SEN. TED KAUFMAN, CHAIRMAN
RICHARD H. NEIMAN
DAMON SILVERS
J. MARK MCWATTERS
KENNETH R. TROSKE

732 NORTH CAPITOL STREET, NW
ROOM C-320
WASHINGTON, DC 20401

Congress of the United States
CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of J. Mark McWatters

Congressional Oversight Panel Hearing on the TARP's Impact on Financial Stability

March 4, 2011

Thank you, Senator Kaufman, and welcome to our distinguished witnesses.

Although the Congressional Budget Office (CBO) has recently revised its estimated subsidy cost of the TARP downward to "only" $25 billion,[1] such metric should not serve as the sole determinate of the success or failure of the program. We should remain mindful that the TARP's overall contribution to the rescue of the U.S. economy was relatively modest when considered along with the multi-hundred billion dollar bailout of Fannie Mae and Freddie Mac, the multi-trillion dollar interventions of the Federal Reserve[2] and FDIC as well as the incalculable efforts of private sector capital market participants. It is particularly difficult to label the TARP or any other government-sponsored program aimed at securing financial stability an unqualified success when the unemployment rate hovers around 9 percent, the combined unemployment and underemployment rate equals 16 percent,[3] and millions of American families are entering foreclosure. It is of cold comfort to these families that the "too-big-to-fail" financial and other institutions aided by the TARP and other generous below market rate government - sponsored programs are recording near-record earnings. That to this day the TARP carries a substantial stigma with the residents of Main Street should come as little surprise.[4]

---

[1] See Congressional Budget Office, Report on the Troubled Asset Relief Program—November 2010 (online at http://www.cbo.gov/doc.cfm?index=11980).

[2] Pursuant to the requirements of Dodd-Frank, on December 1, 2010, the Federal Reserve released data on the amount and frequency of use of the Primary Dealers Credit Facility, an emergency short-term lending facility which was created in March 2008 and expired in February 2010. For the first time since the Great Depression, the central bank's credit was extended to firms other than banks. The facility provided, cumulatively, $8.95 trillion to primary dealers. It was utilized aggressively by every major investment bank. Among the data disclosed was that Goldman Sachs borrowed money from the facility 85 times between March 18, 2008 and November 26, 2008, with the largest transaction amounting to $18 billion. Merrill Lynch used the facility 226 times with its largest transaction being $33.2 billion. The largest single loan was a $47.9 billion loan to Barclays, a foreign bank. For transaction data, *see* Board of Governors of the Federal Reserve System, *Regulatory Reform: Usage of the Federal Reserve Credit and Liquidity Facilities – Primary Dealer Credit Facility* (online at www.federalreserve.gov/newsevents/reform_pdcf.htm).

[3] See Bureau of Labor Statistics, Economic News Release (February 4, 2011) (online at http://www.bls.gov/news.release/empsit.t15.htm and http://www.bls.gov/news.release/empsit.nr0.htm).

[4] In assessing the TARP it is important to consider the reasons underlying the distinct unpopularity of and the "stigma" associated with the program. That the TARP helped to rescue the United States economy from financial collapse in the closing days of 2008 should not have served as the basis for the public outrage and scorn that

In order to better assess the TARP, I offer the following recap of certain issues raised by the Panel and its individual members over the past year.

Quantitative Easing One and the Bailout of Fannie Mae and Freddie Mac

Professor Troske and I noted in our Additional Views to the Panel's September 2010 Oversight Report that the repayment by TARP recipients of advances received under the program is a misleading measure of the effectiveness of the TARP and therefore should not serve as *the* standard by which the TARP is judged.[5] The unlimited bailout of Fannie Mae and Freddie Mac by Treasury and the purchase of $1.25 trillion of GSE-guaranteed mortgage-backed securities (MBS) in the secondary market by the Federal Reserve under its first quantitative easing program no doubt materially benefitted TARP recipients and other financial institutions. These institutions were not required, however, to share any of the costs incurred in the bailout of the

