our emergency powers. I look forward to discussing these ideas with you today, even as we continue our primary focus on confronting current challenges and maintaining stable, orderly financial markets.

In March, I laid out a Blueprint for a Modernized Financial Regulatory Structure in which we recommended a U.S. regulatory model based on objectives that more closely link the regulatory

structure to the reasons why we regulate. Our model proposes three primary regulators: One focused on market stability across the entire financial sector; another focused on safety and soundness at institutions supported by a Federal guarantee; and the third focused on protecting consumers and investors.

A major advantage of this structure is its timelessness and its flexibility, and that because it is organized by a regulatory objective rather than by financial institution category, it can more easily respond and adapt to the ever-changing marketplace.

If implemented, these recommendations eliminate regulatory competition that creates inefficiencies and can engender a race to the bottom. The Blueprint also recommends a number of near-term steps. These include formalizing the current informal coordination among U.S. financial regulators by amending and enhancing the Executive Order which created the President's Working Group on Financial Markets, and while retaining State level regulation of mortgage origination practices, creating a new Federal level commission, the Mortgage Origination Commission, to establish minimum standards for among other things personal conduct and disciplinary history, minimum educational requirements, testing criteria and procedures, and appropriate licensing revocation standards.

The Blueprint includes recommendations on a number of intermediate steps as well, focusing on payment and settlement systems in areas such as futures and securities, where our regulatory structure severely inhibits our competitiveness.

We recommended the creation of an optional Federal charter for insurance companies similar to the current dual charter system for banking, and that the thrift charter has run its course and should be phased out. We also recommend the creation of a Federal charter for systemically important payment and settlement systems, and that these systems should be overseen by the Federal Reserve in order to guarantee the integrity of this vital—

The CHAIRMAN. Mr. Secretary, I don't want you to feel constrained. Both you and the Chairman should ignore the time limits. We will be constrained by them, but this is too important for you to be, so please, both of you can ignore the red lights.

Secretary PAULSON. Okay. I am just about finished.

The CHAIRMAN. No, I didn't mean to—

Secretary PAULSON. Okay.

The CHAIRMAN. Just the opposite. We have enough time to listen to this, so please don't be constrained.

Secretary PAULSON. When we released the Blueprint, I said that we were laying out a long-term vision that would not be implemented soon. Since then, the Bear Stearns episode and market turmoil more generally have placed in stark relief the outdated nature of our regulatory system and has convinced me that we must move much more quickly to update our regulatory structure and improve both market oversight and market discipline.

Over the last several weeks, I have recommended important steps that the United States should take in the near term, all of which move us toward the optimal regulatory structure outlined in the Blueprint. I will summarize these briefly.

First, Americans have come to expect the Federal Reserve to step in to avert events that pose unacceptable systemic risk. But the Fed does not have the clear statutory authority, nor the mandate to do this. Therefore, we should consider how to most appropriately give the Federal Reserve the authority to access necessary information from complex financial institutions, whether it is a commercial bank, an investment bank, a hedge fund, or another type of financial institution, and the tools to intervene to mitigate systemic risk in advance of a crisis.

The MOU recently finalized between the SEC and the Federal Reserve is consistent with this long-term vision of the Blueprint, and should help inform future decisions, as our Congress considers how to modernize and improve our regulatory structure.

Market discipline is also critical to the health of our financial system, and must be reinforced, because regulation alone cannot eliminate all future bouts of market instability. For market discipline to be effective, market participants must not expect that lending from the Fed or any other government support is readily available. I know from firsthand experience that normal or even presumed access to a government backstop has the potential to change behavior within financial institutions with their creditors. It compromises market discipline and lowers risk premiums, ultimately putting the system at greater risk.

For market discipline to effectively constrain risk, financial institutions must be allowed to fail. Today, two concerns underpin expectations of regulatory intervention to prevent a failure. They are that an institution may be too interconnected to fail or too big to fail.

Steps are being taken to improve market infrastructure, especially where our financial firms are highly intertwined. The OTC Derivatives market and the triparty repurchase agreement market, which is the marketplace through which our financial institutions obtain large amounts of secured financing, must be improved. It is clear that some institutions, if they fail, can have a systemic impact.

Looking beyond immediate market challenges, last week I laid out my proposals for creating a resolution process that ensures the financial system can withstand the failure of a large, complex financial firm. To do this, we will need to give our regulators additional emergency authority to limit temporary disruptions. These authorities should be flexible, and to reinforce market discipline, the trigger for invoking such authority should be very high, such as a bankruptcy filing.

Any potential commitment of government support should be an extraordinary event that requires the engagement of the Treasury Department and contains sufficient criteria to prevent cost to the taxpayer to the greatest extent possible.

This work will not be done easily. It must begin now and begin in earnest. Again, thank you for your leadership.

[The prepared statement of Secretary Paulson can be found on page 67 of the appendix.]

STATEMENT OF THE HONORABLE BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BERNANKE. Thank you. Chairman Frank, Ranking Member Bachus, and other members of the committee, I am pleased to be here today to discuss financial regulation and financial stability.

The financial turmoil that began last summer has impeded the ability of the financial system to perform its normal functions and has adversely affected the broader economy. This experience indicates a clear need for careful attention to financial regulation and financial stability by the Congress and other policymakers.

Regulatory authorities have been actively considering the implications of the turmoil for regulatory policy and for private sector practices. In March, the President's Working Group on Financial Markets issued a report and recommendations for addressing the weaknesses revealed by recent events.

At the international level, the Financial Stability Forum has also issued a report and recommendations. Between them, the two reports focused on a number of specific problem areas, including mortgage lending practices and their oversight, risk measurement and management at large financial institutions, the performance of credit rating agencies, accounting and evaluation issues, and issues relating to the clearing and settlement of financial transactions.

Many of the recommendations of these reports were directed at regulators in the private sector and are already being implemented. These reports complement the Blueprint for regulatory reform issued by the Treasury in March, which focused on broader questions of regulatory architecture.

Work is also ongoing to strengthen the framework for prudential oversight of financial institutions. Notably, recent events have led the Basel Committee on Banking Supervision to consider higher capital charges for such items as certain complex structured credit products, assets and banks trading books, and liquidity guarantees provided to off-balance sheet vehicles. New guidelines for banks liquidity management are also being issued.

Regarding implementation, the recent reports have stressed the need for supervisors to insist on strong risk measurement and risk management practices that allow managers to assess the risk that they face on a firm-wide basis.

In the remainder of my remarks, I will comment briefly on three issues. The supervisory oversight of primary dealers, including the major investment banks, the need to strengthen the financial infrastructure, and the possible need for new tools for facilitating the orderly liquidation of a systemically important securities firm.

Since the near collapse of the Bear Stearns companies in March, the Federal Reserve has been working closely with the Securities and Exchange Commission, which is the functional supervisor of each of the primary dealers and the consolidated supervisor of the four large investment banks, to help ensure that those firms have the financial strength needed to withstand conditions of extreme market stress.

To formalize our effective working relationship, the SEC and the Federal Reserve this week agreed to a memorandum of understanding. Cooperation between the Fed and SEC is taking place

within the existing statutory framework, with the objective of addressing the near-term situation.

In the longer term, however, legislation may be needed to provide a more robust framework for prudential supervision of investment banks and other securities dealers. In particular, under current arrangements, the SEC's oversight of the holding companies of the major investment banks is based on a voluntary agreement between the SEC and those firms. Strong holding company oversight is essential, and thus in my view the Congress should consider requiring consolidated supervision of those firms and providing the regulator the authority to set standards for capital liquidity holdings and risk management.

At the same time, reforms in the oversight of these firms must recognize the distinctive features of investment banking and take care neither to unduly inhibit innovation, nor to induce a migration of risk-taking activities to less-regulated or offshore institutions.

The potential vulnerability of the financial system to the collapse of Bear Stearns was exacerbated by weaknesses in the infrastructure of financial markets, notably in the markets for over-the-counter derivatives and in short-term funding markets.

The Federal Reserve together with other regulators in the private sector is engaged in a broad effort to strengthen the financial infrastructure. For example, since September 2005, the Federal Reserve Bank of New York has been leading a major joint initiative by both the public and private sectors to improve arrangements for clearing and settling credit default swaps and other OTC derivatives.

The Federal Reserve and other authorities are also focusing on enhancing the resilience of the markets for triparty repurchase agreements, in which the primary dealers and other large banks and broker-dealers obtain very large amounts of secured financing from money funds and other short-term risk-averse investors.

In these efforts we aim not only to make the financial system better able to withstand future shocks, but also to mitigate moral hazard and the problem of too big to fail by reducing the range of circumstances in which systemic stability concerns might prompt a government intervention.

More generally, the stability of the broader financial system requires key payment and settlement systems to operate smoothly under stress and to effectively manage counterparty risk. Currently the Federal Reserve relies on a patchwork of authorities, largely derived from our role as a banking supervisor as well as on moral suasion to help ensure that the various payment and settlement systems have the necessary procedures and controls in place to manage the risks that they face.

By contrast, many major central banks around the world have an explicit statutory basis for their oversight of payment and settlement systems. Because robust payment and settlement systems are vital for financial stability, the Congress should consider granting the Federal Reserve explicit oversight authority for systemically important payment and settlement systems.

The financial turmoil is ongoing and our efforts today are concentrated on helping the financial system to return to more normal functioning. It is not too soon, however, to think about steps that

might be taken to reduce the incidence and severity of future financial crises.

In particular, in light of the Bear Stearns episode, the Congress may wish to consider whether new tools are needed for ensuring an orderly liquidation of a systemically important securities firm that is on the verge of bankruptcy together with a more formal process for deciding when to use those tools.

Because the resolution of a failing securities firm might have fiscal implications, it would be appropriate for the Treasury to take a leading role in any such process, in consultation with the firm's regulator and other authorities.

The details of any such tools and the associated decision-making process require more study. One possible model is the process currently in place under the Federal Deposit Insurance Corporation Improvement Act, or FDICIA, for dealing with insolvent commercial banks. The fiducial procedures give the FDIC the authority to act as a receiver for an insolvent bank and to set up a bridge bank to facilitate an orderly liquidation of that firm. The fiducial law also requires that failing banks be resolved in a way that imposes the least cost to the government, except when the authorities through a well-defined procedure determine that following the least cost route would entail significant systemic risk.

To be sure, securities firms differ significantly from commercial banks in their financing, business models, and in other ways, so the fiducial rules are not directly applicable to these firms.

Although designing a resolution regime appropriate for securities firms would be a complex undertaking, I believe it would be worth the effort. In particular, by setting a high bar for such actions, the adverse effects on market discipline could be minimized.

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

[The prepared statement of Chairman Bernanke can be found on page 61 of the appendix.]

The CHAIRMAN. Thank you. Let me begin with the Secretary, because I was pleased to note in your statement that you understand that the regulator at OFHEO, of Fannie Mae and Freddie Mac, believe that they are now adequately capitalized. They were important institutions and I think that was—I'm pleased that you made that statement. I think that is important for people to understand.

I said before that we are talking about more regulation done sensibly. Obviously there are still areas that the Secretary indicated where we could improve by simplifying regulation. That doesn't mean that it means more regulation everywhere. But there does seem to me to be emerging a consensus that we need a regulator concerned with threats to the systemic stability of the economy, that come from unconstrained risk-taking in a group of financial institutions outside the commercial banking system. And I was pleased, Mr. Secretary, that you mentioned hedge funds and investment banks. I think it would be a great mistake to talk about type of institution. That would give people an incentive to change their hats.

We are talking about the impact of the activity, and we are talking I think, and a consensus appears to be emerging that it is going to be the Federal Reserve. I have to say that there are people who say, well, either you create a brand new regulator, it seems to me,

which would be I think a mistake, or you give it to the Federal Reserve. And I agree with both of you, that in order to do that, the Federal Reserve needs more power. A situation in which the Federal Reserve is available and is under pressure to provide funding, but does not have the ability to act well before that time to diminish the need for that and to oppose conditions, that is unacceptable.

We are talking, but we should be clear, about an increase in regulatory power. And let me say, you know, there was a time when the notion of requiring hedge funds to register was very controversial. It does seem to me that we have clearly gone beyond that. We are talking about giving the Federal Reserve the power to not just get information but to deal with various things which could include capital requirements and other factors.

Now those are very important issues, and I think, as I said, there was a consensus emerging that it should be the Federal Reserve. And I have to say when people say, "Well," they'll have this or that question about whether the Federal Reserve should do it, I invoke, as people have heard me do, the wisdom of a great 20th Century philosopher, Henny Youngman. The maxim was, "How's your wife? Compared to what?" And the Federal Reserve compared to what? I don't see any alternative to the Federal Reserve.

But my question is this. I think this is an important task, and there's a great deal of agreement, that we should be moving to empower the Federal Reserve to have regulatory authority over a wide range of financial institutions in recognition in part of the fact that they have a systemic impact and that the current situation puts the Fed in an untenable position of being given a set of expectations to respond when it doesn't have the full panoply of tools to respond.

But here is the question: How soon? Now we are where we are. It is July of an election year. This is a very complex subject. We don't want to do anything that would interfere with our wonderful financial system. And I mean our wonderful financial system, which has been so productive. We want to curb abuses without interfering with the productive function.

Mr. Secretary, you said that they don't now have that authority, and we all agree with that. Is it essential that we move now? My sense is this—and I applaud the signing of the memorandum of understanding between the SEC and the Fed. That kind of cooperation has been useful. The cooperation between your two entities has been useful.

I guess there are two options. One is that we have to try and legislate something now. And let me say we should distinguish. Mr. Secretary, you had a broader set of recommendations involving thrift institutions and credit unions, and a whole lot of things that no one in this institution is eager to deal with. So nobody is in any hurry on those. But we have I think taken out of that—and you have elaborated with the resolution issue—the question of macrostability regulator, of the Federal Reserve being given powers to deal with the problems that could come to a system from someone too big or too unconnected to fail.

Here is the question: Working together as we have within existing authorities, with yourselves, with I hope cooperation—that you understand cooperation with us—can we get by until the end of the

year? We obviously will start working on this. Is it your view that immediate legislation is necessary? Or are we able to get by, given the cooperation we have had, given the kind of support we try to give you as much as possible, and begin working immediately together, so that early next year, one of the first items on the congressional agenda will be the legislation you talked about? Let me ask each of you to respond.

Secretary PAULSON. Mr. Chairman, let me respond by saying first of all, the role of the Fed as a macro stability regulator will take time to think through. It's a complex question. It's an important question. The authorities that will go with that, how that will work. That will clearly take some time to consider and to get the legislation through.

Even more pressing is—which is again a complex issue which will take time—is the issue of the resolution process and procedures for complex financial institutions that aren't federally insured. We both talked about that. And so in terms of priorities, that should be even the higher priority in terms of time. But that will take some time.

I think what you are getting at is even though our system may not optimal, the authorities may not be optimal, we have been able to work together to protect the system by communicating with Congress, and that's our plan and our expectation that we are going to need to keep doing that, and we are going to work in that way, recognizing that the requests we have made are not things that can be implemented immediately.

The CHAIRMAN. Mr. Chairman?

Mr. BERNANKE. I would associate myself with Secretary Paulson's remarks. We are working together extremely cooperatively, the Secretary and I, and the other agencies. Obviously, we'd like to have additional tools, but these are very complex matters, as the Secretary has indicated. So my hope would be that the Congress would begin soon to think hard about these issues, and we are happy of course to provide whatever support we can. But I think for the time being that the most likely outcome and the expectation is that we will continue to work in a creative way together to try to manage these ongoing situations.

The CHAIRMAN. I'm going to break my own rule just to make one statement, because I gather what you're saying is, it is better in this very complex and very important set of issues that we do it right and that we do it very quickly.

Mr. BERNANKE. I would agree with that.

The CHAIRMAN. The gentleman from Alabama.

Mr. BACHUS. Thank you. I think there is a consensus that there needs to be a single regulator for market stability, and I think that is in the Treasury's Blueprint. But short term, what are your present powers that you could bring to bear near term on risk management on containing risk, containing systemic risk, what are some things that you can do right now?

Mr. BERNANKE. There were a number of recommendations in those reports I referred to. There are many steps that could be taken at the regulatory and supervisory level to strengthen the oversight of banks and other financial institutions. For example, I mentioned the Basel Accords which are strengthening liquidity re-

quirements, changing capital charges for different kinds of activities, making recommendations to the regulators about how to go about strengthening the risk management systems of these firms.

We are paying very close attention to the system as a whole. We are looking at the payment systems and other parts. The Federal Reserve has after all acted as a de facto—along with the Treasury—crisis manager for many decades. So there are a number of things we can do to strengthen the oversight under existing statutes and to make sure that the infrastructure is working as well as possible. For example, I mentioned also the private-public cooperation that we are now having to strengthen the OTC derivatives infrastructure and the like.

So there's a lot that we can do, but we are doing—I just want to make very, very clear that what we are doing is, you know, working within the current statutory framework. The broader reforms that I believe are necessary are obviously the purview of Congress. And, you know, we hope that you'll be addressing those issues in a timely way.

Mr. BACHUS. Secretary Paulson?

Secretary PAULSON. I agree very much with what Chairman Bernanke has said, and I would just simply say that even if the structure isn't optimal and all of the authorities aren't optimal, regulators are working together seamlessly to address some of the issues that have arisen, and I think progress has been made.

Mr. BACHUS. You know, one thing I have noticed, I know the President's Working Group, you know, as far back as say a year ago or I think as late as March, talked about the risk management practices of the investment banks as being faulty and that resulted in a lot of what we are seeing, market turmoil.

I think the response I have seen from the Fed particularly has been that, you know, establishing risk management standards, which I certainly understand. You have also mentioned I think long term it's necessary to establish capital standards and liquidity standards. But short term, I do worry about new capital requirements and liquidity standards as sort of precipitating and sort of a tension between that and the need for these institutions to raise more capital. So how do you balance that?

And I know one thing that you have talked about, I think the Treasury has talked about, is giving these—a lot of the banks the right to increase borrowing from or raising capital from private equity. Would you like to address that?

Secretary PAULSON. Yes, Congressman. We have encouraged, both of our organizations have encouraged financial institutions to recognize losses and to raise capital, because capital is available, and that is a much better alternative than shrinking their balance sheets and pulling back from the activities that are so necessary.

And as it relates to raising capital, private equity is one source, and we very much endorse the Fed's posture, which is being open to private equity investors and encouraging private equity investors.

Mr. BERNANKE. Congressman, our first objective is to make sure that these firms are safe and able to withstand the current stresses. And so, for example, in our work with the SEC at the investment banks, we have urged them, and they have complied, in

raising capital and especially in raising liquidity, which was one of the key issues with Bear Stearns. So we want them to be safe and we want to do that immediately.

In the longer term, there is this issue of "procyclicality," the possibility that capital rules and reserving rules and so on, accounting rules, will tend to exacerbate the credit cycle. It is a very important issue. We have some elements of the Basel II Accords that address that. But I think it's something that as we go forward, we will want to look at much harder to try to limit the regulatory impact on the procyclicality of credit.

On private equity, I agree absolutely with the Secretary that we are looking for banks and other financial institutions to raise capital. Private equity is a very good source of capital. There are the issues relating to effective control as established by the Bank Holding Company Act, which has a statutory limit of 25 percent ownership. Below that, the Federal Reserve has to address what constitutes effective control. We are currently looking at that in the hope that we will make a clearer statement about when private equity can come in and add capital to the banking system.

Mr. BACHUS. Thank you.

The CHAIRMAN. The gentleman from Pennsylvania.

