Written Testimony for Congressional Oversight Panel, October 22, 2009

Chair Warren, Members of the Panel, thank you for the opportunity to testify today regarding Treasury's efforts under the Emergency Economic Stabilization Act of 2008 (EESA) and the Troubled Asset Relief Program (TARP). You have asked me in particular to describe the progress of our efforts and to assess the effectiveness of our strategy in stabilizing the financial sector. You have also asked me to discuss the findings and recommendations of your recent report on our foreclosure mitigation efforts. I am happy to address these subjects and look forward to engaging in a dialogue with you after my testimony.

TARP – Progress to Date and Effectiveness

One year ago, we were in the midst of one of the worst periods in our financial history. Immediate, strong action was needed to avoid a complete meltdown of the financial system.

On October 3, 2008, Congress passed the Emergency Economic Stabilization Act of 2008, recognizing the need to take difficult but necessary action and giving the Treasury Department unprecedented authority to stabilize the U.S. economy by creating TARP.

The actions of the Treasury Department under TARP last fall must be viewed together with many other actions taken by the government to address the crisis, including Treasury's Money Market Mutual Fund Guarantee Program, the Federal Reserve's liquidity programs that support both financial institutions and the commercial paper market, and the FDIC's Temporary Liquidity Guarantee Program. These efforts collectively succeeded in preventing a catastrophic collapse of our financial system. However, when President Obama took office, the financial system remained extremely fragile and the Administration faced a rapidly evolving set of grave challenges.

In January 2009, what America faced was no longer just a financial crisis; it was a full-blown economic crisis. In January alone, we lost 741,000 jobs, the largest single month decline in 60 years. Home foreclosures were increasing at a rapid rate. Businesses and families were struggling to find credit. It was feared that those banks that remained standing had too little capital and too much exposure to risky assets. Secondary markets for credit had essentially come to a halt; and liquidity in a broader range of securities markets had fallen sharply. Overall, American families had lost $10 trillion in household wealth.

In short, the economy was in a free fall and there was increasing concern we were headed towards a second Great Depression. Christina Romer, the Chair of the President's Council on Economic Advisors, recently gave a speech outlining just how close we came to a second Great Depression. She noted that the decline in household wealth from December 2007 to December 2008 was 17% - five times the decline that occurred in 1929.

The Administration confronted this situation by taking forceful action on several fronts. A comprehensive strategy was put in place to stabilize the financial system and the housing market, to stimulate economic activity, and to provide help to those in most need. We still have a way to go before complete recovery takes hold, but we have stepped back from the brink.

The work we have done under our Financial Stability Plan helped avert a collapse of our financial system. As such, the Treasury is now in a position to begin winding down TARP programs that helped put large banks and the auto companies on a sounder footing. It is time to set a new direction for the TARP, to account for the recent improvements in capital markets and to address lingering weaknesses in housing markets and small business lending.

While the next steps for TARP will focus on the twin challenges of helping responsible families keep their homes and small businesses get better access to credit, it is still appropriate here to provide an update on the progress and impact of the range of existing programs.

