DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

April 2, 2009

Ms. Elizabeth Warren
Chair
Congressional Oversight Panel
732 North Capitol Street, NW
Rooms C-320 and C-617
Mailstop: COP
Washington, DC 20401

Dear Chair Warren:

Thank you for your letters dated March 5 and 20, 2009. We look forward to continuing to work with you and the Panel toward our shared goals of financial stability and economic recovery. Over the past seven weeks, we have put in place our *Financial Stability Plan* (FSP), a comprehensive effort to help lay the financial foundations for economic recovery. In designing the FSP, we have maintained a focus on the root causes of the financial crisis. This reply is intended to address your questions from the March 5 letter by explaining our understanding of the origins of the current crisis and how they relate to the specific programs we have announced. This letter also responds to your inquiry from March 20 regarding the *Term Asset-Backed Securities Lending Facility* (TALF).

I look forward to discussing these and other issues with you and the Panel at my testimony on April 21. I would also like to offer you the opportunity for weekly briefings by my staff, so that we are able to provide you with information through an ongoing regular dialogue. Additionally, I would like to make Treasury staff available to brief you on specific policy initiatives as they are announced.

Origins of the Financial Crisis

As I have stated before, our current crisis has many causes. But at its core, this crisis began because – due to both economic changes and regulatory weaknesses – we borrowed too much and we took on irresponsible levels of risk.

A global boom in savings, partly from growing wealth in emerging economies, resulted in large flows of capital that sought opportunities for higher return – particularly in the United States, which offered a more attractive option for investment due to its deep, liquid capital markets. These flows of capital pushed down long-term interest rates and pushed up asset prices.

In this environment, investors looked for higher returns by taking on greater exposure to the risk of infrequent but severe losses. Home mortgages became cheap, and lenders developed innovative mortgage products to widen the market for home buying, especially to those who might not have been able to afford mortgages under traditional terms. Due to the widening of the mortgage market, there was a sharp increase in home prices, as buyers took advantage of lower rates and more generous terms. Rising home prices encouraged borrowers, lenders and investors to make choices that could only succeed if home prices continued to appreciate.

Demand from investors also led to the creation of new financial products, and the complexity of these products outmatched the risk-management capabilities of even the most sophisticated financial institutions. Compensation packages based on short-term profits rather than long-term returns encouraged people to take unwise risks on these instruments. Financial activity migrated outside the banking system, while regulated institutions held too little capital relative to the risks to which they were exposed. And the combined effects of the requirements for capital, reserves and liquidity amplified rather than dampened financial cycles – intensifying the boom and magnifying the bust.

At the same time, our financial system – regulated through a structure that is unnecessarily complex and fragmented – operated with large gaps in meaningful oversight and without sufficient constraints to limit these risks. Even as a growing share of lending was securitized, regulators did not respond to the challenges posed by the growth in complex financial instruments. Despite implicit or explicit forms of support from the government, investment banks, large insurance companies, finance companies, and the government-sponsored enterprises were subject to only limited oversight. These highly leveraged institutions lacked strong federal prudential regulation and they did not have established access to central bank liquidity. Moreover, they were permitted by law to choose among regulatory regimes, often allowing them to avoid a stronger regulatory authority that might have been applied if they had been supervised as bank holding companies. Meanwhile, U.S. law did not provide regulators with any effective options for managing the failure of systemically important non-bank financial institutions – which left the government with unsatisfactory choices when faced with the potential failure of institutions like Lehman Brothers and American International Group.