Mr. KANJORSKI. Thank you, Mr. Chairman. Secretary Paulson, Chairman Bernanke, listening to your response to the chairman about timing, since last August of course all of us have examined and watched market failure occurring in various and sundry areas growing from subprime failure in August to what we call now a credit crisis. And the information that I am receiving from some entities is that the end is not here; there are other shoes to fall.

And what occurs to me is that this gap we are talking about between now and when the new Congress convenes it could pass the emergency powers or extraordinary powers or change powers that are necessary to meet this crisis. It is probably for all intents and purposes 9 months at least.

In the meantime, between now and March or April of next year, what type of anticipated problems could we be dealing with or could you be dealing with and the American economy be dealing with that we should take cognizance of now? And is there perhaps a need for extraordinary emergency legislation to empower either the Federal Reserve or Treasury to take certain actions to prevent systemic risk if over the next 9-month period the Congress is not able to act and you discern that the powers you have are not adequate to meet the challenges? That hiatus seems to me to be one that we have to address now.

Mr. Secretary?

Secretary PAULSON. Let me say that I have grown up in a world where you don't always have all the tools you'd like to have, and I have very seldom seen a perfect hand that someone has to play. We are dealing in a financial market that has evolved greatly since the time that many of our rules were put in place, that many of the—that the regulatory structure was set. And so, realistically, I agree with the Chairman, that it will be difficult to get it done as quickly as we would like.

The resolution powers for a large financial institution that is not a bank, it would be nice to be able to have that. But I will again

say to you, even though this is a difficult period we are going through, and we both said that it's going to take some time to get through it, there will be some more bumps on the road, I really want to emphasize that you have seen the Federal Reserve, by opening up the discount window to the investment banks, through the Bear Stearns actions, to make a very strong statement about the importance of the stability of our financial system. And I have seen those investment banks working with the Fed and the SEC to strengthen their liquidity, strengthen their capital positions, and re-price risk. So we are making progress here.

And, you know, I get reports all the time. Our regulators are very vigilant. I received a report about the banking industry and get it regularly. As of the end of March, even though the banks are going through some difficult problems, and their situation is evolving, the reports I got indicated that 99 percent of those institutions holding 99 percent of the assets fell into the highest capital category, well capitalized. So we are making progress. We don't have everything we would like to have, but I think the right answer to our question, Congressman, which is a good question, is we have to—we always have to have contingency plans, be prepared for various eventualities. We plan, we work together. We have been doing that from before the turmoil started, from the day I set foot in Washington. And we are just going to have to work together, be creative and work with you.

Mr. KANJORSKI. Mr. Secretary, my time is running out. This morning I spoke to a student loan group, and we worked for the last 4 or 5 months to try and resolve that pressing problem, the failure of the auction market. And even what I received from them is that sometimes the activities or willingness of our Departments, like the Department of Education and even your Department, are unwilling to take the risk of implying the authority to do things.

I am just urging, either you recognize that now, and if you need emergency powers on some of these things you mentioned to us before we get to catastrophe.

Secretary PAULSON. Well, let me mention the student loans, because here is a case where I think you have seen our department work creatively with the Department of Education to deal with a problem that's here and now, and so we have a program in place which I think is going to be acceptable to most fellow lenders. I think it's going to work. To the extent that we need something else, the Department of Education is ready with their direct lending, their lending of last resort. Meanwhile, we are working creatively at Treasury to come up with other market-based solutions to help this market.

So we are working through this. We have a program that's going to get us through this period, and we are working to do things to help that securitization market become more vital.

The CHAIRMAN. The gentleman from Delaware.

Mr. CASTLE. Thank you very much, Mr. Chairman. To the Chairman of the Federal Reserve and to Secretary Paulson, I would just like to thank them I think for what has been excellent work in very difficult circumstances, as well as the chairman and the ranking member of the committee.

My questions, I guess, are going to be more about timing than anything. We see the expressions "short term," "intermediate term," "long term," expressions like that. I guess when you're—we all look at our calendars differently. When you're in Congress, you sort of think in terms of the next election or whatever it may be. We have a couple of more weeks in July. We have September, and then we have the election season coming up. And, Secretary Paulson, you mentioned that the financial institutions need to recognize their losses and raise capital, those kinds of things.

But my question to you regarding the fluctuations in the various equity markets around the world, plus the housing market in the United States is this: Is the short term measurable, in a matter of months or whatever it may be, not years at this point?

Furthermore, is there anything that we in Congress should be doing in the short time we have left that would be helpful with respect to the problems that exist right now in America? Is there anything—and you probably have identified this in your testimony, but I must admit it's complicated enough for me to have trouble following. Are there things that you all should be doing on a short-term basis that would be helpful that we should know about?

Secretary PAULSON. Well, let me mention a couple of things right away. First of all, your committee has been out in front on this, but let's get the GSE reform legislation done, to have a strong, independent regulator that will inject confidence into those institutions and into the markets, and that's a very positive thing.

And then secondly, we both haven't said don't work on this. I mean, work should begin immediately and urgently on these resolution authorities and these steps we have suggested. We are just telling you that realistically, because we have heard from you, and we know it to be the case, realistically, it's going to be difficult to get things done this year. But this is going to take some time, so begin work urgently on that. But those are the two things that I would suggest.

Mr. CASTLE. Chairman Bernanke?

Mr. BERNANKE. Like Secretary Paulson, I have no objection whatsoever to early action and will continue to work with you closely in all directions. It's just our sense, and of course you're in a better place than we are to make the judgment, that the more complex issues like resolution or even financial regulatory restructuring are simply not likely to happen in a short term, and we need to take the time to make sure it's done right and thoroughly worked through.

So we will continue to think about what steps might be taken on a shorter-term basis and be in close touch with Congress. But, again, we are—I just want to be clear that, you know, it's not that we don't have any tools. We have plenty of tools, and we are working together very well I think to address a difficult situation.

Mr. CASTLE. Well, I would agree with you. I think probably everyone in this room would agree with you on GSE reform. I hope you will carry that same message to the Senate, too. We think that is vitally important. And I would agree with you that we do need to work on some of these regulatory systems. But can you give me some sense of what you think the timing may be? I don't see that happening this year, either in Congress or by outside regulatory

procedures. But do you have some sense of what the timing may be on the centralizing of regulation as encapsulated in what you have been stating? Is this something you would expect to happen next year, or would it take 3 to 5 years to do this?

Secretary PAULSON. Well, yes. I think maybe I should have even been clearer on this. In terms of—when we started thinking about regulatory structure, we began the thinking before this period of market turmoil, well before this. And we started off saying, if we were beginning from scratch, which we obviously aren't, how would you design a system? And that was more of a vision to start a discussion. And to me, to get to there, as the Chairman said, would take a good while. We are talking about multiple years. But if you don't know which way you would like to head, you know, you have no chance of getting there.

So we started with that vision, and then we came up with some immediate priorities and some other things that could be done in the intermediate term. And as I look at what can be done in terms of the timing the one thing we are not talking about a lot here, but I do believe we don't want to forget, is the fact that a lot of this problem came about as a result of sloppy and lax mortgage origination procedures. These mortgages were originated, most—many cases at the State level with State regulation and supervision. We weren't proposing doing away with this, but a mortgage origination commission to set standards at the Federal level and evaluate what's going on, you know, at the States, I think is something you shouldn't lose sight of.

And then the things we have talked about here that can be done quickly are the resolution authorities for complex financial institutions that aren't federally insured, giving the Federal Reserve authority and responsibility over the payment systems, which can be done very quickly; moving to have the Fed while retaining their responsibilities as a consolidated regulator, to give them the authorities they need to do the macro stability job, can be done.

And then, looking out a little bit further, there is no doubt that we should have a merger, in my mind, with the SEC and the CFTC. And so that again is something that can be done in the intermediate term, as could an optional Federal charter for insurance.

The CHAIRMAN. The gentlewoman from California.

Ms. WATERS. Thank you very much, Mr. Chairman. I would like to thank you first for holding this very important hearing today, and I would like to thank both Secretary Paulson and Chairman Bernanke for being here today.

Let me start by saying that which you have probably heard too often, how disappointed I am with all of us, Members of Congress, for what appears to have been weak oversight of our regulatory agencies, and our regulatory agencies for what appears to have been weak oversight of our financial institutions.

I have to tell you, I have been holding hearings throughout the country on the subprime meltdown, and I'm absolutely stunned by the extent of the devastation to some of our families and communities caused by this subprime meltdown. I'm stunned when I hear about these exotic products and how they could ever have come into being without any oversight.

I'm really stunned about some of the ARMs and the way that they reset, and the fact that there's something called a margin that I never knew about before, and that margin can be whatever the financial institution decides it should be, above and beyond the going interest rate.

I came on this committee right after the S&L scandal, and I heard a lot about reform. And so while I suppose I should be impressed with the fact that there's a President's Working Group on Financial Markets and the reports that have been issued, I'm skeptical about what is being proposed. As it said in March, the President's Working Group on Financial Markets issued a report and recommendations for addressing the weaknesses revealed by recent events, both at the international level—between the two reports—and at the domestic level, between the two reports, focused on a number of specific problems, including mortgage lending practices and their oversight, risk management and management at large financial institutions.

And then there was, Mr. Bernanke, the Blueprint that you talked about for a modernized financial regulatory structure, and you proposed a new regulatory architecture, and the third regulatory agency would be focused on protecting consumers and investors. I have to tell you, I'm surprised, because I thought that our regulatory agencies, no matter how they were organized, whether it was by financial institution category or not, had as its prime objective, all of those things that you talk about doing now.

So what I really want to know is not so much what you plan that may not be instituted for some time, because it takes some time to get this into practice, I want to know what you're doing now. I want to know what you know about servicers. We have found that there's little if any regulation of mortgage servicers.

And I want to know if you have anything in your plans to deal with them, because after we get finished with all of the President's HOPE NOW program and the money that we are giving to NeighborWorks and other organizations to do counseling, they can't do very much good, because the servicers are the ones who make the decisions.

They're the ones that are in charge of these accounts. They decide to collect—well, they have to collect the fees, they have to collect the mortgage payment. They increase fees. They agree to extend or modify arrangement, but they can do practically whatever they want. I want to know what you know about them, what you're doing about them.

And secondly, I want to know and understand Mr. Bernanke, what you know about the sale of Countrywide to Bank of America. I understand that Bank of America bought these mortgages at quite a reduced rate. And I want to know what that rate was and whether or not these properties could go back on the market appraised at a higher rate than the bank purchased them for, and who gets the profit and the difference, and why can't that go back to the homeowners who are losing their homes through foreclosure. First, I would like to hear from Secretary Paulson.

Secretary PAULSON. Well, first of all, I understand your frustration, and I understand what's going on right now in the market-

place, how it's affecting homeowners, and I feel your frustration and I understand it.

Now—

Ms. WATERS. Mortgage servicers.

Secretary PAULSON. In terms of market servicers, the HOPE NOW Alliance is, I believe, making a big difference and making a difference every single month. It is helping 200,000 people a month. And it is getting to those people, and as far as I can see, Congresswoman Waters, and I look at this data all the time, and the standard I use is this: Are there people who can afford to stay in their homes, who want to stay in their homes but are being forced into foreclosure?

Very sadly, there have been people who have been put in homes who didn't have the ability to stay in the homes and to afford to stay in the homes, and there are others who were speculators and walked away from mortgages. So what we have done, this HOPE NOW Alliance is again focused on getting to people and making a difference. And I think the servicers are making a difference.

Ms. WATERS. I'm sorry. I really do need to ask a question about mortgage servicers.

The CHAIRMAN. We can't ask another question. We are over time. We have a time problem. Mr. Chairman, do you want to answer?

Mr. BERNANKE. I would like to briefly answer, yes. I said a few things. On consumer protection, about a year ago I testified before this committee and said that the Federal Reserve was going to take significant action on protection for high-cost loans. On Monday we will announce the final rules, and I think they will be very effective in addressing some of these issues.

Admittedly, it would be better if it had been earlier, but we have responded and you'll soon see the proposal or the rules that we are going to be issuing with respect to consumer protection. We are also of course working on rules with respect to credit cards as well.

On foreclosure avoidance, again, HOPE NOW has been taking a leadership role. The Federal Reserve has been supporting that in various ways, including urging banks to work with customers in trouble and through a variety of neighborhood activities through our reserve banks around the country, which I would be happy to provide more information about.

And finally, on Countrywide, of course that was a market transaction. The Fed had nothing to do with it, and the discounts related to the probability that some of those loans would go into default. I do think that in a sense some of those savings ought to pass through to the ultimate borrowers. And in a sense, when there's a principal writedown or other loan modification that is essentially what is happening, that you're giving a break to the borrower so the borrower can stay in the home, and I think that's a good thing to do.

The CHAIRMAN. Let me ask, Mr. Secretary, that you respond in writing, particularly because of our time constraints, on the servicer issue.

Secretary PAULSON. Yes, I look forward to doing that.

The CHAIRMAN. So I would ask that you respond in writing to the servicer part of the question. The gentleman from California.

Mr. ROYCE. Thank you, Mr. Chairman. I want to thank you, Secretary Paulson and Chairman Bernanke, for being with us, and I want to begin with a question to Secretary Paulson. And Chairman Bernanke, you might want to comment on this, too.

There was a speech delivered by the Federal Reserve Chairman, former Fed Chairman Alan Greenspan, to the Federal Reserve Bank of Chicago in May of 2005. And he said, "Market participants usually have strong incentives to monitor and control the risks they assume in choosing to deal with particular counterparties. In essence, prudential regulation is supplied by the market through counterparty evaluation and monitoring rather than by the authorities. Such private prudential regulation can be impaired, indeed even displaced," said Greenspan, "if some counterparties assume that government regulators obviate private prudence. We regulators are often perceived as constraining excessive risk-taking more effectively than is demonstrably possible in practice, except where market discipline is undermined by moral hazard, for example, because of federal guarantees of private debt, private regulation generally has proved far better at constraining excessive risk taking than has government regulation."

And more recently, Jeffrey Lacker, the president of the Federal Reserve Bank of Richmond, and he said—he got into details about the need for regulators to distinguish between fundamental and nonfundamental runs on financial institutions when considering intervention by the regulators. And he said, "There are models in which runs are self-fulfilling prophesies, are costly, and could be avoided perhaps through central bank intervention. Other runs arise from fundamental developments, and for these, central bank intervention interference with market discipline distorts market prices."

And so I would ask you both if it is possible to establish a regulatory model that can provide a sense of security to prevent self-fulfilling prophesies, to use, you know, Jeffrey Lacker's words, with respect to runs on our financial institutions, and at the same time avoid interfering with the type of market discipline that Mr. Greenspan believes is so critical to the health of our capital markets.

And if I could start with you, Secretary Paulson.

Secretary PAULSON. I believe that is really the trick. That's what needs to be done, to have the right balance between market stability, you know, the regulatory piece, and market discipline. That is critical. And a well-balanced, healthy system over time is going to need that.

And what I have said, and what I tried to say today is that right now we are going through a period of unusual turmoil. The focus on all of our parts is on market stability. That's what the focus is. But our system will never be what it should be unless we can get to the point where market discipline plays its necessary role. And in order to get there, I want to emphasize what Ben Bernanke said.

We need to do some things to strengthen the infrastructure we have, the over-the-counter derivative market, the tri-party repossession market, and that which is secured financing between institutions, and we need to do that so that the appearance and the reality that institutions are too interconnected to fail no longer exists, and we are going to need broader emergency authorities for

the resolution or wind-down of complex financial institutions that don't have Federal deposit insurance.

But that's where we need to get. That is what we have to drive toward, but let's not forget today our institutions have been doing the things they need to do, shoring up their liquidity, their capital, and our emphasis is on stability today.

Mr. ROYCE. Thank you, Secretary Paulson. Chairman Bernanke, if you could respond.

Mr. BERNANKE. I would like to. Thank you. First of all, I agree absolutely that market discipline is the heart of our system. Avoiding the moral hazard, having strong market discipline makes the system work better, and an example would be the counterparty discipline between the banks, investment banks, and the hedge funds, has protected the banks and the banks and the investment banks from any losses from hedge funds. There have been no material losses to banks or investment banks because of failing hedge funds, and because the banks have been doing due diligence, and that's what we want to see.

Now in my view, our action to address the Bear Stearns situation was necessary, given the financial conditions at the time, but it's absolutely correct, as President Lacker has pointed out, it does raise moral hazard concerns going forward, and then the question is how do you address those.

In my remarks today, I listed three possible approaches or complementary approaches. The first is supervisory oversight of those institutions to make sure that they are in fact doing what they need to do to be safe and sound, are not taking advantage of the implicit backstop. So since we have gone into the investment banks, they have all raised their liquidity, not reduced it. So that is one way to ensure that the moral hazard is minimized.

Second, as Secretary Paulson mentioned, if we can strengthen our infrastructure sufficiently so that it could absorb the failure of a large firm—we felt it wasn't able to do so in March. But if it were clearer that the system could withstand the failure of a firm of Bear Stearns' size, then we would be much more comfortable letting it happen, because we would think the system would be preserved.

And finally, I think that, as has happened in the commercial banking world, we do have stronger resolution procedures that would allow us to intervene in an early stage perhaps and to try to create an orderly process that doesn't create the market externalities at the same time it would avoid moral hazard because the equity holders, the management and subordinate debt holders would all be subjected to losses in that process.

The CHAIRMAN. The gentleman from Alabama had a unanimous consent request.

Mr. BACHUS. Thank you. Mr. Chairman, I would like to ask for unanimous consent to submit for the record Secretary Paulson's speech in London on July 2nd on market discipline.

The CHAIRMAN. Without objection, the speech will be made a part of the record, and the gentlewoman from New York is recognized for 5 minutes.

Mrs. MALONEY. Welcome, and thank you for your service. I want to give a very special welcome to Secretary Paulson who previously

was a business and civic leader in the great City of New York, and it is reassuring to me and many Americans that someone who has deep experience in the day-to-day operation of financial markets is at the helm of Treasury and really initiating this conversation and discussion today.

I also want to welcome Chairman Bernanke, who has brought the Fed to fully realize its role, not only managing monetary policy and guarding the safety and soundness of our financial institutions, but also focusing on curbing unfair and deceptive practices that have hurt working Americans and our overall economy. Next week we look forward and congratulate you on your new regulations to shore up mortgage lending, and I enthusiastically support your proposed role to eliminate abusive practices in credit cards.

I would like to follow up on my colleague's questioning on market discipline and ask Secretary Paulson, who has a great deal of experience in this area. It's clear from recent events that many expected synergies of financial service activities, whatever benefits that they gave during times of economic prosperity, gave rise to conflicts and excessive risk taking. It appears that many firms are in so many lines of businesses that conflicts and excessive risk arise.

Huge trading operations have also put more mundane activities of financial institutions at risk. For example, some have said Bear Stearns' trading operation may have caused risk to its clearing operations. And in view of these recent events and challenges, some have said that the repeal and deregulation of Glass-Steagal may have gone too far.

And I would like to ask, would a financial service industry where banks, hedge funds, investment banks, and other entities were more limited to the array of business they are in help the situation by providing competitive and arm's-length checks and balances on financial activities through the marketplace? And would a more diversified financial service industry that had more specialization and less concentration offer any benefits in reducing risk and the need for regulation?

Secretary PAULSON. Congresswoman Maloney, that's an important question. There is no doubt that our financial system has grown. It has become much more complex. We have seen a complexity of financial instruments, and a lot has taken place between the last stress we had in the market in 1998 and this current period. And so we are seeing how a number of these institutions and securities are performing under stress for the first time.