---

shadows the program to this day. From my perspective, the public rejected the program because hundreds of often profligate and ill-managed financial and other institutions and their shareholders and officers received taxpayer funded bailouts as well as other subsidies from the Treasury, the Federal Reserve and the FDIC on remarkably favorable terms. Many senior officers of these institutions retained their lucrative employment and, although they generally suffered meaningful dilution, the shareholders of most TARP recipients were not wiped out. The public intuitively recognized that such policies were an anathema in a market economy where entrepreneurs and passive investors alike retain their business and investment profits without question but are accordingly expected to bear their full losses with transparency and accountability and without subsidy. Main Street quickly realized that the TARP was heavily tilted in favor of Wall Street while Main Street was stuck with dramatic rates of unemployment and underemployment, neighborhoods decimated by foreclosures, banks that refused to lend and the general sense that its residents were left on their own.

[5] See the Additional Views of J. Mark McWatters and Professor Kenneth R. Troske that accompany the September 2010 Oversight Report of the Congressional Oversight Panel, Assessing the TARP on the Eve of Its Expiration (online at http://cop.senate.gov/documents/cop-091610-report-mcwatterstroske.pdf).

Former Panelist Paul S. Atkins and I concluded in our Additional Views to the Panel's January 2010 Oversight Report as follows:

> In order to expedite the swift metamorphosis of many TARP recipients from insolvent to investment grade, the institutions were arguably subsidized through government sponsored purchases of mortgage-backed securities and by the all but unlimited investment of (and commitment to invest) public funds in Fannie Mae, Freddie Mac and AIG. One may argue that the government has created without meaningful public debate or analysis a series of "bad banks" within the Federal Reserve, Treasury, Fannie Mae, Freddie Mac, and AIG to accomplish what TARP alone failed to achieve. These "bad banks" or, perhaps, "debt consolidation entities" operate by actually and virtually removing toxic assets from the books of TARP recipients and other holders and issuers. The Federal Reserve and Treasury have actually removed [over] $1 trillion of troubled assets from the books of TARP recipients and other holders and issuers through outright purchases. The Federal Reserve and Treasury have also virtually removed additional troubled assets from the books of TARP recipients and other holders and issuers by propping up the market values of such assets and maintaining historically low mortgage rates.

See the Additional Views of J. Mark McWatters and Paul S. Atkins that accompany the January 2010 Oversight Report of the Congressional Oversight Panel, Exiting TARP and Unwinding Its Impact on the Financial Markets, at 145 (online at http://cop.senate.gov/documents/cop-011410-report-atkinsmcwatters.pdf).

GSEs.[6] In effect, the bailout of Fannie Mae and Freddie Mac permitted TARP recipients to monetize their GSE-guaranteed MBS at prices above what they would have received without the GSE guarantees and use the proceeds to repay their obligations outstanding under the TARP, thereby arguably shifting a greater portion of the cost of the TARP from the TARP recipients themselves to the taxpayers.[7] Costs such as this should be thoughtfully considered when evaluating the TARP.

Bailout of AIG

With respect to the bailout of AIG, the Panel offered the following observations in its June 2010 report:

> The government's actions in rescuing AIG continue to have a poisonous effect on the marketplace. By providing a complete rescue that called for no shared sacrifice among AIG's creditors, the Federal Reserve and Treasury fundamentally changed the relationship between the government and the country's most sophisticated financial players. The AIG rescue demonstrated that Treasury and the Federal Reserve would commit taxpayers to pay any price and bear any burden to prevent the collapse of America's largest financial institutions, and to assure repayment to the creditors doing business with them. So long as this remains the case, the worst effects of AIG's rescue on the marketplace will linger.[8]

Robo-signing and other Mortgage Loan Irregularities

With respect to the robo-signing and other mortgage loan irregularities, the Panel offered the following observations in its November 2010 report:

> Treasury has claimed that based on evidence to date, mortgage-related problems currently pose no danger to the financial system, but in light of the extensive uncertainties in the market today, Treasury's assertions appear premature. Treasury should explain why it sees no danger.[9]

---

[6] By contrast, TARP recipients (other than under the foreclosure mitigation programs) are required to repay all of their advances, together with interest or dividends thereon, and grant warrants to Treasury.