Capital Purchase Program

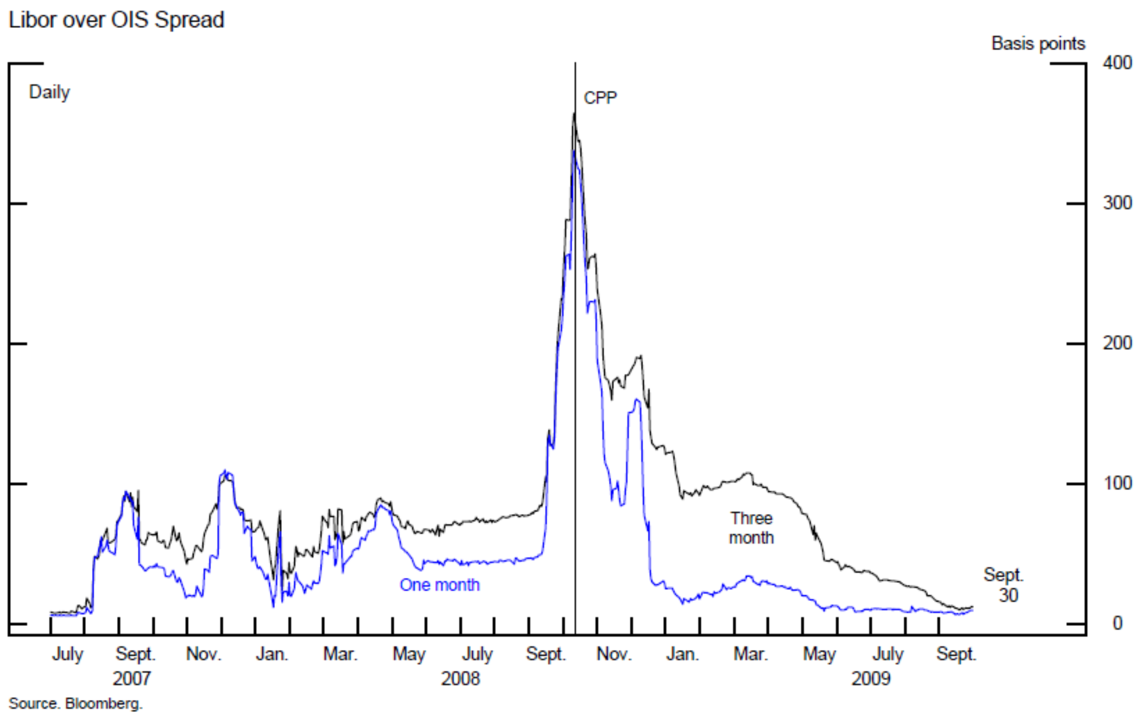
As you know, a key program under TARP has been the Capital Purchase Program (CPP), which has provided a total of $205 billion to 679 financial institutions, including over 300 small and community banks. This capital has been essential in stabilizing the financial system, enabling banks to absorb losses from bad assets while continuing to lend to consumers and businesses.

Treasury also worked with the federal banking regulators to develop a plan for "stress tests". This was a comprehensive, forward looking assessment of the capital held by the largest 19 US banks. The design of the tests and their results were made public, a highly unusual step taken because of the unprecedented need to reduce uncertainty and restore confidence.

Since the stress test results were released in early May, banks of all sizes have raised over $80 billion in common equity and $40 billion in non-guaranteed debt. Importantly, that capital raising has enabled more than 30 banks to repay the TARP investments made by Treasury. We have received over $70 billion in principal repayments, and over $6.5 billion in dividends, interest and fees from CPP participants. In addition, we expect banks to repay another $50 billion over the next 12 to 18 months.

Other metrics further support our conclusion that TARP capital has had a positive effect. First, the TED spread, which measures the difference between interbank lending rates and T-bills and is a measure of the risk in the banking system, had grown to 338 basis points (bps) in December 2008. As a point of reference, the TED spread rose to 219 points in December of 1930. At the end of last week, the TED spread was approximately 23 bps. Second, conditions in interbank markets have continued to improve. The spreads of LIBOR rates to overnight index swap ("OIS") rates, a useful measure of banks' short-term borrowing costs, declined in the third quarter (see Figure B below). The spreads of the one-month and 3-month LIBOR over OIS have narrowed to levels about equal to those prevailing before the financial crisis after having spiked to previously unforeseen levels. In line with these improvements in bank funding markets, the use of the Federal Reserve liquidity facilities directed at depository institutions has declined.

Figure B



When the Obama Administration took office, the Treasury had outstanding commitments to banks under the CPP and other programs of $238 billion. Since mid-January, we have invested $11 billion in nearly 400 institutions, while receiving the repayments noted above of $70 billion. Thus, since January, we have reduced the size of the Treasury's investments in the banking system by $59 billion to $180 billion, shifting the mix of remaining CPP investments significantly toward small and community banks.