I do agree with you that large, complex financial institutions are difficult to manage. So I agree with you there. I would also say, though, that a lot of the diversity in our financial system, and Chairman Bernanke commented about it, you know, the so-called hedge funds where people were saying is that going to be a major problem? And yet those risks, so far we have managed through those pretty well.

I believe that the biggest problems we are dealing with is not the diversification of these organizations but it is the amount of risk that was taken on, and the amount of leverage, much greater than was understood, because a lot of it was taken on through complex

products that were difficult to understand. And that's why it's taking so long to work through this.

So I believe the big part of the answer here is going to be the de-leveraging and going forward enhancing liquidity practices, risk management practices, and getting our arms around some of these complex products.

Mrs. MALONEY. Thank you. My time has expired. Unless you would like to—

The CHAIRMAN. You cut yourself off, but did you want a response from the Chairman?

Mrs. MALONEY. Absolutely, if time permits. If time permits, Mr. Chairman.

The CHAIRMAN. Well, the rule is that no member can ask questions after their 5 minutes is up, but if there is a question pending, we will take it.

Mr. BERNANKE. Just very quickly, Congresswoman. I think Gramm-Leach-Bliley has some definite positives in terms of diversification, complementary services and the like has created very, very big firms. One of the things that the various reports from the PWG and the FSF have highlighted is that firms did not do a good enough job of firmwide risk management. They looked at individual business lines and not the firm as a whole. That's a critical step for them to be doing. We are encouraging that. And we are also trying to do a better job of our consolidated supervision whereby we focus not just on the holding company but we make sure that we interact more intensively with the functional regulators of the subsidiaries or the affiliates.

So I don't think the system is broken, but it does need some improvement in execution.

Mrs. MALONEY. Thank you very much.

The CHAIRMAN. The gentleman from Texas.

Dr. PAUL. Thank you, Mr. Chairman. And welcome, Secretary Paulson and Chairman Bernanke. I'm delighted the two of you are here today because I might just get to the bottom of the question I have been asking for many years, which is, who is in charge of the dollar? Because sometimes when I ask the Fed, I get referred to the Treasury and vice versa, but maybe I can get a better answer today.

I do want to acknowledge the gentleman from New Jersey, Mr. Garrett, for playing a part in bringing these hearings about, and also Chairman Frank for having these hearings because I deeply appreciate it.

But I would like to take a minute to just challenge something he said during his questioning, because he made the flat statement that there was no alternative to the Federal Reserve system. I don't want to take my time to explain the alternative, but maybe later on, Chairman Frank and I can talk and I can explain to him what an alternative might be.

The CHAIRMAN. That's not very likely.

[Laughter]

Dr. PAUL. But anyway, I would like to pursue the theme of the day, and that has to do with systemic risk. And there's a lot of talk about systemic risk and also taken in the context of market discipline. But, you know—and we are talking so much about more

regulations. And quite frankly, I think we should have a lot more regulations, but I think we should have market regulations.

I would like to see a lot more regulations on the government and on the Federal Reserve, because I think it's the ability of the government, through regulatory agencies as well as the Federal Reserve, to disrupt markets and destroy market discipline. That is where I think our problem lies.

When Enron failed, we immediately said, well, it must have happened because we didn't have enough regulation, so Congress immediately responded by passing Sarbanes-Oxley. It hasn't exactly helped our markets. You know, our markets today, almost every index of the market today is where it was 8 to 9 years ago, and that's not taking into consideration inflation, the devaluation of the dollar. So the markets are in severe trouble. They are very dysfunctional.

But the real question is, why are they in such disarray? And of course I maintain that they're in disarray because our monetary policy disrupts the markets because we create interest rates below market rates. Right now the money is free to the banks. They can borrow money at 2 percent. Real inflation is 10 or 12 percent.

And we wonder why there are disruptions when you have artificially low interest rates, you cause the malinvestment, you cause excessive debt to accumulate, and you cause the bubbles to burst. And then when they burst, the only thing we can come back for is more regulations and more inflation, we need lower interest rates, we need to print more money.

But it is back to this basic fundamental problem that we think that we can compensate for lack of savings by creating money out of thin air, and it doesn't work. It has never worked throughout history, it's not going to work this time, and we can't bail ourselves out by more regulations and more monetary inflation. And that is where we are today.

I think the IMF is correct in this circumstance. They say we are in worse shape than since the Depression. And yet our government tells us there's not even a recession. This is utterly amazing. Ask the American people. Our government tells us inflation is 4 percent. Nobody believes that. I mean, just look at the cost of energy. So we have to someday get back to the fundamentals of what is a dollar, where do they come from, and who's in charge of the dollar.

So my question is directed to Secretary Paulson dealing with the dollar, because evidently he is the spokesman and he is the champion of the dollar, and all public statements are that the dollar is to be strong. Well, the dollar lost 20 percent in the last 2 years. In the last 3 years, we have created $4 trillion of new dollars. But when we go to China, we tell the Chinese we want a weak dollar.

I would like to see if I can get the Secretary of the Treasury to explain this to me. Do we want a weak dollar or a strong dollar, and why don't we worry about the value of our dollar?

Secretary PAULSON. Congressman, we want a strong dollar. And what I have said is, a strong dollar is in our Nation's interest, and I think you and I agree on that, at least I think we do. And I have had a career in the financial markets, and that has taught me that a strong dollar is in our Nation's interest.

Now as I look at what's going on in our economy, and we are going to have some ups and downs. Every economy does. We are going through a tough period right now. But I travel around the world, and I don't see a major industrial nation that has better long-term fundamentals than we do. I don't see a major industrial nation that I believe is going to perform better over the long term in their economy than ours will.

And so what I say is, I believe these long-term fundamentals are going to be reflected in the value of our currency. And what we need to do is to have policies that are going to enhance confidence in our economy. And to me, those polices are pro-growth policies, they are continuing to advocate for trade, for open investment.

Now in terms of China and the renminbi, what I believe in, Congressman, are markets, and I think it is a—there are many countries around the world that don't have market-determined currencies. There's no country as big as China and as integrated as they are into the global economy in terms of goods and services. And so in some ways, it's an unnatural act.

And they are not ready yet to have a market-determined currency, but we are encouraging them to move in that direction and move more quickly in that direction, because that will be a key also to their continued development and economic progress, which is important to all of us. Because contrary to what some people may believe, we will benefit if China continues to grow and has a healthy economy.

The CHAIRMAN. Mr. Secretary, I'm going to cut you off because I received a letter, let me just say, from the ranking member of the full committee and the ranking member of the Domestic and International Monetary Policy Subcommittee asking for a hearing on what is being done by you two gentleman—the letter suggested not enough—to protect our currency, and particularly to focus on its relationship to oil prices. I have instructed the staff to schedule such a hearing.

So the request that the minority has made for that hearing is going to go forward. We hope to have it—you know, we will have it before we break in August, and we can get further conversations on that.

Dr. PAUL. I appreciate that very much.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. I want to get back to the framework, the model that Secretary Paulson—I'm over here, I know you are looking for me—has outlined, the three primary regulators. And you—I don't understand it, or I have some concerns about it.

Maybe you can help me understand it. And maybe that will address my concerns. But three areas you outlined: A regulator focused on market stability across the entire financial sector; another focused on safety and soundness of institutions supported by Federal guarantee; and a third focused on protecting consumers and investors.

The first concern I have is that the third one, the one focused on consumers and investors, will be the redheaded stepchild. And the discussions, all of the discussions we have had this morning suggest that because there had been very little discussion of the consumer and investor side.

But I want to set that one aside, because I don't want to spend my 5 minutes talking about my concern about it. I do have that concern and I want you to know it.

If we had a regulator that is solely focusing on consumers and investors, I think it will be so marginalized that it will—it will in effect, be a third powerful regulator rather than a one or two, or equivalent—equal player in the process. But let me make sure I understand the other two, because I don't understand what falls into the second category for example, the one focused on safety and soundness of institutions supported by a Federal guarantee.

Either you are acknowledging the implicit guarantee that we apply to Fannie and Freddie, or you are talking about something else. What are the institutions that would fall, in your model, under that second regulator, the current institutions that you are talking about?

Secretary PAULSON. Yes, Congressman, those are institutions that have Federal insurance or guaranteed insurance.

Mr. WATT. Okay. You are talking about—are you talking about flood insurance, for example?

Secretary PAULSON. Well, it could be. You could have an insurance—

Mr. WATT. Okay. Just give me a couple of examples of who you are talking about.

Secretary PAULSON. The banks. The depository insurance.

Mr. WATT. Okay.

Secretary PAULSON. But again, I want to say something—

Mr. WATT. So that—would that take the portfolio of the OCC?

Secretary PAULSON. Yes, exactly.

Mr. WATT. The credit union regulator.

Secretary PAULSON. Right.

Mr. WATT. So that would be a conglomerate of the existing regulators—

Secretary PAULSON. Right.

Mr. WATT. —but we don't provide a guarantee to credit unions, do we?

Secretary PAULSON. Well, whether there is—what this would do—this would be a charter that would go for every banking institution where there is any kind of Federal deposit insurance, where the depositors have insurance.

Mr. WATT. Okay. But you still have a bunch of entities, financial entities that are left out of that category. And I didn't see them pick up in the first category, because when you all started talking about market stability across the entire financial sector, I assumed that is an expansion of the Federal Reserve's authority now.

But there are some institutions here that are still left out of this equation. And I don't know where they go in these three tranches that you are giving us in this model.

Secretary PAULSON. Are you—let me begin by saying this model is sort of an optimum long-term model to start the discussion. Now I am going to start for the life of me—

Mr. WATT. But you have to get all of your—

Secretary PAULSON. I will—

Mr. WATT. —institutions into the model.

Secretary PAULSON. You are right.

Mr. WATT. Okay.

Secretary PAULSON. Here is what we will do. And let me begin by saying in terms of regulation by objectives, it escapes my imagination how anyone could believe if you—if you had an institution just focused, not divided—just focused on protecting investors and investor protection how somehow whether that would be a weaker institution—one misguided, divided focus.

So again, I believe if you have to have a focus, that would be very strong. Secondly, what we do is in the optimum model—what we do is we say we are not going to have regulatory competition. We will have one charter.

So there will be a charter for every institution, whether it's—I think you are driving at credit unions, whatever it is. And we say specifically, we would not get into business model.

So if there is a cooperative that would be fine. I very much appreciate what credit unions do. If they are community-based, they would have a tax-exempt status.

So again, in the optimum model, and that would be a long time before you get there, we wouldn't do anything in the immediate term. But in the optimum model, you would have one charter for institutions that do the same thing.

You wouldn't have regulatory competition. There would be a level playing field in terms of that. But we wouldn't pre-judge ownership. You could still have cooperative, community-based.

And you could still have tax exemptions that went along with that ownership model. So again, this was—and in the intermediate term, there would be a number of things we would do. But again, it wouldn't impact their credit unions.

The CHAIRMAN. The gentlewoman from Illinois.

Mrs. BIGGERT. Thank you, Mr. Chairman. Chairman Bernanke, I think that you announced on July 8th, this past Tuesday, that you were considering extending the term of the primary dealer credit facility.

I think that Federal Reserve Governor Kevin Warsh has said that the Federal supplied liquidity is a poor substitute for a private sector supplied liquidity. And that the Fed-provided liquidity should not be mistaken for capital.

Do you think that extending the term of the PDCF would make the credit markets even more dependent on continued support from the Federal Reserve?

Mr. BERNANKE. Congresswoman, you are correct. We are considering extending the PDCF. If we extend it, it will be based on the judgement that unusual and exigent circumstances still prevail in financial markets.

And that by withdrawing that facility, we might evoke a severe reaction in the markets. It's true that—I mean two comments about dependency: One is, of course, that barring any change in rules, that this is a self-limiting facility, because it's only legally allowed so long as there is a set of unusual and exigent circumstances.

So at some point we would have to phase it out when we felt that the system had sufficiently recovered. The other point I would make is that even as we take steps like this to support the financial markets and help improve their functioning, we are simulta-

neously on a track to try to strengthen the financial system and reduce the need for these kinds of facilities.

So I mentioned again in my testimony, the necessary supervision, the strength in the infrastructure, the resolution regime. Those are the kinds of things—improved oversight. Those are the kinds of things that would make the PDCF less necessary over time.

And therefore I think those two things should go together to support the improved function of financial markets and to make such facilities less and less necessary.

Mrs. BIGGERT. I guess I was concerned because you said that if current unusual circumstances continue to prevail. So did you think that if it were right now that you would want to extend that—condition such?

Mr. BERNANKE. Well, we have already—in March, when we instituted this, we set a target essentially of 6 months into September. And I don't think there is justification at this point for removing it.

The markets remain quite strained, particularly the dealer funding markets and other markets where this was particularly focused. So I don't think that moving at this point would be a good idea.

What we are considering in this issue is—at this juncture is whether the circumstances warrant an extension. And how to structure that.

Mrs. BIGGERT. Thank you. Secretary Paulson, we have been talking about all the things that need to be done. What is the most pressing priority that needs to be addressed to ensure that our markets remain stable?

Secretary PAULSON. I wish I could tell you one thing, but there isn't a silver bullet. If there was, and we knew how to address it right now, we would. And what is going on now as I said earlier, is it's just taking us a good while because there is much more leverage than was—what was once healthier—much more leverage than was perceived to be the case.

And it was in the form of financial products. And then many of which were complex. There has been recorded progress made. It hasn't been in a straight line, but the progress I would site has been the risk reduction, the de-leveraging, the things that the Chairman has cited, in terms of increased liquidity and management, funding management by the investment banks, the capital that has been raised, being raised.

But I believe part of this of course, is confidence. And having been through periods like this, they always are the worst until they are resolved. And before they are resolved, you wonder how they ever are going to be resolved.

But confidence has a way of returning to the markets. And over time there have been many investors, wise investors, that have come in during times of great risk, adversity, and made investments and have made money on those investments.

I think one of the key things is going to be when you start to see, and we are seeing some, more of these hard-to-sell assets changing hands and private money coming into the markets. But meanwhile, we have, all of us, some real work to do.

The CHAIRMAN. The gentleman from Kansas.

Mr. MOORE OF KANSAS. Thank you Mr. Chairman, for having this meeting. My questions are for both Secretary Paulson and Chairman Bernanke.

For the past several years, the Treasury and the Federal Reserve have argued that the housing GSE's pose systemic risk to the financial system, and that they were a likely source of the next financial crisis. I agree that we should pass legislation that will give the GSE's a strong, new independent regulator.

Do you agree that the GSE's have played a constructive role in trying to stabilize the markets?

Secretary PAULSON. As I said, I believe that GSE's have played a constructive role, and that they are playing a very important and vital role right now. They touch 70 percent of the mortgages that are made in this country.

And so they are a very important part of our economy, a very important part of our housing market. And they are an important part now, and they are going to be an important part in the future.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman.

Mr. BERNANKE. I agree that the GSE's are playing a critical role there at this point, a very big part of the existing mortgage market.

I think they could do an even better job if they were better supervised and better capitalized. With respect to supervision, I support the call for a GSE reform that has been discussed.

With respect to capitalization, I believe that they are well capitalized now in the sense of—in an inventory sense. But I think as we have called upon all financial institutions to expand their capital bases so that they can be even more proactive in providing credit and support for the economy.

So I would include the GSE's in that broad call for increased capital.

Mr. MOORE OF KANSAS. Thank you, and one follow-up question: Do you still believe the GSE's pose a systemic risk to the economy? And if so, how does that risk compare with the risks that have come to light with our current gaps in regulatory oversight that have in part led to the current crisis?

Secretary PAULSON. I would say Congressman, in today's world I don't think it is helpful to speculate about any financial institution and systemic risk. I am dealing with the here and now, and the important role that they are playing, and other financial institutions are playing.

Mr. MOORE OF KANSAS. Thank you, sir. Mr. Chairman, do you have anything to add to that?

Mr. BERNANKE. No.

Mr. MOORE OF KANSAS. Thank you.

The CHAIRMAN. The gentleman from Connecticut.

Mr. SHAYS. Thank you both for being here and for your service. And I want to say before I ask a question that I am very proud of being on this committee and I appreciate the work that our chairman does and our ranking member.

This is the one area in Congress, where I think surprisingly we see less politics and a real interest in trying to do what is right for our country. I am deeply concerned obviously, as everyone else is, about energy and the incredibly high cost of oil.

I am surprised that it has only resulted in a 4-percent increase in inflation. And I want to know if there is just a lag, and if next we are going to see inflation at 5, 6, or 7 percent.

It is hard for me to imagine that we won't. I also have found myself altering what I say. I say we need to be energy independent, and we are. And I was rightfully correct in we are energy independent as it relates to natural gases, it relates to hydropower and coal in a sense.

These are homegrown. And Europe doesn't have these resources. We have a competitive advantage as it relates to energy, ironically in spite of our big gap in oil. And I am being told that because energy is becoming such a high price—in other words, our electric power is much less—our production costs are much less as it relates to energy.

That energy is now beginning to trump labor costs. And that we have reason to believe that we might see a renewal in manufacturing, because of the advantage that we have over many countries over energy.

So one, I would like to know about the impact of energy on inflation, not just this year but the next. And I would like you to comment on do we have a comparative advantage on the energy sector that we could start to see benefiting this country.

Also related to obviously, the value of the dollar and what exports advantage—the advantage we have on exporting. I would like both of you to answer.

Mr. BERNANKE. Let me start, Congressman. First of all, it does take a bit of time for the oil price increases to feed through to the consumer. So when oil prices go up, it takes a bit of time before it shows up at the pump.

And so over the next couple of months, we would expect to see the headline inflation rate rising, reflecting that. Once that impulse has passed through, if oil prices stabilize, even at the current level, then you would expect to see inflation come back down.

But of course, that is an uncertainty at this juncture. I don't think we have a strong comparative advantage. We have been—in energy—we do produce certain kinds of energy. But we are less energy efficient than some countries.

We have less alternatives than some countries. So I think it's very important—one of the benefits of a high price of oil—the—cost of course, but there is at least one benefit, which is it generates incentives for development of alternative forms of energy for conservation, and even for exploration and development of oil.

So we need to allow that process to work. I think it will help us develop the energy, not necessarily independence, but less vulnerability to energy prices than we currently have.

Secretary PAULSON. I don't, Congressman, have much to add to that. There are some parts of our economy where we are maybe more efficient than some others when it comes to using oil, like for instance—

Mr. SHAYS. We are not talking about oil, that is the difference. Our electric generation is coal, hydro—

Secretary PAULSON. Right.

Mr. SHAYS. —it's nuclear. And it's homegrown. And it's less expensive than in almost any other part of the world. And there are

people coming to me now saying that we have this competitive advantage, now that you see energy costs continue to climb.

So the bottom line is this is not something you all have thought about, I am gathering.

Secretary PAULSON. Well, I would say this, I have thought about it. And as I look at energy and power around the world, there are obviously some countries that aren't nearly as efficient as we are, in some of the developing countries aren't nearly as efficient.

Although I can tell you—in our automotive sector, you know that's oil, we rank up there with the inefficient. But the—we are—I again believe that the challenge here for us is going to be continued investment in new technologies and alternative sources of—

Mr. SHAYS. Before the red right light goes on, let me just say I believe absolutely that there are going to be alternative sources of energy that are going to move us along in the long term. But we have short-term needs. Thank you.

Secretary PAULSON. Yes, I agree with that.

The CHAIRMAN. The gentleman from Texas.

Mr. HINOJOSA. Thank you, Mr. Chairman. I also want to thank both of you for coming to our committee, and giving us an opportunity to better understand the problems that we are facing in financial markets.