[7] A portion of this benefit may be offset by the successful exercise of "put-back" rights by RMBS investors and others against mortgage loan originators.

[8] See the June 2010 Oversight Report of the Congressional Oversight Panel, Congressional Oversight Panel Examines AIG Rescue and Its Impact on Markets, at 10 (online at http://cop.senate.gov/documents/cop-061010-report.pdf).

See also the Additional Views of J. Mark McWatters that accompany the June 2010 report (online at http://cop.senate.gov/documents/cop-061010-report-mcwatters.pdf).

[9] See the November 2010 Oversight Report of the Congressional Oversight Panel, Examining the Consequences of Mortgage Irregularities for Financial Stability and Foreclosure Mitigation, at 6 (online at http://cop.senate.gov/documents/cop-111610-report.pdf).

See also the Opening Statement of J. Mark McWatters at the hearing of the Congressional Oversight Panel on

Foreclosure Mitigation under the HAMP

With respect to HAMP and Treasury's other foreclosure mitigation programs, the Panel offered the following observations in its December 2010 report:

> While HAMP's most dramatic shortcoming has been its poor results in preventing foreclosures, the program has other significant flaws. For example, despite repeated urgings from the Panel, Treasury has failed to collect and analyze data that would explain HAMP's shortcomings, and it does not even have a way to collect data for many of HAMP's add-on programs. Further, Treasury has refused to specify meaningful goals by which to measure HAMP's progress, while the program's sole initial goal – to prevent 3 to 4 million foreclosures – has been repeatedly redefined and watered down. Treasury has also failed to hold loan servicers accountable when they have repeatedly lost borrower paperwork or refused to perform loan modifications. Treasury has essentially outsourced the responsibility for overseeing servicers to Fannie Mae and Freddie Mac, but both companies have critical business relationships with the very same servicers, calling into question their willingness to conduct stringent oversight. Freddie Mac in particular has hesitated to enforce some of its contractual rights related to the foreclosure process, arguing that doing so "may negatively impact our relationships with these seller/servicers, some of which are among our largest sources of mortgage loans." Treasury bears the ultimate responsibility for preventing such conflicts of interest, and it should ensure that loan servicers are penalized when they fail to complete loan modifications appropriately.[10]

Foreclosure Mitigation held October 27, 2010 in Washington, DC (online at http://cop.senate.gov/documents/statement-102710-mcwatters.pdf).

[10] See the December 2010 Oversight Report of the Congressional Oversight Panel, *A Review of Treasury's Foreclosure Prevention Programs*, at 5 (online at http://cop.senate.gov/documents/cop-121410-report.pdf).

See also the Additional Views of J. Mark McWatters and Professor Kenneth R. Troske that accompany the December 2010 report, at 126-127 (online at http://cop.senate.gov/documents/cop-121410-reportmcwatterstroske.pdf), which provide:

> It is regrettable that the HAMP creates disincentives for investors and servicers as well as homeowners by rewarding their dilatory and inefficient behavior with the expectation of enhanced taxpayer-funded subsidies. Since any intermediate to long-term resolution of the housing crisis must reside substantially with the private sector lenders and investors who hold the mortgage notes and liens, instead of spending an additional $30 billion on a government sponsored foreclosure mitigation effort, we believe Treasury would be best served by strongly encouraging these participants to engage in good faith, market-based negotiations with their distressed borrowers. In our opinion, this is the best way to bring stability to the housing market so that the economy can start growing again.

As I have stated before, it is critical to note that my assessment of the TARP and HAMP is in no way intended to diminish the financial hardship that many Americans are suffering as they attempt to modify or refinance their underwater home mortgage loans, and I fully acknowledge and empathize with the stress and economic uncertainty created from the bursting of the housing bubble. As such, I strongly encourage each mortgage loan holder and RMBS investor and servicer to work with each of their borrowers in a professional, good-faith, transparent and accountable manner to reach an economically reasonable resolution prior to pursuing a foreclosure remedy. In my view, foreclosure should serve as the exception to the rule that follows only from the transparent and objective failure of the parties to modify or refinance a troubled mortgage loan pursuant to market-based terms.