In this weak regulatory environment – with overleveraged firms participating in interconnected markets – a sharp decline in housing prices provided a catalyst for a broader crisis. The demand for homes began to ease in early 2006, a turning point for the economy and financial stability. That easing in demand led first to a slowing rate of home price appreciation and then to outright declines in home prices. As the price declines accelerated, receding home prices exposed the weaknesses in aggressive lending practices, as loans that made economic sense only when prices were rising sharply began to sour. Delinquencies rose, first on subprime loans, then on the more traditional fixed-rate mortgages. As a result, the value of a wide variety of financial instruments based on mortgages began to decline. Financial institutions with significant exposure to mortgage assets began to see their income shrink and their asset values decline. Firms that had specialized in writing insurance contracts on mortgage-related assets, especially subprime mortgages, found themselves unable to meet their obligations. Companies needed to liquidate

assets to meet the demands of their creditors. The result was the beginning of a vicious downward spiral that reached a crisis stage when credit markets froze in the fall of 2008. Today, banks – still burdened by bad lending decisions from the past – are holding back on new lending, and the credit that is available often carries a high cost for borrowers.

Some parts of the financial system have shown improvement recently; other parts have not. The LIBOR-Overnight Indexed Swap spread, often used as a measure of distress in money markets, fell from a peak of 365 basis points in the fall of 2008 to just above 100 basis points in the past few weeks. Even with that improvement, the spread remains high relative to the levels before the crisis: it averaged about 10 basis points in the first half of 2007. Issuance of asset-backed securities (other than those backed by mortgages) averaged about $20 billion per month in the first half of 2008; in February 2009 about $2.5 billion in non-mortgage asset-backed securities were issued.

The effects of financial market instability on the rest of the economy have been profound. Home prices have fallen sharply, homebuilding activity is down more than 80 percent from its 2006 peak, and mortgage delinquencies are at a record high. The unemployment rate rose 2.5 percentage points from mid-2008 to its current level of 8.1 percent. The after-effects of the crash in credit-sensitive sectors have been severe, and new problems have emerged. Partly in reaction to overleveraging in the past, and partly in response to the deterioration in the economy, credit is now not available to many creditworthy borrowers. This is creating another round of reduced spending leading to layoffs, which in turn further reduces spending.

The economic fallout from this instability has already caused enormous suffering, and much of the damage has fallen on families and small-business owners who behaved responsibly. Our response requires that every policy be judged by the following test: whether it gets our financial system back to providing credit to working families and viable businesses and helps prevent future crises.

In particular, our strategy must address each of the four major challenges that remain at the center of the financial crisis and continue to slow our progress towards recovery. First, falling house prices and rising unemployment have made it difficult for many responsible homeowners to meet their mortgage payments and stay in their homes. Second, frozen secondary markets have constrained the ability of even creditworthy small businesses and families to get the loans they need. Third, uncertainty about the real value of distressed assets and the ability of borrowers to repay loans, as well as uncertainty as to whether some financial institutions have the capital required to weather a continued decline in the economy, have caused both a dramatic slowdown in lending and a decline in the confidence required for the private sector to make much-needed equity investments in our major financial institutions. Finally, the existence of troubled legacy assets is straining the capital of our financial institutions and further limiting their ability to extend credit.

The FSP, which I outlined on February 10, and the steps we have taken since are designed with each of these four challenges in mind. To respond to falling home prices, the President introduced the *Making Home Affordable Plan* to support lower mortgage rates and help millions

of homeowners refinance and avoid foreclosure. In an effort to unlock frozen credit markets, we created – in cooperation with the Federal Reserve – the *Consumer and Business Lending Initiative* (CBLI) to restart activity on the secondary markets for securitized loans, bring down borrowing costs and get credit flowing again. To ensure that major financial institutions have adequate capital to lend even in a worse-than-expected economic environment, we laid out our *Capital Assistance Program* (CAP). In order to help jumpstart the market for the private real-estate-related assets that are at the core of our financial crisis, we introduced the *Public-Private Investment Program* (PPIP) to use private and government capital to purchase legacy assets.