My first question is directed to Secretary Paulson. And I want to say that there are people coming to my office, as the chairman of the Higher Education Subcommittee, and expressing their problems about accessibility and affordability of higher education. And they go directly into asking for relief to college student loan providers.

They talked to us about 3 or 4 months ago about lacking liquidity. And so the Committee on Education went on and passed some legislation that would give them some relief, as you mentioned earlier in your comments about your Department being a lender of last resort.

Secretary PAULSON. The Department of Education is a lender of last resort.

Mr. HINOJOSA. We talked about both the Treasury being involved,—

Secretary PAULSON. Right.

Mr. HINOJOSA. —and that the—as secretary—

Secretary PAULSON. Right.

Mr. HINOJOSA. —be that lender of last resort. But it's not working. And this week, we have had representatives of companies, entities that are not-for-profit, including COSTEP of South Texas and the Panhandle Plains Higher Education Authority. The third one was the Razos Higher Education Service Corporation, all saying that they need for us to be aware that some of their lenders are no longer wanting to participate.

And an example is this COSTEP memorandum that says, "It is with the deepest regret that I have to announce that effective July 1, 2008, Texas State Bank Trustees for COSTEP will suspend making new Federal Family Education Loan Program loans." And they go on to explain why.

Secretary PAULSON. Let me first of all say that this is a very important area. It is critically important that students receive loans.

And that the Treasury Department is doing everything we can to work with the Department of Education to address the need. That's the first thing.

The second thing I will say is let's make a distinction between certain lenders that don't participate and whether or not students are getting loans, because I think the key question for all of us is are the students going to get the loans they need to attend college?

And what the program, and we very much appreciate in that Congress gave to the Department of Education and the programs that have been put in place to get us through this period. The first part of the program was government buying loans you know, that originated by these—by these financial services firms.

And most of the failed lenders are participating in that program. Some aren't, but most are. And most are participating at a level where they will be able to make money and students will have loans. And as I have said, if to the extent that just to be sure the Department of Education has greatly expanded it's resources, ready to do—get involved with direct loans, lender of last resort.

And the other thing we are doing at Treasury is working to develop market-based solutions to help further make this market more robust, because it's not ideal but I think the thing that will really get my attention is if you come to me and say, "Here is a student who qualifies and can't get a loan."

I think that is our first priority, to make sure students get loans, and do what we can to get this market up and going again.

Mr. HINOJOSA. All I can tell you is that when you get—the university is also coming in to see me and talking about the barriers such as the one that is explained in this note here. In order to participate in the Loan Participation Purchase Program, the eligible lender must certify they—participation interest in front loans to the Department of Education with an aggregate balance of not less than $50 million.

And so that eliminates companies like these three that I have mentioned, which by the way Mr. Chairman, I ask unanimous consent that they be included in today's—

The CHAIRMAN. Without objection, and the witnesses will respond.

Secretary PAULSON. Yes. And I will—I am sure that Secretary Spellings will be very happy to get back to you with the details with that. But again, and it's regrettable when any of these lenders don't participate.

The program that was designed—hopefully they all would have participated, but some didn't. But again, the key thing is, are students getting the loans? I believe students are going to get loans and attend college, and we are going to meet that need and we are going to keep working on strengthening the market.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. I appreciate you calling this hearing and I appreciate the gentleman from New Jersey for his leadership in calling for this hearing as well.

Chairman Bernanke, I believe the central question really before the committee is should the Federal Government really become the guarantor of last resort, or the lender of last resort to investment banks, not unlike they are commercial banks for the purpose of cre-

ating financial stability within our markets, obviously doing this with taxpayer dollars, given the recent intervention of the Fed by facilitating the Bear Stearns sale, which I am led to believe is the first time in 70 years that the Fed has opened up a discount window to a non-depository institution.

My question is, have investment banks become so big and so interconnected that their bigness and interconnectedness alone now defines systemic risk?

Mr. BERNANKE. There were really three reasons why we took the action we did. One was the actual size of the firm and its implications for the broad financial markets. The second one was the fact that the infrastructure was not strong enough to deal with the implications of the failures in the derivatives markets in triparty repo markets and other areas. And the third was that the existing financial conditions were extremely fragile at the time that we made that decision.

So I think we made the right choice in the sense that it was necessary at that time and in those circumstances to prevent much wider prices in financial markets and I was reminded of the gentleman from Texas asking about student loans. The problem with student loans came directly from the option rate securities market which fell apart because of the financial stresses.

These things directly impact Americans. It is not just a question of Wall Street, it really affects broad based welfare and the economy. So I believe we did the right thing. I would do it again. I think it was necessary to protect the financial system.

I don't want to do it again, and so to avoid doing it again, we want to have things in place that will make it unnecessary, and that includes good supervision and includes strengthening the infrastructure, and it includes other measures to make the financial markets more stable. If we do those things, I hope that such events will be extraordinarily rare, as they have been historically.

Mr. HENSARLING. Mr. Chairman, in another speech, you were quoted as saying, "Under more robust conditions we might have come to a different decision about Bear Stearns." Again, you haven't been at the Fed for 70 years, but this is the most extraordinary remedy.

Looking in the rear view mirror, were there other circumstances that you believe that the Fed should have opened the discount window to non-depository institutions in the past, and by what criteria, what extraordinary criteria will be used under your current authority to do it in the future?

Mr. BERNANKE. Well, there have been many financial crises going back to the 1930's, which was of course was probably the worst of the 20th Century. Each one is different—

Involves, in some way or another, with most of these financial crises, either through, as oversight, as moral exhortation, it is convening power, and we have a wide variety of episodes where the Fed has been involved in trying to mitigate a potential financial crisis.

The Fed always has to make the choice whether or not it needs to intervene to protect the system or whether the system is strong enough to accept a failure, and in some cases the failure shows in the latter. For example, Drexel was allowed to fail because it was

viewed at the time that it would not bring down the whole system and that was the correct assessment.

So I think it is a very rare thing to do. This particular confluence of circumstances has not occurred in the past and these were the powers that we had available to try and address this problem.

Again, I share your concerns. This is not something I want to do again, it is not something I really wanted to do in the first place, and I hope that the Congress can work with us to develop a set of regulations and rules that will make this unnecessary in the future.

Mr. HENSARLING. Mr. Chairman, you alluded to the 1930's and obviously the Great Depression. Now those who seem to have an abiding faith in regulators and regulation, I know you have studied the Great Depression, can not a case be made that frankly we had very bad regulation that helped turn a garden variety recession into the Great Depression, including the Fed allowing the money supply to contract dramatically, protectionism in a trade war brought about by Taft/Hartley and the prohibition of nationwide branch banking?

Mr. BERNANKE. All those things were relevant but another thing that was quite relevant was that the Federal Reserve did not follow through on its responsibility to try to stem the bank failures, and the continuation of bank failures over a number of years contributed to the decline in the money supply and to the contraction of credit and was a major source of the Depression. So it was exactly the failure of the Fed to act in the early 1930's that made the situation as bad as it was.

Mr. HENSARLING. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Massachusetts.

Mr. LYNCH. Thank you Mr. Chairman. Mr. Chairman I appreciate you holding this hearing and I want to thank the ranking member as well. I want to thank the Secretary and the Chairman for appearing before us and helping the committee with its work.

I want to go back to a point that was raised earlier, Mr. Secretary, in your response to Ms. Maloney and also I think, Mr. Chairman, you address it at page three of your remarks.

And basically my question is this. A lot of the lack of confidence, I think, in some aspects of our market come from the complexity and the opaqueness of some of these derivatives that we have actually gone back and tried to drill down into the models on which some of these derivatives are actually based. And in some cases they probably stretch from myself to Mr. Hensarling down there.

I am just wondering, is there anything in your proposed reforms that might get at this issue? I mean, some of these derivatives I have to admit, it is just very, very tough to value them or mark them to book as some of my friends in the industry have described it. The credit default swaps that are a huge, huge part of the market out there, these collateral debt obligations, the failure of these risk and recovery models to really predict or to ascertain the value of these things, they are so complex, I honestly believe if we adopted a simple rule that said an investor had to understand these things before they bought them, that this whole market would come to a screeching halt. I honestly believe that, and I am only half joking.

But is there anything that you have proposed that would get at that opaqueness and lack of transparency and complexity? Something that would allow investors to have more confidence? I mean, in some of these cases, and synthetic CDOs, we don't even know where the actual ownership lies. So it is just very, very tough for an investor, especially in difficult times to have confidence in their investment when they can't really determine that on their own.

Secretary PAULSON. I think Congressman, both the Chairman and I spoke about how important it was to make enhancements in the infrastructure and the transparency around credit default swaps and other over the counter derivatives. And I think you heard him say that the New York Fed is driving an effort, or we need to have a clearinghouse, we need more transparency, we need better protocols, I think more standardization. So there is a lot of work being done.

Now I want to also say to you that there is—these contracts have done a lot to make the markets more efficient, and we have gone through periods of time where we have had some major failures, at the time of Enron and so on, and the markets were able to weather it because of the efficiency of these markets. But they clearly need more discipline and stronger infrastructure.

Now there were other things that have been suggested and are being pursued really quite aggressively to deal with this. One is, as you have made the point, investors need to do their work and make sure they understand, and if they don't, then they shouldn't be investing.

And there is a lot of work being done on the part of the rating agencies and Chairman Cox has spoken to that and he has done a lot of good work there in terms of reforming those practices. We at the President's Working Group have suggested that when the rating agencies make their ratings, that they make a differentiation between a rating that goes to a standard corporation or a municipality and one that is a structured, highly structured financial product, maybe they should get a different designation.

So there have been a number of suggestions that have been made, and they are all being pursued. Now it is going to take some time to work through this, but progress is being made here.

Mr. LYNCH. Okay. Mr. Chairman?

The CHAIRMAN. Quickly, Mr. Chairman.

Mr. BERNANKE. I would just say that the Federal Reserve is very much involved in this process to make the post-trade clearing and settlement process, the management of the risks associated with this, the transparency, the standardization, these are all things we are working on, and I elaborated a bit on that in the speech I gave earlier this week, and this is a very high priority for us.

Mr. LYNCH. I look for it. Thank you.

The CHAIRMAN. The gentleman from New Jersey.

Mr. GARRETT. Thank you, Mr. Chairman, and thank you, Chairman Bernanke and Secretary Paulson for your service to the country.

Secretary Paulson, I was very pleased to see your comments on Tuesday regarding covered bonds and how there can be maybe another way to increase the availability and lower the cost of mortgage financing to hopefully get us back to normal home buying in

this country. I agree that covered bonds both in the commercial area and in residential area present a great way to provide more liquidity to the U.S. housing market during this credit crunch.

I have spoken to Chairwoman Baer directly about cover bonds and I know my staff has been in touch over the weeks with your colleagues at the Treasury. And over the last 3 months, I have been working with outside interested parties to see whether we can work together on coming up with legislation to help facilitate covered bonds.

Chairman Bernanke, on this topic I have not heard, maybe you have made a statement, but I have not heard it, do you have position, are you generally in favor or support of Secretary Paulson with regard to helping address the mortgage situation?

Mr. BERNANKE. I do. Like you Congressman, I think it is very important for us to be—here we mean both the regulatory community but also the private sector—looking for new ways to get financing.

Covered bonds are a very successful financing vehicle in Europe, and therefore it is an attractive thing for us to look at here. The FDIC has a rule that is about worked out that will clarify some of the issues associated with the priority of covered bond collateral versus deposit insurance fund. I'm in favor of working in this direction.

I wonder, I think it is not yet known, whether this can be successful without legislation. I think that is a question we want to look into.

Mr. HENSARLING. I look forward to working on this legislation. Turning now to the issue that most of us have talked about so far, the Bear Stearns situation. I had a chart, but I know the numbers are pretty small, but you should be familiar with it because it comes from your own folks on your Web site, it is the Federal Reserve balance sheet as of June 25, 2008.

As I read and others explain, it indicates that there is only roughly $22 billion, generally speaking, of Treasury bills remaining, and the Fed has already exchanged $255 billion, roughly, for a variety of types of private debt, some of which you could question the quality.

Now today the Secretary has made remarks to the need for a new statutory framework and the deal with the unwinding of the situation. I am sure you have seen a number of the articles that talk about this, and the press indicate there are several other brokers out there that might be facing significant problems as well going forward, and you have already indicated you would hate to have to deal with this situation as you had with Bear Stearns in the past.

So, Mr. Chairman, it appears to me that if one of these highly interconnected investment banks were to fail in the near future, the Fed's balance sheet then has limited or no room left on it coupled with there being no legislative framework in place going into this, would the Fed, in essence, have to monetize the situation to bail them out? Would the Fed have to deal with new Treasury paper to bail out the bondholders, which is what really occurred with the Bear Stearns situation, if another situation came?

I have three questions. First, can you assure, and I think I know the answer to this question, but can you assure us that you will not conduct any similar Bear Stearns transaction if another investment bank or a GSE gets in trouble without the prior explicit authorization of Congress via some sort of enabling legislation?

Second, if you decide that there is no alternative than to conduct another bail out or support, however you want to call it, to one of these troubled organizations, will you be willing to monetize the debt to finance such a transaction due to the current limitations on your balance sheet?

And third, your claim that your actions with the Bear Stearns transactions are granted to you under section 13 of the Federal Reserve Act, are there any limitations within that section or elsewhere as to your abilities going forward to deal with these situations?

Mr. BERNANKE. Well, to try to address that range of questions, over the weekend where we were working on the Bear Stearns issue, I was in touch with congressional leaders, kept them informed, and the sense I got was that there was not an objection to pursuing it. I also of course worked very closely with the Treasury and with the SEC and other authorities to develop a consensus for the actions we took, and as I have argued before, they were necessary.

So I don't want to make any commitments. I don't think a situation like this is at all likely, but unless I hear from Congress that I should not be responding to a crisis situation, I think that it is a longstanding role of the central bank to use its lender of last resort facilities to address—

Mr. HENSARLING. The first answer is "yes." The second question then is would you essentially monetize the situation at the—

Mr. BERNANKE. There is not monetization. This is a sterilized operation; there is no effect on the money supply.

And in addition, I would add that our lending, not only to Bear Stearns but more generally to the banks and so on, is not only collateralized with good hair cuts, it is also a recourse to the banks themselves. We have not lost a penny on any of this lending, and it is just lending, we are not purchasing any of it, it goes back to the bank when the term of the loan is over.

Mr. HENSARLING. So there is no limit to the amount.

The CHAIRMAN. No, I'm sorry, no further questions. We were over the 5 minute—

Mr. HENSARLING. Can I get an answer to my last question?

The CHAIRMAN. He can answer, but no further questions from us.

Mr. BERNANKE. It does not affect the money supply. We have plenty of balance sheet room left, so I don't visualize that as a constraint in the near term.

The CHAIRMAN. The gentleman from North Carolina.

Mr. MILLER. Thank you. I have served on this committee for almost 6 years, and I remember the testimony pretty well on mortgage lending, but I have recently gone back and reviewed some of it to see what the lending industry was saying at the time about the kind of mortgage practices that have led to the problem.

And what they have always said was that the provisions of the mortgages that may seem to be a problem, they seem unfavorable

to consumers, actually were risk based, they were responding to a greater risk by certain borrowers, and that without those provisions they would not be able to lend to those borrowers, and those borrowers would be denied credit, would be unable to buy a home, and be unable to borrow against their homes to provide for life's rainy days.

Looking back on the practices that actually led to the problem, the subprime mortgages made in 2005 and 2006, it is pretty clear that those provisions had nothing to do with risk and nothing to do with benefiting consumers or making credit available to them that would otherwise not have been available. It was a fundamental change in consumer lending from making an honest living off the spread to trying to trap consumers, homeowners into a cycle of having to borrow repeatedly and paying penalties and fees when they did, and that the loans were intended to become unpayable for the borrowers, so the borrower would have to borrow again.

Insurance regulation at the State level generally requires that policy forms provisions and policies and premiums be approved in advance by the State regulator, and that the insurer has to justify those provisions. So the kinds of arguments that we heard in this committee that we were not really in a position to judge on a provision by provision basis, a reasonably competent regulator could judge and determine whether that really was related to the risk, whether it really was to the advantage of the consumer, and whether it also presented a solvency issue for an insurer.

Secretary Paulson, the proposed regulator to protect consumers, will that regulator have the authority, should it have the authority, to review consumer lending products in advance to see if the practices can be justified both for what it might do to the solvency of the institution and also what it does to the consumer?

Secretary PAULSON. Well, I would say this, whether it reviews in advance or not, I believe that if we had a regulator that was focused solely, completely on consumer protection and investor protection, it is difficult to imagine we would have had some of the abuses that we have had today.

In terms of, we did not intend when we set out this Blueprint to get involved in exactly what this regulator would do and how it would do it, but if that was the pure focus, there is no doubt that it would be involved there.

I think in the meantime, because that is a long-term vision, the things that we are seeing done by the Fed right now in terms of the HOPE NOW Alliance and in terms of looking at unfair lending practices, it is very, very essential.

And again, in the meantime, I do hope, because I think it is unlikely that anytime soon we are going to supplant the State regulation of mortgage origination, I do encourage you, even if it is in the next Congress, to pick up the idea of this mortgage origination commission which will be able to work with States and evaluate the State programs and do it in a very transparent way, and I think that may help.

Mr. MILLER. Chairman Bernanke, do you think there should be some way to review in advance before they go into widespread use, consumer financial products, to make sure that they are not rapacious to the consumer?

Mr. BERNANKE. Well, to some extent that is happening, in the following sense that first, as Secretary Paulson mentioned, the Federal Reserve is releasing on Monday a new set of rules which will limit the parameters, essentially, of how the mortgage can be constructed, and will eliminate certain kinds of confusing and other practices from the possible contracts.

Second, we are continuing—as we have recently done in credit cards—a very sensitive set of disclosure reviews so that the lender will be required to explain and provide essential information to the borrower. I think we are going to go a long way towards reducing both the predatory aspects of the lending that you were referring to and also what I would just call the bad lending which ended up being losses for the lenders themselves because they had insufficient oversight and care when they made the loans.

In terms of creating a standardized project in advance, I think it is an interesting idea. It would simplify things in some ways, but on the other hand, there are some benefits to having flexibility and innovation in the mortgage market to have different types of mortgages available like shared appreciation mortgages or variable maturity mortgages and so on, so I wouldn't want to take government action to eliminate the possibility of innovation in that market.

The CHAIRMAN. The gentleman from California.

Mr. CAMPBELL. Thank you, Mr. Chairman.

There seems to be general agreement—with which I concur—that we need regulatory restructuring, regulatory reform, and that we want to do it right rather than quickly. However, markets don't wait. If we are waiting until next year, which is I think the implication here in the next Congress, the next President, three-quarters are going to pass at least before we have something in place.

So my question to both of you is, if there were a financial institution that, to use your terms, Secretary Paulson, is either too big or too connected, that we are approaching some failure, some major difficulty, do you currently have the transparency to know in time and the tools to deal with that and/or is there anything we can give you quickly to help with that?

Secretary PAULSON. Let me say what history shows us is that it is very difficulty to predict in advance, and I don't think you're going to be able to reasonably give us any tool right now. So I'm going to just tell you that there is an urgent need. We are not saying take your time, wait. There is an urgent need to get more tools. But I also will tell you that I believe that the focus on market stability and the actions that the Fed has taken, not just in the Bear Stearns episode, but in the follow-up in opening the PDCF to the opening of the diskette window to the investment banks has sent a very strong signal. And the work that the Fed and the SEC has done with these good institutions is a strength in their liquidity management, is, I think, very important. So neither of us are predicting another incident and we are looking at the progress that has been made.