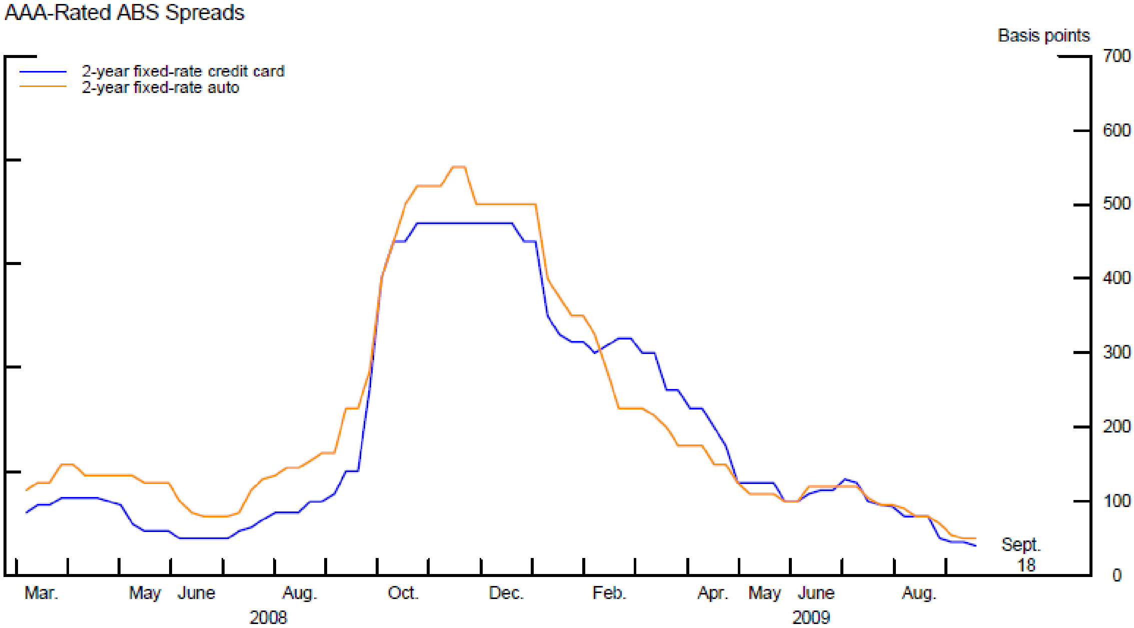
Other Programs

Let me turn now to some of the other EESA programs and their impact on the overall economy. The Public-Private Investment Partnership (PPIP) was designed to help cleanse the balance sheets of major financial institutions and re-liquefy key markets for financial assets. Recently, the first closings with asset managers selected to run the PPIP funds have taken place, and to date Treasury has closed on approximately $9.2 billion of capital commitments, representing $12.3 billion of purchasing ability when combined with private capital. Although purchases of assets under the program are just beginning, the announcement of the program itself helped reassure investors. Since the announcement, non-agency mortgage-backed securities have gone up substantially in price. Prime fixed rate securities issued in 2006 that traded as low as $60 in March have increased in value by over 40 percent as additional liquidity has come back to the markets. That improvement in financial market conditions has created the positive backdrop to enable us to proceed with the program at a scale smaller than initially envisioned. Treasury expects to provide approximately $30 billion in equity and debt financing to special purpose entities (SPEs) formed by the PPIP fund managers.

Another problem area of the economy one year ago was the asset-backed securities markets, through which credit is extended to consumers, small businesses and students. The Term Asset-Backed Securities Loan Facility (TALF) has been a successful effort to help restart those markets. Opened in March 2009, TALF is a lending facility operated by the Federal Reserve Bank of New York (FRBNY) under which FRBNY provides term non-recourse loans collateralized by certain types of AAA-rated asset-backed securities (ABS). Treasury has consulted in the design of the program and will provide up to $20 billion for the purchase of ABS in the event of a default.

I am pleased to report that, since March, a total of $79.6 billion of new TALF-eligible ABS has been brought to market, of which $46.5 billion was funded using TALF loans. This aid to the securitization market has had a decidedly positive impact on liquidity, spreads, and the availability of consumer and small business credit. The figure below details the entire market impact (TALF and non-TALF) on the for AAA-rated interest rate spreads for credit card receivable and automobile loan-backed securities.

AAA-Rated ABS Spreads



Source: ABS spreads are trader estimates provided by Merrill Lynch.

This decline in spreads leads Treasury to believe that there will be less reliance on TALF funding in the future as TALF "money" becomes more expensive in comparison to financing now available in the private markets – an original design of the program.

As you know, Treasury has also implemented a number of programs designed to stabilize specific institutions or sectors of the economy. For example, Treasury has implemented the Automotive Industry Financing Program (AIFP) for General Motors (GM), Chrysler, GMAC, Chrysler Financial and automotive parts suppliers, the Targeted Investment Program (TIP) for Bank of America and Citigroup, the Asset Guarantee Program (AGP) and has provided support, in conjunction with the Federal Reserve, to American International Group (AIG). In each case, Treasury responded quickly to help stave off further deterioration in the financial condition of the institutions involved and the overall economy. In the case of the automotive industry, Treasury's leadership and forceful action helped GM and Chrysler effect large-scale asset sales through bankruptcy court proceedings that resulted in leaner and more efficient companies.