The FSP represents a comprehensive approach to stabilizing and strengthening our financial system, and the Administration recognizes that accomplishing this goal is central to restoring economic growth. At the same time, we are also committed to modernizing our financial regulatory system for the 21st century by providing stronger tools to prevent and manage future crises. The lack of a modern regulatory regime and resolution authority helped create the current crisis, and it will limit our ability to address future crises until we put in place fundamental reforms. Last week, I outlined an approach to financial regulation that will address systemic risk, protect consumers and investors, eliminate the gaps in our regulatory structure, and foster international cooperation. As part of this reform effort, Treasury also proposed legislation for a resolution authority that would grant additional tools to avoid the disorderly liquidation of systemically significant financial institutions that fall outside of the existing resolution regime for banks under the FDIC. These reforms, accompanied by our efforts to restore the proper functioning of our banking system, are essential to our recovery.

Recapitalizing the Banking System – A Key Plank of the Financial Stability Plan

Currently, the vast majority of banks have more capital than they need to be considered well capitalized by their regulators. However, concerns about future economic conditions – combined with the destabilizing impact of "legacy assets" – have created an environment under which uncertainty about the health of individual banks has sharply reduced lending across the financial system, working against an economic recovery. Providing confidence that banks have a sufficient level of capital even if the economic outlook deteriorates is a necessary step to restart lending so that families have access to the credit they need to buy homes or pay for college, and businesses can get the loans they need to expand.

In normal times, the best way to recapitalize the banking system would be to allow private market forces to allocate capital to where it is in greatest demand and yields the highest return. Today, however, a cloud of uncertainty over the market has induced much more caution by lenders than might otherwise be the case. As the collapse of the real estate market has led to large losses in the value of legacy assets, market participants have become uneasy about the balance sheets of banks who own these assets, making it harder for banks to raise the equity they need. At the same time, because banks themselves want to ensure they will have sufficient capital to survive even an extreme, worse-than-expected recession, too many banks are hesitant to lend with the capital they have. While each bank alone may feel this behavior is rational, when done collectively by too many banks, it dries up lending, accelerates recession, and thus increases the chances that a more severe economic downturn will occur. The risk is a self-

fulfilling prophecy – where concerns about worse economic conditions help create those conditions – and it is this negative outcome that CAP is designed to prevent.

CAP is designed to help ensure our banking institutions have sufficient capital to meet potential economic challenges and help restore confidence in U.S. banking institutions. This strategy begins with the idea that in order to ensure our largest banks have adequate capital to weather a more severe economic scenario and continue to lend, we must first accurately diagnose their problems. More specifically, we believe it is crucially important to determine the capital buffer banks would need to remain well-capitalized even under more adverse economic conditions. As a result, bank supervisors are currently undertaking a comprehensive supervisory capital assessment of the 19 largest banking organizations – those with assets over $100 billion – that is slated to be completed by the end of April. Banks needing additional capital will be encouraged to access private markets to obtain it, but will also have access to a "capital buffer" provided by Treasury to help absorb losses and serve as a bridge to receiving increased private capital. The capital will be provided to eligible banking organizations in the form of a preferred security that is convertible into common equity. This security will serve as a source of contingent common capital for firms, convertible, when and if needed to retain the confidence of investors or to meet supervisory expectations regarding the amount and composition of capital. With supervisory approval, banking organizations will be allowed to exchange their existing TARP preferred stock for the new CAP preferred instrument. CAP is already open and available to qualified institutions.

In conjunction with CAP, we believe that addressing the problem of legacy assets – whose decline in value was both a direct cause and a consequence of the current crisis – is necessary to ensure banks feel confident they have the capital they need to lend. Due to the collapse in the housing market, both "legacy loans" held on bank balance sheets and "legacy securities" owned by banks as well as insurance companies, mutual funds, pension funds and other financial institutions have declined dramatically in value. As investors and banks have tried to reduce their risk, it has created deleveraging in the markets for these assets, triggering fire sales. The result has been a vicious cycle where declining asset prices leads to further deleveraging, which in turn leads to further price declines. The excessive discounts in the prices of these assets has strained capital for banks, limiting their ability to lend, while creating uncertainty that makes it difficult for financial institutions to raise capital on their own.