We both would like additional tools. We are not saying take forever, but we recognize the fact that the regulatory structure hasn't been changed in a long time and the fact that we don't have these tools mean that it's not going to be easy. It's going to need to be thought through and the sooner the better, but we are prepared to

work together, work with you to deal with the situation on the interim.

Mr. CAMPBELL. You do believe, and then a question for you Chairman, you do believe you could deal with a too big or too connected failure to prevent the systemic damage?

Mr. BERNANKE. What distinguishes the situation today from where it was before Bear Stearns is we have taken additional steps to try to prevent such a contingency in the first place. So, in particular, in conjunction with the SEC, we have pushed the investment banks to increase their capital and particularly liquidity, which they have been doing. We have opened up the window to provide a backstop source of liquidity so that reduces the chance of a run. So those things, I hope and expect, will make this contingency much less likely, and should it arise, we would have to deal with it in real time with what tools we have.

With respect to timeframe, you know, again, it's really Congress's judgment about what is possible and in what period of time, if there is an appetite in Congress to work in some of the things for example that we have outlined in our various proposals. I'm sure we will be more than happy to facilitate that in any way possible, but it has just been our sense that given the complexity of these issues, it's probably going to take longer rather than what could be done in this year.

Mr. CAMPBELL. Okay, and my final as we expire question is relative to this, but also to the GSEs, to Fannie and Freddie. If there were issues and so forth there, you have the tools you need there.

Secretary PAULSON. Well, I don't think we should be speculating or talking about what-ifs with any particular institutions. And so with Fannie or Freddie, what I'm emphasizing is the tool that I want is the reform, and the reform legislation that will inject a confidence into the marketplace. And we have a situation here where the independent regulator said as adequate capital and where we both know this is a very important institutions that have an important role to play in their economy.

Mr. CAMPBELL. Thank you.

The CHAIRMAN. The gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman.

I think this is a most important hearing and I am greatly appreciative that you decided to have it.

Chairman Bernanke, I want to thank you. I think it took great courage to do some of what you have done. You are in a tough position and you have made some very difficult choices. And, you have done it, I think, with the notion that you were doing it in the best interest of the country.

I thank you, Secretary Paulson, for some of the things that you have done. I have read some of your messages at home and abroad and I think that the two of you understand that it is time for us to act, and I greatly appreciate it.

Mr. Chairman, you indicated that because you did not have and I'm paraphrasing, "restraints," imposed upon you, you felt it appropriate to move forward with the Bear Stearns, for want of better terminology, "deal." Given that these things are always going to be different, there probably will not be a cookie cutter approach to dealing with a Bear Stearns scenario.

Given this and given that you have to act sometimes expeditiously because you have exigent circumstances, systemic problems, systemic failures that may erupt, do we need to clarify this area of law, if you will, such that there won't be any question as to whether you can act. And you indicated that unless Congress said no, you would move forward. But is there a need for some clarity in this area so that you can act without reservation or hesitation?

Mr. BERNANKE. Well, the two that we used was our 13(3) authority, which allows us to lend to individuals, partnerships, and corporations, so long as there are not other credit accommodations available. That was set up by Congress with the intention of creating a very flexible instrument that could be used in a variety of situations, and it allowed us to address a situation in which we did not anticipate and which had not been seen before. And so in that respect, having that flexibility, I think, was very valuable.

That being said, both in the short term, I think it would be entirely appropriate for us to have discussions. And as I have discussed personally with congressional leadership about what the will of the Congress is and how we should be approaching these types of situations; and, in the longer term, as Secretary Paulson has proposed, it would be better if we had a more formal mechanism that created some hurdles from decisionmaking that set a high bar in terms of when these kinds of power would be invoked and provided more than this lending tool, which was really not well-suited in some cases to address systemically important failures.

So I think the IPC authority is an important authority and it has important flexibility, but I certainly agree that ultimately it is the decision of Congress about, you know, in terms of advice and in terms of legislation about how they want the authorities addressing these kinds of situations.

Mr. GREEN. For the short term, you are comfortable with the 13(3) authority?

Mr. BERNANKE. Well, we have needed it. We have used it in several contexts, and it does give us a lot of flexibility. I think prior to putting any constraints on that it would be important to provide some substitutes, some alternative methods or approaches for dealing with systemically relevant failures.

Mr. GREEN. Thank you.

I appreciate the way you have approached dealing with some of these large, financial institutions in terms of commenting on their strength or lack thereof, because perception has a lot to do with reality and we don't want to create perceptions that can infringe upon reality.

With this understanding, as we approach trying to draft and craft the regulations that can have the positive impact we desire, we, I think, have to be very careful that we don't create the perception with the institutions that there is something imminent about to occur, and I quite frankly don't know all of what we can do to prevent that perception from developing. Just know how important it is to prevent it.

Your comments, please?

Mr. BERNANKE. Well, that is one advantage of having a deliberate process. If you take time to do it right and then take some

time to get this done it will be evident to the market that you're not addressing some immediate crisis, but rather, thinking about the next set of issues.

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

The CHAIRMAN. The gentleman from Illinois.

Mr. ROSKAM. Thank you, Mr. Chairman.

Mr. Chairman, I was involved in a meeting with you and other members a couple of weeks ago where you kind of walked through the decisionmaking that you and your leadership went through in the Bear Stearns situation and kind of in a nutshell, I don't want to over-characterize this, but you're the umpire. You're calling balls and strikes. You called it a strike, did what you felt like you had to do. Others called it a ball.

But you made it very clear that you weren't happy about that situation and you made it clear that there's a plan moving forward. In your testimony today, you outlined three points. I just would like you to focus in, and I don't think this will take all 5 minutes, and I'll give you all the time.

Could you focus in particularly on the supervision piece as it relates to investment banks, and could you comment on the interplay between statutory change that you might think necessary, the regulatory piece that are rules that you can promulgate in relationship with the Securities and Exchange Commission.

But also, could you please comment on the attitude of the investment banks and kind of what is the backdrop of the conversation? Because basically dad came home, right? I mean, at the party, and looked around, and what is the look in their eye as they're interacting with you and the demeanor going forward?

Mr. BERNANKE. Well, on the last point, our presence in the investment banks is based on agreement and coordination with both the SEC and with the firms. We have had a good working relationship with the firms. They have not resisted our interest. Your broader question, I think, where the statutory authority is needed in clarifying that the investment banks require consolidated supervision, and what the powers of that consolidated supervisor should be.

Currently, the SEC's authority is based on essentially a voluntary agreement between the companies and the SEC. I think it ought to be made more explicit and required. In terms of the actual, regulatory practice I started off my testimony by referring to some reports and activities by the committee and others. There really is a remarkably globally-integrated response to this set of issues, and many of them bear on supervisory practice and supervisory expectations.

The triumvirate, which is always critical, is capital liquidity and risk management, and in all those areas, the regulators around the world are talking about ways in which we need to strengthen financial institutions on those three dimensions. I think one concern the investment banks might have, and I'm putting words in their mouths, they would say our business model and our financing is not the same as a commercial bank. Therefore, we wouldn't be comfortable having the exact rules used in a commercial bank context

applied without modification to us. And I think that's a legitimate concern.

Again, as long as we stick to the basic principles of capital liquidity risk management the details could be different from a regulatory perspective for investment banks because of the differences in their business models and their financing. So I am very much in favor of differentiating between different types of firms in our regulatory approach.

The CHAIRMAN. The gentleman from California.

Mr. SHERMAN. Thank you, Mr. Chairman.

Mr. Bernanke, we see what happens when there's a lot of risk to financial institutions. We would all want to reduce that risk.

Would allowing financial institutions, including commercial banks, go into real estate brokerage or other lines of commerce, increase the financial risks they bear?

Mr. BERNANKE. Well, the issue you're referring to is of course under Gramm-Leach-Bliley. The Treasury and the Fed are in power to allow banks or bank holding companies to enter activities that are incidental to financial activities. The law will require us to make a determination as to whether that's incidental or not. But the Congress, obviously, had some concerns about this; and, therefore, Congress has essentially prevented us from even making that determination. We have not attempted to determine whether it meets the statutory test, nor have we done extensive analysis of the systemic implications of such a move, so, for the time being, it seems to be pretty much a moot question.

Mr. SHERMAN. So with Congress taking the stance, you haven't even investigated whether you have the legal right to let that happen and then having not determined the legal right, you haven't done the economic analysis to see whether it would be a wise move. But, in general, I would think that the greater you expand the rights of banks to engage in all kinds of non-financial commerce, the greater the risks that they face, my other question is Black Rock gets the contract to administer this portfolio. It was a no-bid contract.

Will you provide us with a copy of that contract? And, now that the immediate crisis has passed, will you put asset management out to bid, or will Black Rock receive a long-term, no-bid contract that would last until the portfolio is disposed of?

Mr. BERNANKE. We will certainly provide you with all the important information, the relevant information, associated with our contract with Black Rock. They are one of our relatively few number of firms that could address the needs that we have; and, given the exigencies of the weekend, it was obviously beneficial that we could get their services in a very short-term notice.

We will be reviewing these conditions and terms and try to ascertain whether any additional steps are necessary. I can't at this point, I guess at this point, it's not an immediate plan to change the company as they have been working very effectively for us. We think that it has been a good arrangement with them at this point.

Mr. SHERMAN. Well, now that there's not a crisis situation, wouldn't you want competitive bidding on such an important contract?

Mr. BERNANKE. We will look into it.

Mr. SHERMAN. Okay. I now have quite a number of questions for the record, because I realize my time is limited and I look forward to getting responses. The first is whether off-balance sheet financially engineered instruments oppose a risk to the major corporations of this country. The second is whether we have moved to a system of capitalism for the poor and socialism for the rich. The pizzeria in my district that goes out of business, they're not going to get any kind of bailout from the Fed. And, the subordinated debt-holder, namely the guy's uncle who lent him money to start the place, he isn't going to get anything either.

I understand why the Fed acted in an emergency situation, but now we are no longer in an emergency situation, and the question is what are we doing to make sure that those who should have borne the risk, the shareholders, the subordinated creditors, who are going to come out of this thing whole, even though they bought subordinated debt, and the regular debtors of Bear Stearns are not contributing and paying for this $30 billion worth of risk that the taxpayers have borne.

Should we, and I would like both Treasury and the Fed to respond to this, be looking to impose a tax on the subordinated creditors, on the shareholders, to recapture for the Federal Government a fair fee for the incredible risk that the Federal Government is assuming, or should we just make this huge gift that no private sector company would ever engage in to those who are thought on Wall Street to be so important, something we would never consider doing for a pizzeria in my district.

The CHAIRMAN. The gentleman's time has expired.

Mr. SHERMAN. Thank you.

The CHAIRMAN. We will get, as the gentleman requested, responses in writing.

The gentleman from Missouri.

Mr. CLEAVER. There are those who suggest that had Congress not approved the stimulus package when it did, the current crisis would probably be worse. There's no way to tell for sure whether they are accurate or not.

But I'm curious about your position on the talk now about stimulus package no. 2, which might include an extension of employment insurance and perhaps even deal with some of the issues that we failed to deal with in the first stimulus package, like infrastructure construction, where the Federal Government funds infrastructure projects and the local communities are able to go out and hire.

And in addition to that, also predicting that the 4th quarter will look very, very bleak, and that the positive benefits from stimulus no. 1 are fading. So they would suggest that there is a need for stimulus no. 2. Do you agree with those who are encouraging stimulus no. 2?

Mr. BERNANKE. Well, it's a preliminary matter of fact. I think UI extension was in fact—is that passed, or is that—

The CHAIRMAN. It has been signed; it is part of the supplemental.

Mr. BERNANKE. Yes. So that part has been—

The CHAIRMAN. That was signed, not cheerfully, but it was signed.

Mr. BERNANKE. That has been done. I think it's just a bit early. The stimulus package no. 1, as you call it, is only now really begin-

ning to feed into consumer incomes. Our sense is that it is being helpful. We have seen consumer spending hold up, despite a lot of other concerns. But I guess my inclination would be to wait a bit longer to see: (a) if the economy begins to strengthen on its own; and (b) to assess the effects of the stimulus that has already been put into the system.

Mr. CLEAVER. Well, as we talk about systemic action, I mean do we wait until we get into the 4th quarter and realize—

The CHAIRMAN. Could I say again that we are going to have the Chairman back next week on Humphrey-Hawkins, when this will be very much the center of the discussion.

Mr. CLEAVER. Yes. This will be more appropriate at that time. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Ellison, I'm going to miss the previous question on the Washington Rochambeau myself. I think my constituents will forgive me. We are going to end soon. You know, members, that the vote is about to end. It is the previous question on the rule for the Washington Rochambeau or whatever it is. I'm going to stay here, so anyone who wants to stay and ask questions can do that.

The gentleman from Minnesota?

Mr. ELLISON. Mr. Chairman, a lot of my questions do have to do with Humphrey-Hawkins—

The CHAIRMAN. Well, then we will take it back. The gentleman from Indiana?

Mr. DONNELLY. Thank you very much, and thank you both for being here.

I'll ask a question real quick, because I do have to vote. Do you think that the immense amount of monies being sent overseas for energy purchases weakens the dollar? And that it almost becomes a vicious cycle that we are defunding ourselves, the dollar weakens, oil increases even more because the dollar weakens, and then it just keeps going around?

Secretary PAULSON. You know, that's interesting. I have heard a number of people say that one of the reasons the price of oil has gone up so much is the dollar has depreciated. And yet when you look at the statistics, look at what has really happened, if you go back to February of 2002, the dollar has declined in value 24 percent, the price of oil gone up over 500 percent. And so again, I really think the price of oil is being driven by supply-and-demand factors, and the real solution here is to address both. There is not an easy, short-term solution, but there is a lot that has to be done.

Mr. DONNELLY. And if I could just ask you real quick, do you think it's dangerous that there has been such a transfer of wealth for energy purchases to our country?

Secretary PAULSON. Well, I would say this: If you're asking me whether we should have greater energy security in this country, the answer is, you betcha. And we have a lot to do. And there are things, this is subject to self-help. There are things we can do ourselves right now in this country in terms of development of oil resources and things we can on the conservation and efficiency side and alternative sources of energy.

Mr. DONNELLY. Okay. Thank you.

The CHAIRMAN. The gentlewoman from California?

Ms. SPEIER. Thank you, Mr. Chairman. Thank you, Secretary Paulson and Chairman Bernanke, for your service during this particularly difficult time in our country's financial history. I'm one of the newer members, as you can tell by my seating here, so maybe I have a little license to ask some dumb questions.

I guess to you, Mr. Chairman, the investment banks are now eligible to access money through the discount window. Unlike the commercial banks that are subject to much regulation, they are not. And I want to know if you intend to put any regulations on the investment banks that the commercial banks presently have.

Mr. BERNANKE. Congresswoman, we are already doing that. The SEC has been their oversight regulator for some time, and they have tried to apply rules very similar to the ones that are applied to commercial banks, in particular the Basel II Capital Rules. Since we began lending to the investment banks, the Federal Reserve has also had people onsite, collaborating with the firms and with the SEC to make sure that those firms do meet safety and soundness standards.

So in fact we are doing that now, and in my statement I do think, though, that it is something of an ad hoc arrangement, and I do think that the Congress ought at some point to clarify what the supervisory regulatory responsibilities are with respect to the investment banks.

But we are already doing most of what you're suggesting in that we are onsite in those firms, working with the SEC to make sure that the investment banks meet the appropriate standards of safety and soundness.

Ms. SPEIER. Well, the Washington Post editorial today would suggest that is not the case. And in fact, it was entitled "Bail Out Ben," which I guess is attributed to you. But the point being made in the editorial was that there is money being made available without strings attached to investment banks. And you're saying that is not the case.

Mr. BERNANKE. No, it's not the case. We are there and we have expectations for their capital liquidity and risk management. I think the way I would have interpreted some of the concerns is that, as I said, this is sort of an ad hoc arrangement. You know, we have joined the SEC in looking at these firms because we made the loans. No one intends us to be the long-term, permanent arrangement. And I think what the thrust of that editorial was that Congress needs to begin to clarify its views on how they would like to see these firms supervised, going forward.

Ms. SPEIER. So how do we make sure that investment banks don't continue to take undue risk, because we now have a history where the U.S. Government has bailed them out?

Mr. BERNANKE. Well, again, there are several ways of doing that.

The first is prudential supervision, a consolidated supervision, where you're there and you make sure that they meet the appropriate standards. If the capital regulations tie the amount of capital they hold to the risk that they take, so if they want to take bigger risk, they have to hold more capital. So by ensuring through prudential supervision on capital and liquidity and risk management, we can ensure—well not ensure, but at least make much

more likely that those firms won't get into trouble or take excessive risks in the future.

Secondly, I suggested in my testimony a few other steps we can take to make the system as a whole stronger, so that should the time come, if a Bear Stearns were to ever happen again, unlike in March, when we just felt that the system was not strong enough, resilient enough to suffer the consequences of that, we might be able to make a different decision in the future, because we would say this is something that the system can absorb.

So, as I have noted earlier, along with our lending decisions, we have also been looking at ways in which we and the Congress can move forward to make sure that there's a commensurate supervision that balances out whatever lending privileges the investment banks get.

Ms. SPEIER. Mr. Chairman, I would like to just point out that there probably is some action that we should take as the committee sooner than later, as it relates to the authority of the Fed over investment banking institutions, because another Bear Stearns can happen, it could happen in the course of 6 months while we are campaigning for re-election. And if it's as important as you say it is to get some authority in place, so it's very clear, I would think that would be one priority—

The CHAIRMAN. Well, if the gentlewoman would yield, I would disagree with her. And I think frankly it's a disservice to suggest that they don't have the authority. They had it under Bear Stearns, and I don't think we should be suggesting—in fact I think there is an agreement here that they do have the authority—it's not as perfect in many ways as they want it to be, but they did for Bear Stearns. I have talked to the agencies, and people have talked about this, but I haven't seen anybody draft anything. There are a whole lot of people ready to write, but they are in favor apparently of somebody else drafting this legislation.

Anybody is free, of course, to introduce a bill or do whatever they want. But I do think it's a disservice to suggest that there's a shortfall in authority now. I believe that with the memorandum and with the work we have done together, and with the support that they would get from us, so that no one would think they could end run things, that we are capable of getting through this. And if someone things he or she can write a bill that we can pass that quickly, obviously, everybody has that right.

I am very skeptical, and I think beginning a process and getting it bogged down in the Senate or elsewhere is more likely to cause uncertainty than saying, "Look, we have gotten this far, we will continue to work this way together."

Other members are free, if they want to write up something and try to offer it. The Departments are free to do it. The Fed is free to do it. I think the fact that no one has done it is a recognition of reality.

Ms. SPEIER. Mr. Chairman, I recognize that I have very little expertise in this area at this point. But I do sense from our two speakers that there is a sense of urgency that we need to act. And I just want to make sure that we are not in a situation in a few months where there is a need to act—

The CHAIRMAN. Well, I want to respond. I very much disagree with gentlewoman's statement. As we made clear at the beginning—I don't know if the gentlewoman was here for the whole hearing.

Ms. SPEIER. I was—

The CHAIRMAN. We addressed that early on, and they said—and I don't think that should be undercut—that the authority that we have had so far is still there. I think it is a mistake to suggest that there is a lack of authority, and yes, we all agree that there is an urgency. The Treasury has not and the Federal Reserve has not asked us specifically to do something. And I think that is in recognition that it is best for everybody out there to understand that we are going to continue as we have been, pending this situation until we can do new legislation.