Contracting Authority under the TARP

With respect to Treasury's contracting authority under the TARP, the Panel offered the following observations in it October 2010 Report:

> The largest TARP financial agency agreements were those with Fannie Mae and Freddie Mac to provide administration and compliance services for Treasury's foreclosure mitigation programs. As described in detail in the case study accompanying this report, these agreements raise significant concerns. Both Fannie Mae and Freddie Mac have a history of profound corporate mismanagement, and both companies would have collapsed in 2008 were it not for government intervention. Further, both companies have fallen short in aspects of their performance, as Fannie Mae recently made a significant data error in reporting on mortgage redefaults and Freddie Mac has had difficulty meeting its assigned deadlines.[11]

General Motors, Chrysler and GMAC/Ally Bank[12]

With respect to the rescue of General Motors, Chrysler and GMAC/Ally Bank, the Panel offered the following observations in its January 2011 report:

> Treasury is now on course to recover the majority of its automotive investments within the next few years, but the impact of its actions will reverberate for much longer.

---

[11] See the October 2010 Oversight Report of the Congressional Oversight Panel, Examining Treasury's Use of Financial Crisis Contracting Authority, at 6 (online at http://cop.senate.gov/documents/cop-101410-report.pdf).

[12] With respect to the bailout of GMAC, the Panel offered the following observations in its March 2010 report:

> Although the Panel takes no position on whether Treasury should have rescued GMAC, it finds that Treasury missed opportunities to increase accountability and better protect taxpayers' money. Treasury did not, for example, condition access to TARP money on the same sweeping changes that it required from GM and Chrysler: it did not wipe out GMAC's equity holders; nor did it require GMAC to create a viable plan for returning to profitability; nor did it require a detailed, public explanation of how the company would use taxpayer funds to increase consumer lending.
>
> Moreover, the Panel remains unconvinced that bankruptcy was not a viable option in 2008. In connection with the Chrysler and GM bankruptcies, Treasury might have been able to orchestrate a strategic bankruptcy for GMAC. This bankruptcy could have preserved GMAC's automotive lending functions while winding down its other, less significant operations, dealing with the ongoing liabilities of the mortgage lending operations, and putting the company on sounder economic footing. The Panel is also concerned that Treasury has not given due consideration to the possibility of merging GMAC back into GM, a step which would restore GM's financing operations to the model generally shared by other automotive manufacturers, thus strengthening GM and eliminating other money-losing operations.

See the March 2010 Oversight Report of the Congressional Oversight Panel, *The Unique Treatment of GMAC Under the TARP*, at 4 (online at http://cop.senate.gov/documents/cop-031110-report.pdf). See also the Additional Views of J. Mark McWatters and Paul S. Atkins that accompany the March 2010 report (online at http://cop.senate.gov/documents/cop-031110-report-atkinsmcwatters.pdf).

> Treasury's rescue suggested that any sufficiently large American corporation – even if it is not a bank – may be considered "too big to fail," creating a risk that moral hazard will infect areas of the economy far beyond the financial system. Further, the fact that the government helped absorb the consequences of GM's and Chrysler's failures has put more competently managed automotive companies at a disadvantage. For these reasons, the effects of Treasury's intervention will linger long after taxpayers have sold their last share of stock in the automotive industry.[13]

After reflecting upon the analysis conducted by the Panel and its individual members over the past two years, it is clear that the success or failure of the TARP remains an open question and that neither a favorable adjustment to the CBO subsidy rate nor the repayment of TARP funds by some recipients tells the entire story. In concluding, it is significant to note that although the TARP played a meaningful role in the rescue of the U.S. economy during the closing days of 2008, its enduring legacy may be to have all but codified the implicit guarantee of the "too-big-to-fails"[14] notwithstanding the profound moral hazard risks arising from such action.[15] The TARP, in essence, reinforced the "bubble-bailout cycle" as the government's preferred business model.[16]

---

[13] See the January 2011 Oversight Report of the Congressional Oversight Panel, *An Update on TARP Support for the Domestic Automotive Industry*, at 5-6 (online at http://cop.senate.gov/documents/cop-011311-report.pdf).