The creation of PPIP is intended to restart the market for these assets, while also restoring bank balance sheets as these devalued loans and securities are sold. Using $75 to $100 billion in capital from the Emergency Economic Stabilization Act and capital from private investors – as well as funding enabled by the Federal Reserve and FDIC – PPIP will generate $500 billion in purchasing power to buy legacy assets, with the potential to expand to $1 trillion over time. By providing a market for these assets, PPIP will help improve asset values, increase lending capacity for banks and reduce uncertainty about the scale of losses on bank balance sheets – making it easier for banks to raise private capital and replace the capital investments made by Treasury.

By following three basic principles, PPIP is designed as part of an overall strategy to resolve the crisis as quickly as possible with the least cost to the taxpayer. First, by partnering with the FDIC, the Federal Reserve and private sector investors, we will make the most of taxpayer resources. Second, PPIP will ensure that private sector participants invest alongside the government, with the private sector investors standing to lose their entire investment in a downside scenario and the taxpayer sharing in profitable returns. Third, the program will use competing private sector investors to engage in price discovery, reducing the likelihood that the government will overpay for these assets. By contrast, if the government alone purchased these legacy assets from banks, it would assume a larger share of the losses and risk overpaying. Alternatively, if we simply hoped that banks would work off these assets over time, we would be in danger of repeating the Japanese experience and prolonging the crisis. PPIP strikes the right balance, making the most of taxpayer dollars, sharing risk with the private sector, and taking advantage of private-sector competition to set market prices for currently illiquid assets.

While this crisis was caused by banks taking too much risk, the danger now is that they will take too little. Both CAP and PPIP are intended to return our system back to a healthy equilibrium, avoiding the excessive leverage and risk-taking that helped create this crisis while giving banks the confidence to again lend to creditworthy borrowers.

Consumer Debt

As noted above, lower borrowing costs and a lack of regulatory protections led to excessive levels of consumer debt that helped contribute to the current financial crisis. Even as we saw increased access to credit for large parts of the American economy, those gains were overshadowed by pervasive failures in consumer protection, leaving many Americans with obligations they did not understand and could not sustain. Yet it is important to recognize that today, many creditworthy consumers are suffering – through no fault of their own – because the credit crisis has sharply reduced their ability to borrow money they need to pay for a home, a car or a college education.

Recent experience has reminded us that while there is no hard and fast rule that prescribes the proper debt burden for consumers – and the optimal level of debt should vary with age, earning capacity, job security, family structure, and other factors – some levels of debt are unsustainable in any but the most optimistic of scenarios. Rising mortgage delinquencies and foreclosures are evidence that excessive debt is causing distress in the consumer sector. In 2008Q4, nearly 8 percent of all mortgages (4.2 million) were at least 30 days past due and slightly more than 3 percent were in foreclosure. Compounding the debt burden, consumer net worth dropped nearly 20 percent during 2008 because of falling asset values.

In response to declining wealth and rising delinquencies, households have begun to deleverage and save more. In early 2008, the personal saving rate was about 0.1 percent. In the most recent data available, the saving rate has risen to 5 percent. Households are adjusting to an environment in which credit is not so easy to obtain and the risk of job loss is rising. The result is an increase in precautionary saving, which is dampening aggregate demand.