And the likelihood of being able to do this very complicated subject—and I would say this: Doing it and then redoing it would be, I think, a very bad idea. I think the instability that would be there would be a mistake.

So as I listen to our two witnesses, their view is that in an ideal world, we would have more authority, but that we are able to continue working together as we have been, with the SEC, with them and with us. And as I said, I think it's a great mistake to suggest that there is going to be some crisis we can't handle. We did handle Bear Stearns, and I think we will be able to deal with others.

Ms. SPEIER. I yield back.

The CHAIRMAN. The gentleman from Massachusetts?

Mr. CAPUANO. Thank you, Mr. Chairman.

Mr. Secretary and Mr. Chairman, first of all, thank you for coming. And I apologize. My plan today was to be here for the entire hearing. Unfortunately, I had to go to the—

The CHAIRMAN. No. It was at my request. The gentleman from Massachusetts was accommodating my request to handle bills on the Floor. It was not his fault.

Mr. CAPUANO. I don't mind, and it has nothing to do with the chairman. It got embroiled in some political chicanery and I got stuck. So I apologize.

But I do want to ask—first of all I want to make it very, very clear that I support almost everything you have done and are discussing doing. Both of you I think are doing a great job. I think both of you are talking about the things you need to talk about. I think both of you are on the right path to where we need to go. I know how difficult it's going to be to get there. I know now controversial it is to some. I'm not so sure we are all going to agree on every detail, but that's not important.

The concepts you are talking about, in my opinion, are exactly the right concepts that we should be talking about. I personally think we should have been talking about them years ago, but we will let that dog lie for a while, and we will just move forward.

So I'm looking forward to getting us from where we are now to where we need to be.

I do want to talk about a couple of specific items, though, that have been concerning me—especially relative to the Fed. I believe—I agree with the chairman—I believe that you have the authority to have done what you have done thus far. Under the un-

usual and exigent circumstances language, I believe that. I agree with what you have done; I think it's fine.

However, it does raise serious questions. I think you know that. And I believe that moving forward, we will try to address those on a more permanent basis.

My concern is in the meantime—you have seen this today, and I haven't seen the debate here today, but I have heard it a thousand times—there are a lot of people here that every time you hint at this much more oversight or regulation, they go absolutely berserk and somehow that's anti-American, and it's going kill the entire capitalist system, and the world will go to hell in a hand basket. I'm not like that; I believe that reasonable, fair, clear regulation actually helps the capitalistic society, and I think it's a good thing

Between now and there, I'm deeply concerned of what we are going to do and what we have, and I am particularly concerned with the—it's not the amount, but the amount combined with what I see is the lack of requirements that the Fed is putting on those people who are coming to all the different windows that you have created. They are huge amounts of money.

In the last 6 months, by my figures, the Fed has, all totalled, loaned out, give or take, over $3 trillion, which is more than 100 times more than you loaned out the previous 6 months. I'm not complaining about it. I think it's necessary. I think it's fine. I don't think it's unstable. I think it's the right way to go. But it's a huge amount of money. And almost all of that money has gone out with virtually, in my opinion, minimal at best, if any, requirements.

I would argue—and I would ask your opinion—I would suggest that since you have the power to loan the money—you do not have the power, and I agree, to impose regulations on people before they get to the window—but I do believe that as a condition of the loan, you do have the ability to impose, not regulation but conditions of the loan that may look like regulations to some, that simply allows those people who come to the window to say, "Hey, if I want the money, I will meet these requirements," whatever they might be. Capital requirements—and I trust your judgment as to what they might be; I know you would do it in conjunction with the Secretary and others—and I'm just curious, do you believe, do you agree or disagree that you currently have the authority, if you chose to use it, to put very clear, very concise conditions—not regulations, but conditions—on the loan that hopefully would lead us and my colleagues to know where you might want to go, if we gave you the authority—which I would be happy to do—if we gave you the authority to have those regulations before they got to the window?

Mr. BERNANKE. Well, Congressman, there are two classes of firms that are borrowing from us. There are the commercial banks—

Mr. CAPUANO. Right.

Mr. BERNANKE. —which already have a well-established regulatory structure and a set of regulators. And we are, of course, along with our fellow regulators, working hard to make sure that they have adequate capital and that they are taking all the steps necessary.

Mr. CAPUANO. Right.

Mr. BERNANKE. The investment banks have had a more ad hoc relationship because we have been working with the SEC, as you know. But as I have mentioned, between us we have made strong demands on the firms. We have insisted that they raise their liquidity holding in particular, because that turned out to the major point of vulnerability for Bear Stearns. And we have also asked them to raise their capital, to improve the practices of risk management, and so on.

So we are doing very much the same kind of thing between the Fed and the SEC in the investment banks that we and other regulators already do in the commercial banks. So there is a quid pro quo that if we are going to lend to you, you have to take steps to—

The CHAIRMAN. The gentleman from Massachusetts earned a waiver of the 5-minute rule. So if he has any further questions—

Mr. CAPUANO. Thank you, Mr. Chairman.

I'm glad to hear that. I agree with it. I would personally like to see it in a more organized fashion as opposed to—and I understand that you're still running quickly to get where you want to go.

And Mr. Secretary, I would ask you—I mean I know you're very familiar with what the Fed is doing—do you agree with what the Chairman has said, and do you agree with the general format that they're operating under?

Secretary PAULSON. I couldn't agree more. I agree totally. This is an example of regulators coming together to transcend some of the issues in the regulatory system. And again, the emphasis that the Fed and the SEC are placing on the investment banks is one that is different from commercial banks, because the issues here are different and the focus has been more on funding and liquidity. I strongly agree with that, and I have been gratified to see some of the improvements that are resulting.

Mr. CAPUANO. One of the reasons I ask—actually the main reason—I believe that if these requirements were put in a more formalized fashion, there would be more uniform, as opposed to each time you come to the window—I actually—maybe I'm wrong—but I think it would actually help the market, it would help some of my friends who might have some concerns about the concept of regulation. And I think it would actually help some of the stabilization.

I know you have addressed some of the issues, some of the so-called rumors about Fannie and Freddie today, and as I understand it, you have addressed those issues that, you know, some people are concerned that capital requirements are going to go through the roof, and they're going to get shaky. It's my understanding that has been addressed and clarified.

At the same time I think that if there were formalized regulations across the board—not regulations, I shouldn't use the word—formalized requirements for a loan, then I would argue that they would help stabilize the market.

And the other question I want to ask—and again I apologize—but just a few days ago there was a story in the paper that concerned me deeply. I raised it yesterday, and I'm going to raise it again today with you. I read—again, it's only on the basis of news reports, I have not yet had an opportunity to get beyond the news reports, so forgive me if anything I say is wrong—but I read that

the SEC is considering basically for all intents and purposes adopting international accounting standards—a little overstatement, maybe a little overreaching for that—but going much further along that way, doing it relatively quickly, hopefully I guess theoretically before the term ends or the current chairman.

My concern with that is, I'm not opposed to moving thoughtfully and steadily towards international accounting standards, but I am deeply concerned that to simply say American regulators no longer have authority here, and the American regulations, just in yesterday's news, were going to international regulations like this, that it would undermine many of things you are currently doing to try to stabilize the market.

It raises questions on how do we make the transition. It raises questions on transparency. It raises questions on investor protections. And I think it raises questions on whether we have the ability or the authority to somehow regulate our own financial markets.

I know it's not directly what you're doing, but I ask: Are you familiar with what the SEC is doing on this issue? And if you are familiar, I would like to know what your initial opinion is of the matter.

Secretary PAULSON. Yes. I would say I'm familiar and I'm supportive of it. And I thought that statement was—I read the same press report, and I didn't agree with the way it was slanted—that what the SEC is doing is moving toward greater convergence in accounting and acceptance, and they're concentrating on those accounting regimes where the standards and the qualities are very similar to what we see in the United States and in the principals. So I'm supportive.

Mr. CAPUANO. Mr. Chairman?

Mr. BERNANKE. Well, there are two elements. One is that FASB and the International Regulatory Accounting Board are on a convergence path already. They've set goals to essentially be the same or very similar within a couple of years. And so that process is useful and taking place.

As I understand it, the SEC's action is to give internationally active companies a choice—this doesn't apply to all U.S. firms but to companies that already have to do the international standards, can they avoid having a duplicate set of books, essentially, using the FASB standards? And that seems to make sense in terms of giving, you know, more incentive for foreign companies to operate in the United States, for example.

So long as the system that we are looking at is one that we are comfortable with and is very similar to FASB, I don't think it creates necessarily any major problems with either accounting system or our regulatory system.

The CHAIRMAN. Can I—let me just speak. The Secretary referred to some, I thought, questionable things in the article. Nothing in that, as you have described it, Mr. Chairman, to allow either set to be done would, for instance, waive any part of the Sarbanes-Oxley or non-account or any other regulation. I don't think that was clear from the article. So is that correct?

Secretary PAULSON. I didn't mean to cast aspersions on the article. I'm just saying I read the article quickly—

The CHAIRMAN. It's okay to cast aspersions on articles. Free speech works both ways.

Secretary PAULSON. And again, as I look at accounting, we have by industry different accounting standards. We have different accounting standards for different financial institutions. It's hard to say there is one—

The CHAIRMAN. But it does not—that decision about mutual recognition would not relax any other regulatory standards.

Secretary PAULSON. No.

Mr. CAPUANO. Let me just say—Mr. Chairman, if I might.

The CHAIRMAN. Yes.

Mr. CAPUANO. I actually have the article. And I would suggest it didn't imply anything. Again it's an article, but it's an article from a reputable source. It says very clearly—and again, it's an article, and that's why I caveat it right up front and I haven't had a chance to talk to the SEC about it—but it says it would "permit American companies to shift the international rules which are set by foreign organizations and give companies greater latitude in reporting earnings."

Now that alone right there—greater latitude in reporting earnings after our Enron mess and all the mess that we have right now—if that doesn't raise hackles on the back of your neck, I don't know what does. After all the work that you have done to try to stabilize the books and stabilize—and again I'm not saying the article is right, I'm simply saying if that is correct.

And it goes on to say that it enabled companies, for example, to provide fewer details about mortgage-backed securities. Now if that's correct—I don't know yet—I hope that raises concerns, if it's correct. If it's not correct, so be it. Again, I agree with the Chairman. I don't necessarily accept anything wholehearted, no matter how good the source.

But those lines just in and of themselves in a relatively short article raised major questions in my mind that with all the problems we have in mortgage-backed securities right now, to then go into a regime now—I'm not saying that we shouldn't do it over time, thoughtfully one step at a time—as you stabilize things, we can head towards convergence, I'm all for it—but if this is correct, and they do it like this, I will tell you that I for one will have some major concerns, because I want you two to be able to finish what you're doing to get us to a more stable ground, so that we can then look to continue to progress in our economic status.

Secretary PAULSON. Yes. I totally—you should definitely talk to Chairman Cox about this.

But the only thing I will say is that there are different accounting regimes that have different standards and different requirements that doesn't make them worse than ours. We have had plenty of issues in our markets, in our system, with our accounting regime. And so again, I think that the Chairman's approach is to take other countries where they have accounting systems and regimes, which he thinks have standards that are very similar to ours, the highest standards, and then allowing for this—

The CHAIRMAN. Let me say—and I have to wind this up. I am very appreciative of the witnesses' time; they have stayed over time and it has been helpful. We have a hearing in 2 weeks with Chair-

man Cox and the President of the New York Federal Reserve, Mr. Geithner, to go over many of these same issues, and that obviously will be something that we will expect Mr. Cox to be addressing.

I would just say for the purposes of the members on the Democratic side of the aisle, or others listening, we will begin the questioning there with those who didn't get to ask a question today, as we will next week on Humphrey-Hawkins begin the questioning with those who didn't have a chance.

Some other substantive points I wanted to make: One, I disagree with the gentleman from California, Mr. Sherman. Obviously we have a different view here. I do not think that competitive bidding would have made any sense in the crisis atmosphere regarding Bear Stearns with Black Rock. Two, I don't think that people thought this was the most desirable assignment ever set up. And three, to now disrupt what Black Rock is doing and put it out to bid, I think, would be very disruptive. So I think—I would also add that the Government Operations Committee had requested some information about this, and the Chairman of the Federal Reserve did respond very appropriately to their inquiries.

I understand that there are questions about urgency. I guess a lot of people believe in urgency in principle, but not on paper. And you can't be urgent in theory. You have to be urgent with very specific legislation. I do not believe that it is either necessary or possible to deal with this complex set of issues with the appropriate degree of certainty or at least assuredness, and to do it and then have to re-do it or amend it a few months later, I think would be a terrible idea.

But this is what I want to make very clear. No one should think that we here in the Congress are available for end-runs. We have a situation where the SEC and the Federal Reserve and the Treasury and other regulators will be putting together their various powers, so that if crises arise they can be met. I believe we have sufficient power now to get through the crisis. We don't have sufficient power, frankly, to avoid some of the crises. And that, I think, is a distinction.

We have the power to respond if there are crises. What we are looking for are rules that will make the crises less likely. And I think that is a very high priority. We will begin working on this. Work we begin now—frankly if we were to decide to do it now, I don't think we could get it finished just in terms of the complexity of the issues and the hearings and the bills in both Houses.

But we are going to start now, and I hope that early next year we will able to complete it. But I don't want anyone to think that there are somehow loopholes that they can run through, and that they might get some cooperation here. I think we have all worked together very cooperatively when it comes to the crisis situation, and I believe that we will be able to continue to do that.

I thank the Chairman and the Secretary, and the hearing is now adjourned.

[Whereupon, at 1:17 p.m., the hearing was adjourned.]

A P P E N D I X

July 10, 2008

OPENING STATEMENT OF CONGRESSMAN PAUL E. KANJORSKI

COMMITTEE ON FINANCIAL SERVICES

HEARING ON SYSTEMIC RISK AND THE FINANCIAL MARKETS

JULY 10, 2008

Good morning. Mr. Chairman, this hearing comes at a critical juncture, as the economy reels from a widespread, far-reaching financial crisis that continues to wreak havoc on everything from the housing market to student loans. While we remain focused on the many current economic difficulties average Americans face, we must simultaneously look to the future to determine how to prevent or at least mitigate future crises.

Financial innovation and the proliferation of complex and exotic financial instruments are probably inevitable under our capitalist system. But we must develop innovative regulatory and oversight responses to keep pace as these market transactions evolve.

One such proposal worth considering is the Systemic Risk Reduction Act of 2008, put forth by the Financial Services Roundtable. This bill seeks to make regulation more efficient by closing gaps in our regulatory structure and by promoting consolidation and cooperation among regulatory agencies. Their proposal includes a provision of particular interest to me. Namely, it proposes establishing a bureau, similar in concept to the Office of Insurance Information, which passed the Capital Markets subcommittee yesterday. Without a federal repository to collect and analyze information on insurance issues, we cannot fully understand and control systemic risk.

The Roundtable proposal would also expand the authority of the Federal Reserve so that investment banks who borrow from the Fed's discount window and various facilities do not get a free pass. No one else can borrow money without conditions, and the American people do not expect that investment banks be allowed to do so.

Chairman Bernanke spoke two days ago and raised many of these issues and offered ideas for consideration, noting that the "financial turmoil since August underscores the need to find ways to make the financial system more resilient and more stable." I wholeheartedly agree. He further stated that the Fed's powers and its responsibilities should be commensurate. It is the job of Congress to strike that proper balance.

While many concur that the Federal Reserve's move to bail out Bear Stearns in March of this year was necessary to prevent a financial meltdown, most also agree that we should be concerned about setting precedents with broad ramifications down the road. Taxpayers cannot be asked to bail out financial institutions, and we should look for ways to prevent such dire situations from arising in the future.

Another area germane to today's discussion is speculation. Specifically, we must determine to what extent speculation in commodities futures has hurt American consumers by artificially inflating the price of oil, energy, and other goods. I appreciate the ongoing debate on speculation – with economists, traders, pundits, and politicians

staking out various positions on the issue. To the extent that we can glean further insight from our panelists today, that would be of tremendous help. For if it is true that speculators bear blame, then Congressional action in the form of increased oversight and enhanced authority is warranted.

Relatedly, I am very interested in consolidating the regulation of our securities and commodities markets. While the CFTC currently has jurisdiction and has done commendable work, the Treasury's recommendation to merge the SEC and CFTC seems the sensible course of action for the Congress. We need a unified practical regulatory system. The merger of these two entities would help us achieve that goal.

That issue aside, consumers have taken a beating, and it is time for the Congress to speak up for them. The price of gas is simply unbelievable. Americans having to choose between running errands and eating dinner is not acceptable. Moreover, the decision to heat one's home should not be left to wealthy players in the futures market.

Having referred to complex financial instruments earlier, I should note that I am currently finalizing a request to the Government Accountability Office that it begin a study on structured financial products. This study will examine a number of issues, including what exactly these instruments are; the degree of transparency and market regulation surrounding them; the degree of oversight of their issuance and trading; which regulators do what; whether and how regulators monitor compliance; and how we should improve regulation in this sector of our financial system.

To the panelists, I very much appreciate your being here today. I look forward to your testimony. Bipartisan, carefully thought-out solutions to managing and possibly preventing systemic risk can and must be found and implemented.

House Financial Services Committee
Congressman Randy Neugebauer Opening Statement
July 10, 2008

I appreciate Chairman Frank organizing hearings on regulation in our financial markets.

With the current challenges and rapidly changing situation in our nation's credit markets, the actions taken by the Fed and Treasury in response must be measured and within the scope of their authorities. Their actions earlier this year to facilitate the sale of Bear Stearns and the Fed's use of its emergency lending authority concern me. So too do proposals to significantly change our financial services regulatory structure.

I don't disagree that modernization in financial services regulation is needed. My concern, however, rises from the tendency of Congress and federal agencies to over-reach and over-regulate. Markets are not always without risk, and elimination of risk is not the government's responsibility.

A federal regulator that can protect our economy from systemic risk is big request. We must ensure that government does not provide a false sense of security to the marketplace. Regulatory modernization and oversight cannot and should not insulate investors, lenders, and borrowers from due diligence in their decision making. Markets are efficient when it comes to discipline.

Our committee had much discussion on systemic risk when we worked on GSE regulatory reform legislation, and I also had the opportunity to discuss systemic risk with Secretary Paulson in that context. With all the debate about the systemic risks posed by Fannie Mae and Freddie Mac, other sources such as investment banks and subprime lenders have caused significant disruptions in our financial markets. In contrast, the GSEs have been the primary source of mortgage liquidity in many areas of the country.

Certainly our economy faces systemic risks from many sources. While empowering a federal regulator with the authority to determine those risks before harm can take place sounds reasonable, all of the effects may not be positive. We must ensure actors in the marketplace do not assume such a regulator protects them from harm or from poor decision making. Most importantly, the American taxpayer should not be held responsible through a government bailout for decisions made by those waiting for a regulator to put a stop to their actions rather than responding to market disciplines. I look forward to further discussion and debate on the best way to update financial regulation.

For release on delivery
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July 10, 2008

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

July 10, 2008

Chairman Frank, Ranking Member Bachus, and other members of the Committee, I am pleased to be here today to discuss financial regulation and financial stability.

The financial turmoil that began last summer has impeded the ability of the financial system to perform its normal functions and adversely affected the broader economy. This experience indicates a clear need for careful attention to financial regulation and financial stability by the Congress and other policymakers.