[14] Financial and other institutions may evolve into too-big-to-fail entities in a stealth-like manner during periods of rapid bubble expansion when market participants and, perhaps, their regulators are consumed with congratulating themselves on their financial, business and regulatory acumen and the tax coffers are growing with the oversized profits generated from a breathless array of paradigm shifting financially engineered transactions. By the time these institutions awaken from their stupor, the bubble has broken and the markets are in a flat spin.

As we now appreciate, the few contrarians who identified and spoke out against the inflating bubble of 2005-2008 were correct in their assessments, and the too-big-to-fail institutions with their vested interests in bubble economics were not. Regrettably, after the creation and implementation of the TARP there is all the more reason for the too-big-to-fail institutions to ignore the contrarians and conduct their affairs secure in the expectation, if not a sense of entitlement, that a TARP-like rescue will follow any future misadventures.

[15] It, perhaps, would have been preferable to have resolved the most insolvent of the TARP recipients in early to mid-2009 (but probably not in the last quarter of 2008 when confidence in the markets had shattered). While this approach may appear harsh, such action would have sent a clear message to corporate directors, officers and shareholders that in a market economy the right to fail will be respected by the government and that financial and other institutions should revise their internal control and risk management protocols accordingly.

Any regulatory response to this problem, however, may offer little practical comfort because bubbles don't necessarily develop simply because regulators are carelessly asleep at the switch or because existing regulation is inadequate, but instead, they inflate because regulators and business professionals often fail to appreciate in a timely and appropriate manner the inherent systemic risk embedded in the assembly-line propagation of historically profitable, yet otherwise pedestrian, business transactions such as the securitization of home mortgage loans. Otherwise, why did the regulators fail to identify and preemptively respond to the most recent bubble, and why did many financial institutions and other investors continue to drink their own home-brewed toxic mix of mortgaged-backed Kool-Aid well after the music had stopped? Some, no doubt negligently or even recklessly, chose to ignore the emerging risk, yet many others never saw it coming.

[16] The Additional Views issued by J. Mark McWatters and former Panel member Paul S. Atkins with respect to the Panel's January 2010 report on *Exiting TARP and Unwinding Its Impact on the Financial Markets* describes some of the challenges presented by the TARP:

Thank you and I look forward to our discussion.

> The January report analyzes the difficulties that may arise when the United States government directly or indirectly undertakes to prevent certain systemically significant institutions from failing. Although the government does not generally guarantee the assets and obligations of private entities, its actions and policies may nevertheless send a clear message to the market that some institutions are simply too big or too interconnected to fail. Once the government adopts such a policy it is difficult to know how and where to draw the line. With little public debate, automobile manufacturers were recently transformed into financial institutions so they could be bailed out with TARP funds and an array of arguably nonsystemically significant institutions – such as GMAC – received many billions of dollars of taxpayer funded subsidies. In its haste to restructure favored institutions, the government may assume the role of king maker – as was surely the case in the Chrysler and GM bankruptcies – and dictate a reorganization structure that arguably contravenes years of well-established commercial and corporate law precedent. The unintended consequences of these actions linger in the financial markets and legal community long after the offending transactions have closed and adversely – yet subtly – affect subsequent transactions that carry any inherent risk of future governmental intervention. The uninitiated may question why two seemingly identical business transactions merit disparate risk-adjusted rates of return or why some transactions appear over-collateralized or inexplicably complicated. The costs of mitigating political risk in private sector business transactions are seldom quantified or even discussed outside the cadre of businesspersons and their advisors who structure, negotiate and close such transactions, yet such costs certainly exist and must be satisfied.

See the Additional Views of J. Mark McWatters and Paul S. Atkins that accompany the January 2010 report, at 157-158 (online at http://cop.senate.gov/documents/cop-011410-report-atkinsmcwatters.pdf).

http://cop.senate.gov