Still, we know there are many households that are in solid financial condition, and it hurts our economy unduly if these households are unable to borrow, even though their income, stage of life, and employment make it prudent for them to take on more debt. The FSP is not aimed at increasing consumer debt levels. In fact, overall relative consumer debt levels should continue to fall, as homes are refinanced and mortgages are modified. But the FSP is intended to restart responsible lending, and is focused on ameliorating an unfortunate side effect of the deleveraging process: for ordinary families – even those with strong credit – it has become difficult to get student loans, car loans, and credit to finance everyday needs. By providing banks with a greater confidence to lend through CAP and our efforts to create a market for legacy assets, our intention is to ensure that lenders extend credit to creditworthy borrowers. Likewise, CBLI is directed at jumpstarting the securitization markets that supported a significant portion of all consumer lending prior to this crisis – revitalizing the market activity that provides lenders with the liquidity they need to continue making new loans. These programs are intended to restore balance to our financial system – ensuring that borrowers have access to the credit they need without encouraging the kinds of excessive risk and leverage that helped create the current crisis.

Responding to Questions About the Term Asset-Backed Securities Lending Facility (TALF)

I also want to respond to your March 20, 2009 letter on behalf of the Congressional Oversight Panel, including questions regarding the Term Asset-Backed Securities Lending Facility.

As noted above, unlocking the frozen secondary markets that support consumer lending is a key component of FSP. Last year, new issuance of consumer asset-backed securities dropped precipitously, as many traditional investors left the market and many other potential buyers lost access to the funding they needed to make purchases. The TALF – which is part of the overall CBLI – is designed to restart secondary markets by stimulating investor demand for these securities. While the TALF was initially proposed last fall to include securities backed by credit cards, auto loans, student loans and SBA-guaranteed loans, it has been expanded in recent weeks to cover additional asset classes in order to unlock the markets most likely to drive an economic recovery.

The TALF's launch last month illustrated the potential of this structure to spur activity in these markets, as $9 billion in new securitizations were completed in the program's first week – more than in the previous four months combined. Yet even as the TALF has been expanded to new assets, key elements of the program have been implemented to ensure taxpayer interests are protected. By restricting eligibility to assets with certain credit ratings (or government-guaranteed SBA loans), requiring a risk-based haircut and including a risk premium in TALF loan rates, the facility has been structured so that investors bear an appropriate level of risk. In doing so, the TALF's overarching goal is to have the greatest possible impact on lending to consumers and small businesses while minimizing credit risk to the U.S. government.

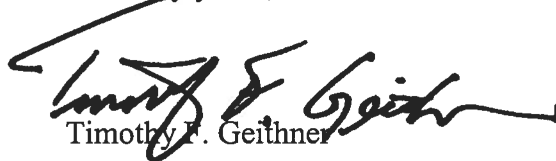
As you know, the TALF comprises two parts: (i) a secured lending facility established and administered by the Federal Reserve Bank of New York (FRBNY) and (ii) a special-purpose asset-disposition vehicle (SPV) owned and controlled by FRBNY but funded in substantial part

by a $20 billion loan commitment from the Treasury Department's Troubled Assets Relief Program. Treasury has no role in making loans or administering the lending facility. Instead, Treasury has only invested in the SPV for the purpose of providing some protection to FRBNY against losses incurred on loans made under the lending facility.

Because the questions you have raised pertain primarily to the structure and operation of the FRBNY lending facility, FRBNY staff has taken the lead in responding. Their response accurately summarizes the problems Treasury sought to address and the goals we hope to achieve by participating in the program. It is also consistent with our understanding of the analyses that were done and the choices that were made by FRBNY in structuring and developing procedures for operation of the lending facility. We believe FRBNY's responses address your concerns, but if you have any further questions about Treasury's loan to the SPV, I would be happy to make Treasury staff available to speak with you.

Thank you again for your inquiries. We are constantly seeking to ensure that we are taking the right steps to create a financial system that both provides the credit necessary for recovery, and ensures we do not find ourselves facing this type of financial crisis again. I look forward to working with you and the Panel as we seek to achieve this goal.

Sincerely yours,



Timothy F. Geithner

cc: Rep. Jeb Hensarling
Sen. John E. Sununu
Mr. Richard H. Neiman
Mr. Damon A. Silvers
Mr. John M. Reich
Mr. John Dugan