Regulatory authorities have been actively considering the implications of the turmoil for regulatory policy and for private-sector practices. In March, the President's Working Group on Financial Markets (PWG) issued a report and recommendations for addressing the weaknesses revealed by recent events.[1] At the international level, the Financial Stability Forum has also issued a report and recommendations.[2] Between them, the two reports focused on a number of specific problem areas, including mortgage lending practices and their oversight, risk measurement and management at large financial institutions, the performance of credit rating agencies, accounting and valuation issues, and issues relating to the clearing and settlement of financial transactions. Many of the recommendations of these reports were directed at regulators and the private sector and are already being implemented. These reports complement the blueprint for regulatory reform issued by the Treasury in March, which focused on broader questions of regulatory architecture.[3]

Work is also ongoing to strengthen the framework for prudential oversight of financial institutions. Notably, recent events have led the Basel Committee on Banking Supervision to

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[1] President's Working Group on Financial Markets (2008), "Policy Statement on Financial Market Developments," March 13, www.treas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf.
[2] The membership of the Financial Stability Forum consists of central bankers, regulators, and finance ministers from many countries, including the United States. Their report is available at: Financial Stability Forum (2008), "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," April 7, www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf.

consider higher capital charges for such items as certain complex structured credit products, assets in banks' trading books, and liquidity guarantees provided to off-balance sheet vehicles. New guidelines for banks' liquidity management are also being issued. Regarding implementation, the recent reports have stressed the need for supervisors to insist on strong risk-measurement and risk-management practices that allow managers to assess the risks they face on a firmwide basis.

In the remainder of my remarks I will comment briefly on three issues: the supervisory oversight of primary dealers, including the major investment banks; the need to strengthen the financial infrastructure; and the possible need for new tools for facilitating the orderly liquidation of a systemically important securities firm.[4]

Prudential Supervision of Investment Banks

Since the near-collapse of The Bear Stearns Companies, Inc., in March, the Federal Reserve has been working closely with the Securities and Exchange Commission (SEC), which is the functional supervisor of each of the primary dealers and the consolidated supervisor of the four large investment banks, to help ensure that those firms have the financial strength needed to withstand conditions of extreme market stress. To formalize our effective working relationship, the SEC and the Federal Reserve this week agreed to a memorandum of understanding.[5]

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[3] The Treasury blueprint is available at: U.S. Department of the Treasury (2008), "Blueprint for a Modernized Financial Regulatory Structure," March 31, www.treas.gov/offices/domestic-finance/regulatory-blueprint.

[4] Primary dealers are banks and securities broker-dealers that trade in U.S. government securities with the Federal Reserve Bank of New York. On behalf of the Federal Reserve System, the New York Fed's Open Market Desk engages in the trades to implement monetary policy.

[5] Under the memorandum of understanding, the SEC and the Fed will freely share information and analyses pertaining to the financial conditions of primary dealers. The two agencies have also agreed to work jointly with the firms to support their continued efforts to strengthen their balance sheets, their liquidity, and their risk-management practices. See: Board of Governors of the Federal Reserve System and Securities and Exchange Commission (2008), "Federal Reserve and SEC Issue Memorandum of Understanding to Deepen Information Sharing and Cooperation," press release, July 7, www.federalreserve.gov/newsevents/press/bcreg/20080707a.htm.

Cooperation between the Fed and the SEC is taking place within the existing statutory framework with the objective of addressing the near-term situation. In the longer term, however, legislation may be needed to provide a more robust framework for the prudential supervision of investment banks and other large securities dealers. In particular, under current arrangements, the SEC's oversight of the holding companies of the major investment banks is based on a voluntary agreement between the SEC and those firms. Strong holding company oversight is essential, and thus, in my view, the Congress should consider requiring consolidated supervision of those firms and providing the regulator the authority to set standards for capital, liquidity holdings, and risk management.[6] At the same time, reforms in the oversight of these firms must recognize the distinctive features of investment banking and take care neither to unduly inhibit innovation nor to induce a migration of risk-taking activities to less-regulated or offshore institutions.

Strengthening the Financial Infrastructure

The potential vulnerability of the financial system to the collapse of Bear Stearns was exacerbated by weaknesses in the infrastructure of financial markets, notably in the markets for over-the-counter (OTC) derivatives and in short-term funding markets.

The Federal Reserve, together with other regulators and the private sector, is engaged in a broad effort to strengthen the financial infrastructure. For example, since September 2005, the Federal Reserve Bank of New York has been leading a major joint initiative by both the public and private sectors to improve arrangements for clearing and settling credit default swaps and other OTC derivatives. The Federal Reserve and other authorities also are focusing on

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[6] Bank-affiliated primary dealers are already subject to mandatory consolidated supervision, but the focus of that supervision has been on limiting risks to the banks and other insured depository institutions within the holding company. Existing provisions may need to be modified to provide regulatory authority to assess and limit risks to all functionally regulated entities, including securities subsidiaries.

enhancing the resilience of the markets for tri-party repurchase agreements, in which the primary dealers and other large banks and broker-dealers obtain very large amounts of secured financing from money funds and other short-term, risk-averse investors. In these efforts, we aim not only to make the financial system better able to withstand future shocks but also to mitigate moral hazard and the problem of "too big to fail," by reducing the range of circumstances in which systemic stability concerns might prompt government intervention.

More generally, the stability of the broader financial system requires key payment and settlement systems to operate smoothly under stress and to effectively manage counterparty risk. Currently, the Federal Reserve relies on a patchwork of authorities, largely derived from our role as a banking supervisor, as well as on moral suasion to help ensure that the various payment and settlement systems have the necessary procedures and controls in place to manage the risks they face. By contrast, many major central banks around the world have an explicit statutory basis for their oversight of payment and settlement systems. Because robust payment and settlement systems are vital for financial stability, the Congress should consider granting the Federal Reserve explicit oversight authority for systemically important payment and settlement systems.

Preventing or Mitigating Future Crises

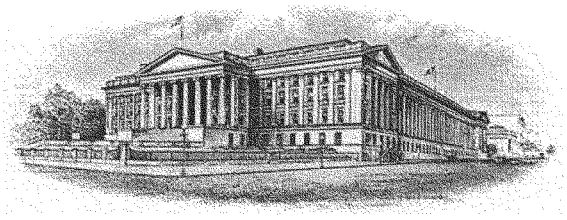
The financial turmoil is ongoing, and our efforts today are concentrated on helping the financial system return to more normal functioning. It is not too soon, however, to think about steps that might be taken to reduce the incidence and severity of future crises.

In particular, in light of the Bear Stearns episode, the Congress may wish to consider whether new tools are needed for ensuring an orderly liquidation of a systemically important securities firm that is on the verge of bankruptcy, together with a more formal process for deciding when to use those tools. Because the resolution of a failing securities firm might have

fiscal implications, it would be appropriate for the Treasury to take a leading role in any such process, in consultation with the firm's regulator and other authorities.

The details of any such tools and of the associated decisionmaking process require more study. One possible model is the process currently in place under the Federal Deposit Insurance Corporation Improvement Act (FDICIA) for dealing with insolvent commercial banks. The FDICIA procedures give the Federal Deposit Insurance Corporation the authority to act as a receiver for an insolvent bank and to set up a bridge bank to facilitate an orderly liquidation of the firm. The FDICIA law also requires that failing banks be resolved in a way that imposes the least cost to the government, except when the authorities, through a well-defined procedure, determine that following the least-cost route would entail significant systemic risk. To be sure, securities firms differ significantly from commercial banks in their financing, business models, and in other ways, so the FDICIA rules are not directly applicable to these firms. Although designing a resolution regime appropriate for securities firms would be a complex undertaking, I believe it would be worth the effort. In particular, by setting a high bar for such actions, the adverse effects on market discipline could be minimized.

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



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL, 10 a.m., (EDT), July 10, 2008
CONTACT Brookly McLaughlin, (202) 622-2920

OPENING STATEMENT BY SECRETARY HENRY M. PAULSON, JR. ON REGULATORY REFORM BEFORE HOUSE COMMITTEE ON FINANCIAL SERVICES

Washington, DC— Good morning Chairman Frank, Ranking Member Bachus and Members of the Committee. Thank you for the opportunity to talk with you this morning and for your continuing leadership on the many issues facing our financial markets.

Shortly after I came to Washington, I pointed out that our financial regulatory structure has not kept pace with financial services market evolution over the past decades. And so in 2006, Treasury began work to outline a new financial regulatory structure that is better suited to protect investors and the stability of the financial system, and support the innovation and risk-taking that fuel our economy. We released our Blueprint for a Modernized Financial Regulatory Structure, in March of this year.

In the Blueprint, we recommend a U.S. regulatory model based on objectives that more closely link the regulatory structure to the reasons why we regulate. Our model proposes three primary regulators: one focused on market stability across the entire financial sector, another focused on safety and soundness of institutions supported by a federal guarantee, and a third focused on protecting consumers and investors.

A major advantage of this structure is its timelessness and its flexibility and that, because it is organized by regulatory objective rather than by financial institution category, it can more easily respond and adapt to the ever-changing marketplace. If implemented, these recommendations eliminate regulatory competition that creates inefficiencies and can engender a race to the bottom.

The Blueprint also recommends a number of near-term steps. These include formalizing the current informal coordination among U.S. financial regulators by amending and enhancing the Executive Order which created the President's Working Group on Financial Markets and, while retaining state-level regulation of mortgage origination practices, creating a new federal-level commission, the Mortgage Origination Commission to establish minimum standards for, among other things, personal conduct and disciplinary history, minimum educational requirements, testing criteria and procedures, and appropriate licensing revocation standards.

The Blueprint includes recommendations on a number of intermediate steps as well – focusing on payment and settlement systems and on areas, such as futures and securities, where our regulatory structure severely inhibits our competitiveness. We recommend the creation of an Optional Federal Charter for insurance companies, similar to the current dual-chartering system for banking, and that the thrift charter has run its course and should be phased out. We also recommend the creation of a federal

charter for systemically important payment and settlement systems and that these systems should be overseen by the Federal Reserve, in order to guard the integrity of this vital part of our nation's economy.

When we released the Blueprint, I said that we were laying out a long-term vision that would not be implemented soon. Since then, the Bear Stearns episode and market turmoil more generally have placed in stark relief the outdated nature of our financial regulatory system, and has convinced me that we must move much more quickly to update our regulatory structure and improve both market oversight and market discipline. Over the last several weeks, I have recommended important steps that the United States should take in the near term, all of which move us toward the optimal regulatory structure outlined in the Blueprint. I will briefly summarize these.

First, Americans have come to expect the Federal Reserve to step in to avert events that pose unacceptable systemic risk. But the Fed does not have the clear statutory authority nor the mandate to do this; therefore we should consider how to most appropriately give the Federal Reserve the authority to access necessary information from complex financial institutions – whether it is a commercial bank, an investment bank, a hedge fund, or another type of financial institution – and the tools to intervene to mitigate systemic risk in advance of a crisis.

The MOU recently finalized between the SEC and the Federal Reserve is consistent with this long-term vision of the Blueprint and should help inform future decisions as our Congress considers how to modernize and improve our regulatory structure.

Market discipline is also critical to the health of our financial system, and must be reinforced, because regulation alone cannot eliminate all future bouts of market instability. For market discipline to be effective, market participants must not expect that lending from the Fed, or any other government support, is readily available. I know from first hand experience that normal or even presumed access to a government backstop has the potential to change behavior within financial institutions and with their creditors. It compromises market discipline and lowers risk premiums, ultimately putting the system at greater risk.

For market discipline to effectively constrain risk, financial institutions must be allowed to fail. Today two concerns underpin expectations of regulatory intervention to prevent a failure. They are that an institution may be too interconnected to fail or too big to fail. Steps are being taken to improve market infrastructure, especially where our financial firms are highly intertwined - the OTC derivatives market and the tri-party repurchase agreement market, which is the marketplace through which our financial institutions obtain large amounts of secured funding.

It is clear that some institutions, if they fail, can have a systemic impact. Looking beyond immediate market challenges, last week I laid out my proposals for creating a resolution process that ensures the financial system can withstand the failure of a large complex financial firm. To do this, we will need to give our regulators additional emergency authority to limit temporary disruptions. These authorities should be flexible, and – to reinforce market discipline – the trigger for invoking such authority should be very high, such as a bankruptcy filing. Any potential commitment of government support should be an extraordinary event that requires the engagement of the Treasury Department and contains sufficient criteria to prevent costs to the taxpayer to the greatest extent possible.

This work will not be done easily. It must begin now, and begin in earnest. Thank you.

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PRESS ROOM
U.S. DEPARTMENT OF THE TREASURY

July 2, 2008
HP-1064

Remarks by U.S. Treasury Secretary Henry M. Paulson, Jr.
on the U.S., the World Economy and Markets before the Chatham House

London - Thank you, Robin. I am pleased to be in London again. Today I will provide my perspective on current U.S. and global economic conditions and then look forward to your questions.

When President Bush visited the United Kingdom last month, Prime Minister Brown remarked on the similarities between our countries -- that both are "founded upon liberty, our histories forged through democracy, our shared values expressed by a commitment to opportunity for all." And indeed our countries are loyal and true allies, our people are friends and we stand and work together on the world economic stage.

U.S. Economy

Today, the U.S. economy is going through a rough period. And while we have seen better growth in Europe over the last few quarters, there are signs of a slowdown in Europe in general and the UK specifically. However, emerging economies are expected to continue a period of strong growth, which will support global growth overall.

Early this year, President Bush and the U.S. Congress enacted an economic stimulus package that is injecting $150 billion into the U.S. economy now when it's most needed. To date, almost 95 million payments totaling over $78 billion have been sent. Consumer spending data in May show these payments are helping families weather this period of slow growth and higher food and gas prices.

Still, the U.S. economy is facing a trio of headwinds: high energy prices, capital markets turmoil and a continuing housing correction.

U.S. Housing Market

While we have implemented several public and private initiatives to prevent avoidable foreclosures, the housing correction continues to pose a significant downside risk to the U.S. economy. As the market works through past excesses, U. S. foreclosures will remain elevated and we should not be surprised at continued reports of falling home prices. Our policy continues to be to work to avoid

preventable foreclosures while not impeding the necessary correction because the sooner housing prices stabilize and more buyers return to the market the sooner housing will begin to contribute to economic growth.

U.S. and Global Capital Markets

Today I will focus on our capital markets – where the United States and the United Kingdom face similar challenges and are pursuing similar approaches. I see our work in three tranches; first and foremost, our number one priority continues to be promoting market stability and limiting the impact on the broader economy as we work through today's institutional and markets stresses. Second, implementing the appropriate policy responses to recent events to address the deficiencies in our markets which the current problems have exposed. Third, improving our overall financial regulatory structure to better prevent and address future turmoil.

Working through the current turmoil will take additional time, as markets and financial institutions continue to reassess risk, and re-price securities across a number of asset classes and sectors. I have encouraged financial institutions to de-lever, recognize and disclose losses and raise capital, so they can continue to play their vital role in supporting economic growth. Even in this difficult environment, financial institutions worldwide have raised over $338 billion. Institutions in the U.S. and the U.K. have raised capital equal to 95 and 96 percent of their recognized losses, respectively. In continental Europe, the gap is wider; there, institutions have raised only 56 percent of their recognized losses so far. I encourage financial institutions to continue to strengthen balance sheets by raising capital, de-leveraging or reviewing dividend policies.

Today's markets are difficult and this is a tough earnings environment for our financial institutions as they work through the present market turmoil and adjust to the underlying challenges in our economy. For example, high oil prices will in all likelihood prolong our economic slowdown and housing continues to pose a significant downside risk.

U.S. Response to Policy Issues Arising from Market Turmoil

As the United States and international capital markets work through the immediate turmoil, policymakers around the world have been focused on addressing the policy implications.

In the United States, the Treasury Department, the Federal Reserve, the Securities and Exchange Commission and the Commodities Futures Trading Commission worked together through the President's Working Group on Financial Markets, the PWG, to recommend and implement specific near-term policy actions. U.S. regulators, investors, financial institutions and credit ratings agencies have begun to implement these and other recommendations, which include stronger mortgage origination oversight, national licensing standards for mortgage brokers, and actions to improve market infrastructure, regulatory oversight, risk management practices, steps to address valuation issues, and policies and practices related to

the credit ratings agencies and the mortgage securitization chain.

International Policy Response to Market Turmoil

From the outset, U.S. and world policymakers knew that the interconnectedness of U.S. and global markets required an internationally coordinated response. Throughout this process, we have been in regular contact and worked closely with our international colleagues, particularly with the UK. At our meeting last October, the G7 tasked the Financial Stability Forum, the FSF, to analyze the underlying causes of the turbulence and offer proposals for change. The FSF, which brings together the supervisors, central banks, and finance ministries of major financial centers, has done its work quickly and effectively, and recently produced 67 recommendations. These are consistent with and complement efforts in the United States.

We have already seen progress on the implementation: an updated code of conduct for credit rating agencies has been issued and is being implemented; disclosure practices have been published and are being put in place; and the Basel Committee just issued updated bank liquidity guidance. A large number of other projects are well underway, and the FSF is closely monitoring progress. The United Kingdom and European nations are taking a number of other actions that support and reinforce the FSF recommendations.

There is no easy solution that will immediately relieve current financial market stress or protect against future problems and market challenges which will inevitably occur. Together, the United States, the United Kingdom, other nations and the FSF are addressing current challenges and the underlying weaknesses that contributed to present economic circumstances.

Vision for a Modern U.S. Financial Regulatory Structure

That said, I believe we in the United States need to go further – to address not only the specific policy issues that gave rise to recent turmoil, but also the outdated nature of the U.S. financial regulatory system. Few, if any, defend our current balkanized system as optimal.

Treasury made our recommendations for an optimal structure when we released our Blueprint for a Modernized Financial Regulatory Structure last March. We recommend a U.S. regulatory model based on objectives that more closely link the regulatory structure to the reasons why we regulate. Our model proposes three primary regulators: one focused on market stability across the entire financial sector, another focused on safety and soundness of institutions supported by a federal guarantee, and a third focused on protecting consumers and investors.

A major advantage of this structure is its timelessness and its flexibility. Because it is organized by regulatory objective rather than by financial institution category, it can more easily respond and adapt to the ever-changing marketplace. These recommendations eliminate regulatory competition that creates inefficiencies and

can engender a race to the bottom.

We began work on this Blueprint well before our current challenges emerged. Our goal then, which has only accelerated now, is to modernize the U.S. financial regulatory structure to better reflect modern financial markets. Of course, regulation alone cannot fully protect the financial system. Market discipline must also constrain risk-taking. Finding the right balance between market discipline and market oversight is critical to maintaining the market stability and innovation necessary to support vibrant economic growth.

When we released the Blueprint, I was clear that it was a long-term vision that would take time to consider and implement. That is still the case, but today we have both a clear need and a unique opportunity to accelerate this process. The Bear Stearns episode and market turmoil more generally have placed in stark relief the outdated nature of our financial regulatory system. We are working with the Fed and the SEC on the immediate issues raised by the Fed's provision of liquidity to the primary dealers, an extraordinary step taken in the wake of Bear Stearns and one that was necessary to ensure the stability and orderliness of our financial system.

The Bear Stearns episode highlighted the need for the Fed and SEC to work constructively together including an MOU that should be helpful and inform future decisions as our Congress considers how to modernize and improve our regulatory structure.

In addition to the MOU, there are three important steps that the United States should take in the near term, all of which move us further in the direction of the optimal regulatory structure outlined in the Blueprint.

