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CONGRESSIONAL OVERSIGHT PANEL

Opening Statement of J. Mark McWatters

Congressional Oversight Panel Hearing with Treasury Secretary Timothy Geithner

December 16, 2010

Thank you Senator Kaufman and welcome Mr. Secretary.

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 nears 10-percent, the combined unemployment and underemployment rate equals 17-percent,[3] and millions of American families are struggling to modify their mortgage loans so as to avoid foreclosure. It is of cold comfort to these individuals and families that the too-big-to-fail financial institutions aided by the TARP and other government-sponsored programs are recording near-record earnings.[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 84 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 $35 billion. The largest single loan was a $47.9 billion loan to Barclays, a foreign bank.

See *Fed aid in financial crisis went beyond U.S. banks to industry, foreign firms*, The Washington Post (Dec. 2, 2010) (online at http://www.washingtonpost.com/wp-dyn/content/article/2010/12/01/AR2010120106870.html).
[3] See Bureau of Labor Statistics, *Economic News Release* (Dec. 3, 2010) (online at http://www.bls.gov/news.release/empsit.t15.htm and http://www.bls.gov/news.release/empsit.nr0.htm).
[4] See *Wall Street Sees Record Revenue in Recovery from Bailout,* Bloomberg (Dec. 12, 2010) (online at http://www.bloomberg.com/news/2010-12-13/wall-street-sees-record-revenue-in-09-10-recovery-from-government-bailout.html).

Until small and large businesses regain the confidence to hire new employees and expand their business operations it is doubtful that the broader aspirations of the TARP will be realized. As long as businesspersons are faced with the multiple challenges of rising taxes, increasing regulatory burdens, enhanced political risk associated with

In assessing the overall effectiveness of the TARP, it is particularly important to consider the non-TARP funded bailouts of Fannie Mae and Freddie Mac, the TARP funded bailouts of GMAC and AIG, the robo-signing and other foreclosure irregularities that have recently surfaced, Treasury's foreclosure mitigation efforts under the HAMP as well as Treasury's contracting authority under TARP.[5] I offer the following abbreviated analysis of these financial stabilization efforts.

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 [6] 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. 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.[7] These institutions were not required, however, to share any of the costs incurred in the bailout of the GSEs.[8] In effect, the bailout of Fannie Mae and Freddie Mac permitted TARP recipients to

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unpredictable governmental interventions in the private sector as well as uncertain health care, energy, and regulatory compliance costs, it is unlikely that they will enthusiastically assume the entrepreneurial risk necessary for protracted economic expansion and a recovery of the labor markets. See the Opening Statement of J. Mark McWatters at the field hearing of the Congressional Oversight Panel on Commercial Real Estate held January 27, 2010 in Atlanta (online at http://cop.senate.gov/documents/statement-012710-mcwatters.pdf).

[5] HAMP is an acronym for "Home Affordable Modification Program."

[6] 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).

[7] According to the Congressional Budget Office, the bailout of Fannie Mae and Freddie Mac is projected to cost more than ten times the projected cost of the TARP, including the Capital Purchase Program employed by Treasury to bail out over 700 financial institutions.

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

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.[9] Costs such as this should be thoughtfully considered when evaluating the TARP.[10]

Bailout of GMAC

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.
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> 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.[11]

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. Today, AIG enjoys a five-level improvement in its credit rating based solely on

[9] 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.

[10] The TARP also created significant moral hazard risks and all but enshrined the concept that some financial institutions and other business enterprises are too big or too interconnected to fail.

[11] 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).

its access to government funding on generous terms. Even more significantly, markets have interpreted the government's willingness to rescue AIG as a sign of a broader implicit guarantee of "too big to fail" firms. That is, 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.[12]

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:

> To put in perspective the potential problem, one investor action alone could seek to force Bank of America to repurchase and absorb partial losses on up to $47 billion in troubled loans due to alleged misrepresentations of loan quality. Bank of America currently has $230 billion in shareholders" equity, so if several similar-sized actions – whether motivated by concerns about underwriting or loan ownership – were to succeed, the company could suffer disabling damage to its regulatory capital. It is possible that widespread challenges along these lines could pose risks to the very financial stability that the Troubled Asset Relief Program was designed to protect. 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. Bank regulators should also conduct new stress tests on Wall Street banks to measure their ability to deal with a potential crisis.[13]

Foreclosure Mitigation under the HAMP

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

> 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

[12] 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).

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

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.[14]

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[14] 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-report-mcwatterstroske.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.

See also the Opening Statement of J. Mark McWatters at the hearing of the Congressional Oversight Panel on Foreclosure Mitigation held October 27, 2010 in Washington, DC (online at http://cop.senate.gov/documents/statement-102710-mcwatters.pdf), which provides:

> I also wish to note that in my view, the Administration's foreclosure mitigation programs – including the HAMP and the HARP – have failed to provide meaningful relief to distressed homeowners and, disappointingly, the Administration has inadvertently created a sense of false expectations among millions of homeowners who reasonably anticipated that they would have the opportunity to modify or refinance their troubled mortgage loans under the HAMP and HARP programs. In fairness, however, to the efforts of the Administration, I remain unconvinced that government sponsored foreclosure mitigation programs are necessarily capable of lifting millions of American families out of their underwater home mortgage loans. From my perspective, the best foreclosure mitigation tool is a steady job at a fair wage and not a hodgepodge of government-subsidized programs that create and perpetuate moral hazard risks and all but establish the government as the implicit guarantor of distressed homeowners. I question why the taxpayers should subsidize mortgage lenders and RMBS participants when it is most often in the best interest of such parties to forgive principal and modify or refinance troubled mortgage loans without government assistance. Why should the taxpayers provide incentives when they appear to be neither needed nor merited?
>
> I remain troubled that HAMP itself may have exacerbated the mortgage loan delinquency and foreclosure problem by encouraging homeowners to refrain from remitting their monthly mortgage installments based upon the expectation that they would ultimately receive a favorable restructure or principal reduction

As I have stated before, it is critical to note that my assessment of the TARP and the 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 only follows from the transparent and objective failure of the parties to modify or refinance a troubled mortgage loan pursuant to market-based terms.

<u>Contracting Authority under the TARP</u>

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.[15]

After reflecting upon the analysis conducted by the Panel and its individual members over the past several months it is clear that the success or failure of the TARP program 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. Although the TARP played a meaningful role in the rescue of the United States 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-fail" financial institutions notwithstanding the profound moral hazard risks arising from such action.[16]

> subsidized by the taxpayers. The curious incentives offered by the HAMP arguably convert the concept of home ownership into the economic equivalent of a "put option" – as long as a homeowner's residence continues to appreciate in value the homeowner will not exercise the put option, but as soon as the residence falls in value the homeowner will elect to exercise the put option and walk away – or threaten to walk away – if a favorable bailout is not offered.

[15] 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).

[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:

> 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

Thank you and I look forward to our discussion.

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 non-systemically 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).

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