First, whether it was Long Term Capital Management in 1998 or Bear Stearns this year, it is clear that Americans have come to expect the Federal Reserve to step in to avert events that pose unacceptable systemic risk. But, as we noted in our Blueprint, the Fed has neither the clear statutory authority nor the mandate to attempt to anticipate and prevent risks across our entire financial system. Therefore we should consider how most appropriately to give the Federal Reserve the information and authority necessary to play its expected role of market stability regulator. The Fed would need the authority to access necessary information from complex financial institutions -- whether it is a commercial bank, an investment bank, a hedge fund, or another type of financial institution -- and the tools to intervene to mitigate systemic risk in advance of a crisis.

This is a tall order. History teaches us that in a dynamic market economy regulation alone cannot eliminate instability. To be clear, I do not believe that we can eliminate, by regulation or otherwise, all future bouts of market instability -- they are difficult to predict and past history may be a poor predictor of the future. However, just because the overall task is difficult, we should not stop trying to understand and mitigate instability.

To that end, we should create a system that gives us the best chance of foreseeing a crisis, including a market stability regulator with the authorities to avert systemic issues it foresees and providing the information, tools and authorities to deal better with unexpected events when they inevitably occur.

To complement this regulator's efforts, we must have strong market discipline to reinforce the stability of our markets. For market discipline to be effective it is imperative that market participants not have the expectation that lending from the Fed, or any other government support, is readily available. Otherwise, market discipline will be compromised severely. I know from first hand experience that normal or even presumed access to a government backstop has the potential to change behavior within financial institutions and with their creditors. It compromises market discipline and lowers risk premiums, ultimately putting the system at greater risk.

So how do we strengthen market discipline? Today's priority is clearly market stability. However, looking beyond the immediate turmoil, we need to design carefully and put in place a stronger capacity for resolution and crisis intervention that reinforces market discipline. In an optimal system, market discipline effectively constrains risk because the regulatory structure is strong enough that a financial institution can fail without threatening the overall system. For market discipline to constrain risk effectively, financial institutions must be allowed to fail. Under optimal financial regulatory and financial system infrastructures, such a failure would not threaten the overall system.

However, today two concerns underpin expectations of regulatory intervention to prevent a failure. They are that an institution may be too interconnected to fail or too big to fail. We must take steps to reduce the perception that this is so -- and that requires that we reduce the likelihood that it is so.

Strengthening market infrastructure will reduce the expectation that an institution is too interconnected to fail. We need to strengthen our practices and financial infrastructure in the OTC derivatives market and in the tri-party repo system. Important work is underway in each of these areas, and needs to be completed quickly.

To address the perception that some institutions are too big to fail, we must improve the tools at our disposal for facilitating the orderly failure of a large complex financial institution. As former Federal Reserve Chairman Greenspan often noted, the real issue is not that an institution is too big or too interconnected to fail, but that it is too big or interconnected to liquidate quickly.

Today, our tools are limited. We have the Fed's broad lender of last resort powers which are currently being used to help stabilize our markets. Current law also allows our President to declare a national economic emergency, and then dictate the actions of commercial banks. But this tool is both too blunt, in that exercising it would likely spur greater concern and too narrow, in that commercial banks are only one group of participants in today's broad financial markets. We also have

specialized resolution provisions that apply solely to insured depository institutions, but these do not apply to a large group of complex financial companies.

In general, bankruptcy law serves as the resolution regime for non-depository financial institutions and most corporations. This regime has a long legal history, and is initiated by private-sector decisions to initiate bankruptcy proceedings, which then start a process to pay claims. In contrast, under the administrative procedures for insured depository institutions, regulators determine when and how to start the proceeding and in many ways regulators largely take the place of the courts in determining the allocation of claims.

These two very different approaches for resolution have advantages and disadvantages. Bankruptcy imposes market discipline on creditors, but in a time of crisis could involve undue market disruption. An administrative procedure under the control of regulators helps to mitigate market disruption, but can reduce market discipline. For insured depository institutions, this special insolvency regime was deemed necessary because of the role these institutions play in the overall financing of economic activity and the presence of a government guarantee.

As I have continually noted, the financial landscape has changed, and non-bank financial institutions play a significantly greater role. We need to consider broadly the resolution regime in light of these changes. It is clear that some institutions, if they fail, can have a systemic impact, so we must give regulators the authorities to limit that impact and facilitate an orderly failure. In my view, looking beyond the immediate market challenges of today, we need to create a resolution process that ensures the financial system can withstand the failure of a large complex financial firm. To do this, we will need to give our regulators additional emergency authority to limit temporary disruptions. These authorities should be flexible and -- to reinforce market discipline -- the trigger for invoking such authority should be very high, such as a bankruptcy filing. And as part of this process we should consider ways to ensure that costs are imposed on creditors and equity holders. Any commitment of government support should be an extraordinary event that requires the engagement of the Executive Branch. It should be focused on areas with the greatest potential for market instability and should contain sufficient criteria to ensure that the cost to the taxpayers is minimized.

In the United Kingdom, you gave recently proposed changes to your regulatory system as the United States is doing now. While your regulatory system is different from ours, we both recognize the direction our systems must take to better deal with market stability issues and today's financial markets. In the U.K., colleagues have recently proposed modifications to your regulatory structure and authorities similar to what Treasury envisioned in our Blueprint. Under this new proposal, the Bank of England would be given specific statutory responsibility for financial stability regulation. A new Financial Stability Committee, chaired by the Governor of the Bank of England, would oversee the Bank's functions as they relate to market stability. The Bank of England would also have new authorities to carry out this function, including access to firm-specific information related to market stability, formal oversight of payment systems, as we are recommending for the Federal Reserve in the U.S., and a lead role in working with the FSA to

establish a new resolution regime.

As U.S. and global regulators respond to recent events, we must recognize that the stability and vitality of our markets require both robust oversight and market discipline.

Conclusion

The United States and the United Kingdom share a long history and a bright future. As we cooperate and work closely with you during this period of economic difficulty we look forward to emerging, as we always do, to a new day of promise and prosperity. Thank you.

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Contents of Letter Sent to ED with Notice of Participation

Below please find the body of a letter sent to ED offering our suggestions. This letter was sent as a cover letter when we gave notice to ED of our participation in the program.

Dear Ms. Hansen:

Brazos Higher Education Service Corporation, Inc. ("BHESC") respectfully submits the attached Notice(s) of Intent to Participate on behalf of various entities for whom we serve as Master Servicer.

At this point in time, however, it seems unlikely that any of the entities for which Notices are being filed herein will be able to participate. Due to numerous issues, which we respectfully submit for your consideration, the Program does not solve the liquidity problem that exists in the market for non-Bank lenders, acting through Eligible Lender Trustees.

The primary issue which still remains is that of the reduced yields on FFELP loans which came with the passage of the College Cost Reduction Act. While the liquidity crisis prompted by the home mortgage debacle is certainly a hindrance to liquidity in the current market environment, the reduced yields make it such that the FFELP loans have no value and, thus, even if the markets loosens up, without a change to the yield rates on the FFELP loans, the crisis is not over for non-Bank lenders. In a good market environment, non-Bank lenders are going to be hard pressed to obtain financing on FFELP loans which are valued at under PAR, or to find financing at a cost that does not result in working at a substantial deficit. Thus, the real problem that remains unresolved is that of the yield rates.

With that said, the other market issues in the FFELP for non-Bank lenders resulting from the mortgage crisis is the inability to find both front-end liquidity and long term financing solutions in a tight, troubled market. It was the basic understanding of most in the industry that the Ensuring Access to Student Loans Act of 2009 (the "Act") was going to address both of these issues. Unfortunately, however, as we have recently learned, the Act does not go far enough to resolve both pieces of the problem. Because the loans have to be disbursed before they are eligible for the participation interest, lenders must obtain up-front financing to get the loans originated. In addition, lenders have to subsidize the costs associated with making the loan, costs that are inflated from the normal costs given the added complexities and costs associated with the involvement of a Custodian, and these costs can not be recovered until the entire facility is resolved. Thus, the front-end liquidity problem is not adequately addressed by the Act and we, as are other non-Bank lenders, are faced with having to find short term financing solutions on loans that have little to no value in tight market conditions and must finance the full costs of origination until the loans are fully disbursed and can be sold to the Department. Even if financing can be obtained, it will most likely be at a cost that will make the program cost prohibitive for most. This is an issue that will most likely impede a large number of non-Bank lenders from participation in the Program.

Several issues could be addressed, within the framework of what has been put forth that may ease the burden and help non-Bank lenders stay in the program. These are as follows:

1. We suggest that a lender participating in the Loan Participation Purchase Program be given the ability to make a commitment at the outset to sell the loans made pursuant to

Please Turn

the Program only to the Department. In cases where this commitment is made, we suggest that the Department waive the payment of the 1% lender origination fee and that such lenders are not required to make negative special allowance payments. This will ease the amount of front-end financing that is necessary, in addition to easing reconciliation issues within the facility.

2. We suggest that, during time in which the Department owns a participation interest, the Sponsor not be required to pay negative special allowance payments, but rather that the Department offset any monies due against the amount of special allowance payments or subsidized interest owed to the Sponsor.

3. The costs of origination during the Participation Program are likely to be more than was anticipated thus making the $75 paid at the time the loans are sold to the Department insufficient. The key pieces that are not accounted for are those that will exist as a result of the way in which the Custodian factors into the process. Not only will there be deconversion fees, which must be borne by the Sponsor, at the time that the loans are sold to the Department, there will also be additional transfer fees when the loans have to move from the Sponsor's LID to the Custodian's LID. These fees are in addition to the normal costs associated with origination and servicing of the loans. As well, the Custodian will charge fees to perform their duties and, without having a clear understanding of exactly what they are required to do, we can only assume at this point what the Custodian Fees will be. The fees associated with the servicing and Custodian may be mitigated if the Department would allow the Servicer to also function in the capacity of the Custodian.

With fall disbursements coming very quickly, time is of the essence. In order for us to proceed with attempting to find financing, we need to see the program Agreements. No credit providers will commit to anything until they have those in hand and can review them.

We appreciate your consideration of our suggestions.

Sincerely,

Murray Watson, Jr.
President

On-going Barriers to Continued Participation in FFELP for Not-for-Profit Lenders

H.R. 5715, the Ensuring Continued Access to Student Loans Act, provided a critical avenue to liquidity in the student loan market place. However, as the Department has begun to implement the law, there continue to be significant barriers that could prevent not-for-profit secondary markets from participating in the student loan programs, which could compromise access and service for students in high need areas.

Barrier – In order to participate in the Loan Participation Purchase Program, the eligible lender must certify that it will sell participation interests in FFELP loans to the Department of Education with an aggregate balance of not less than $50 million. This requirement will prohibit smaller lenders, many of which serve, high need communities, from being able to participate.

Example – COSTEP of South Texas is not able to meet the $50 million threshold either on its own or in the aggregate. COSTEP's two largest lenders have suspended participation in FFELP and have indicated that they are not interested in participating in the Department's plans under H.R. 5715.

Solution – The Department should remove or significantly lower the $50 million threshold requirement.

Barrier – The Department's plan to implement H.R. 5715 will require lenders to advance funding to make the loans, to pay the origination fee and to pay the negative special allowance payment. As the Department has interpreted the law, H.R. 5715 does not give the Department the authority to advance funds to lenders, it may only purchase loans. The loan is not a loan until it is disbursed. The Department has proposed that it will be able to fund the purchase of loans within a window of 7 to 1 0 business days. In effect, lenders would need to finance student loans for those 7 – 10 days with another line of credit. In addition, the lender will have to fund in advance the origination fee and the negative special allowance payment that is the difference between the fixed rate of interest that the student pays and the variable rate of return for the lender. Given that the student loan crisis is due to a lack of liquidity, many not-for-profit secondary markets are unable to secure the bridge financing necessary to participate.

Example – Brazos Secondary Market announced that they would resume participation in FFELP with the passage of H.R. 51715 with the understanding that the law would provide advanced funding to make loans. They are currently reassessing their ability to participate in light of the Department's plans to implement H.R. 5715. Brazos currently has $4 billion in student loans that are stuck in lines of credit that cannot be refinanced due to market conditions. They have been denied new lines of credit to make new loans because of the lower investment value of the new loans.

Solution - Congress should clarify that the Department has the authority to provide advance funding or the Department should reduce the time to fund the purchase of loans to, at most, an overnight transaction, which in common in other areas of banking. The origination fees and the negative special allowance payment should be offset from the earnings that are being accrued on the loans rather than paid in advance.

Barrier – Many not-for-profit secondary markets have their resources frozen in the failed auction rate securities. The interest expense is climbing on these bonds, compromising the secondary markets ability to continue to participate in the student loan programs.

Example – Panhandle-Plains Secondary market has approximately $1.9 billion in auction rate securities – most of which have failed auctions. Bond interest expense is the largest expense for Panhandle-Plains, and these costs have increased by as much as 200 basis points with a portfolio average of 60 -90 basis points. A 60 basis point increase, results in additional costs of $1,030,775 per month.

Solutions – Legislation such as Rep. Kanjorski's bill, H.R. 5914, the Student Loan Access Act, would provide an avenue for lenders to refinance the auction rate securities. Additionally, an aggressive outreach campaign by the Department of Education, Treasury and other federal financial institutions to highlight the underlying value of student loan assets (97 percent guarantee) could boost investor confidence and provide renewed ability for secondary markets to refinance student loan-backed-auction rate securities.

Other areas of concern –

Servicing – In selling loans to the Department, it is not clear whether servicing arrangements would move to the Department as well. Splits or multiple changes in servicing arrangements could result in a lack of continuity of services/due diligence to borrowers and institutions, increasing risk of delinquency and defaults. Every effort should be made to maintain continuity for the borrower and the institution.

50 percent rule – With some lenders suspending participation in FFELP, those that remain may find themselves unable to pick up the volume because of the 50 percent rule, which states that no more than 50 percent of a lender's consumer credit business can be student loans. For example COSTEP has reported that half of their lenders have suspended participation as has Panhandle-Plains. These lenders have accounted for 60 percent of the originations in the region Lenders that remain in the program may be unable pickup the extra loan volume.

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Dear Partners:

It is with the deepest regret that I have to announce that effective July 1, 2008, the Texas State Bank Trustee for COSTEP (Lender I.D. 833102) will suspend making new Federal Family Education Loan Program (FFELP) loans. All second and third disbursements on loans where the first disbursement was made on or prior to June 30, 2008 will be honored. Actions taken by Congress in October under the College Cost Reduction and Access Act have reduced lender yields on student loans to a point where a student loan is not even marginally profitable for either a non-profit entity or a for-profit entity. The auction rate security capital markets where the secondary market authorities across the nation auctions their bonds have completely shut down and coupled with the downgrading of the industries mono-line bond insurers has caused borrowing costs on some bonds to skyrocket. In May of this year the Department of Education announced a short-term liquidity plan that would provide an outlet for lenders to sell their loans that are originated between May 1, 2008 through July 1, 2009. The Department's announcement provided a ray of hope for the industry; however, as the saying goes the "devil is in the details". At best, the processes and procedures that a lender must comply with in order to garner funds from the Department to originate or sell their loans back to the Department is extremely inefficient and costly.

COSTEP applauds the efforts of every individual working in the financial aid offices around the country and especially in Texas. We have witnessed first-hand their dedication and tireless efforts in providing exceptional and unfettered access to the students attending their university or college. COSTEP will continue to monitor the capital markets and ongoing efforts by the Department with the expectation that we'll be able to participate in the FFELP in the near future.

Best regards,
COUNCIL FOR S. TEXAS ECONOMIC PROGRESS, INC.

Patricia Beard
President

Memorandum

July 8, 2008

TO: Texas Congressional Staff

FROM: Jimmy Parker, PPHEA

Panhandle-Plains Higher Education Authority (PPHEA)

Year Founded
PPHEA began as a small company in Canyon, TX in 1979 with the hopes to help aspiring students in the Panhandle and south Plains of Texas take hold of their college education and their futures. PPHEA is a non-profit organization dedicated to assisting students, educational institutions (secondary and post secondary), and financial institutions towards continued success. Currently the Panhandle Group of companies has approximately 179 employees in Canyon, Lubbock, Abilene, Dallas, San Marcos, and Houston.

Mission
PPHEA's mission is to work for the success of students by promoting college financial aid awareness, helping students obtain financial resources for their post secondary education and delivering all aspects of student loan service with a personal approach.

Programs Offered
PPHEA usually does not make student loans, but buys them from lenders allowing their financial institutions to recycle their funds and offer more student loans. These purchased loans are FFELP loans, consisting of Stafford, PLUS, and Grad Plus. Currently PPHEA works with over 65 lenders across the state of Texas and purchased loans in the amount of $284 million during the 07/08 year. PPHEA has student loan receivables of approximately $2 Billion with more than 200,000 borrowers.

PPHEA had been an originator of consolidation loans which refinance a student's educational loan indebtedness. These consolidation loans allowed borrowers to combine their federal student loans into one easy monthly payment. PPHEA originated approximately $80 million dollars in consolidation loans during the 07/08 year and has now suspended origination of consolidation loans due to increased fees from the College Cost Reduction and Access Act of 2007 (CCRAA) and the disruption in the capital markets.

Key Outreach Services
Panhandle-Plains' dedicated team of financial aid educators conducts more than 250 financial aid nights and college fairs at high schools and colleges across Texas each year. These educators also make classroom visits providing information on higher education, the financial aid process, and career options to students. They assist in the educating and providing of information to more than 10,000 students and parents on the federal financial aid process (grants, loans, work study programs) including completing the free Application for Federal Student Aid (FAFSA).

Key Industry Related Issues Impacting PPHEA

The College Cost Reduction and Access Act of 2007 (CCRAA), which was signed by the President September 27, 2007, has reduced special allowance payments by 40bps to PPHEA, reduced reinsurance to 97%, and increased the lender fee on all loans originated to 1%. These changes are effective for loans originated with a first disbursement on or after October 1, 2007.

PPHEA has approximately $1.9 billion in auction rate securities, both taxable and tax exempt, with the majority of these having failed auctions.

Bond investors have been contacting PPHEA concerning their lack of liquidity due to their failed auctions. A number of the investors have been small corporations, non-profits, or foundations that cannot afford to have their funds inaccessible.

Bond interest expense is the largest expense for PPHEA and these costs have increased by as much as 200bps on some of the bond issues with a portfolio average of 60 – 90bps increase. A 60bps increase in bond interest rates across the portfolio would increase bond interest expense by $1,030,775 per month.

Disruptions in the capital markets have made it difficult for secondary markets such as PPHEA to obtain needed liquidity for new bond financings or refinance existing bond financings that contain failed auctions. In addition if PPHEA is unable to obtain new financing by August 1, 2008 PPHEA will be forced to temporarily suspend purchases from our lender partners.

Also, due to the current disruption in the capital markets and financial decreases within CCRAA, PPHEA has eliminated all borrower benefits on federal student loans as of June 1, 2008. These benefits include zero origination fees for students, a .25% interest rate reduction for ACH, a 1% principal reduction after 12 consecutive on-time payments and up to the last $500 of the borrowers account is forgiven.

Currently 34 of the lenders that work with PPHEA have temporarily suspended participation in the FFELP program for the 2008/09 academic year. This represents approximately 60% of the loans originated during the 2007/08 academic year.

Panhandle-Plains Student Finance Corporation (PPSFC), a Texas non-profit corporation, has suspended the alternative loan program due to the disruption in the capital markets. This program was set up as a true gap loan and required school certification with the amount that could be borrowed limited to cost of attendance minus other financial aid.

If you should have any additional questions concerning these issues please feel free to contact Jimmy Parker at jimmyp@ppslc.com or 806/324-4115.

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