The effects of EESA and TARP cannot be evaluated in a vacuum – they must be considered in conjunction with the many other measures the government has taken to combat this crisis. Nevertheless, in many ways, as noted above, we believe the programs have been successful. As the utilization of the extraordinary policies put in place to combat the financial crisis declines, Treasury looks ahead to a prudent exit and the sustainable supply of credit for consumers and families. The financial system still has significant issues which must be addressed – key parts of the financial system remain impaired and the system as a whole is still somewhat fragile. Unemployment is too high and the equity markets remain volatile. We must continue to be ready to provide support if needed, and we must unwind these programs carefully, so that the nascent recovery is not disrupted.

<u>Housing – Updates and a Response to the October 9th Recommendations</u>

You have asked that I address the findings and recommendations of the Congressional Oversight Panel in their recent October 9th report. We welcome the thoughts of the Congressional Oversight Panel on the nation's housing crisis, and we thank you for your suggestions on how to improve the Making Home Affordable Program.

The Congressional Oversight Panel report correctly recognizes that the Home Affordable Modification Program (HAMP), is achieving its intended goal of providing struggling borrowers with more affordable modified monthly payments – it reports that HAMP is saving families an average of $500 a month on permanent modifications. I am pleased that on October 8, almost one month ahead of the November 1 benchmark set earlier this year, we reached a new milestone of more than 500,000 trial loan modifications underway.

As of September 30th, we have signed contracts with 63 servicers, including the five largest. Between loans covered by these servicers and loans owned or guaranteed by the GSEs, more than 85 percent of all residential mortgage debt in the country is now covered by the program. As of September 30th, more than 757,955 trial modifications have been offered under HAMP, and as of October 8th, more than 500,000 trial modifications are underway.

Today, I want to outline some of the recent steps that Treasury and the Administration have taken or will shortly be taking to improve the effectiveness of HAMP with the goal of strengthening the housing sector, helping millions of homeowners and laying the foundation for economic recovery and financial stability.

First, we are committed to helping eligible homeowners obtain a final modification if they are qualified for HAMP. We do not want eligible borrowers to fail the trial period because the document requirements are unnecessarily burdensome. We recently released guidance – Streamlined Borrower Documentation – that reduces the volume of paperwork needed to obtain a trial modification or final modification, and standardizes documentation across servicers. We worked with the Internal Revenue Service, for example, to to simplify the process of obtaining income tax return transcripts directly from the IRS, eliminating the need for borrowers to mail or fax bulky returns. The new standardized forms provide borrowers with more information about the modification process but in a format that is easy to understand. We hope and expect that the streamlined document revisions to HAMP will enable more borrowers to successfully complete the requirements of the trial period and enable them to obtain a permanent modification.

Second, we are developing a foreclosure alternatives program for HAMP, which will provide incentives for short sales and deeds-in lieu of foreclosure where borrowers are unable or unwilling to complete the HAMP modification process. We are aware that there are many borrowers whose modifications under HAMP will not be sufficient to keep them out of foreclosure; for example, borrowers who do not have sufficient income to support a modified payment. The Foreclosure Alternatives Program can help prevent costly foreclosures and minimizes the damage that foreclosures impose on borrowers, financial institutions and communities.

Third, we have established denial codes that require servicers to report the reason for modification denials in writing to Treasury. We will shortly require servicers to use those denial codes as a uniform basis for sending letters to borrowers who were evaluated for HAMP but denied a modification. In those letters, borrowers will be provided with a phone number to contact their servicer as well as the HOPE hotline, which has counselors who are trained to work with borrowers to help them understand reasons they may have been denied a modification and explain other modification or foreclosure prevention options that may be available to them.

Fourth, we have expanded the efforts of the federal government to combat mortgage rescue fraud and put scammers on notice that we will not stand by while they prey on homeowners seeking help under our program. On September 17, Secretary Geithner hosted Attorney General Eric Holder, Housing and Urban Development (HUD) Secretary Shaun Donovan, Federal Trade Commission (FTC) Chairman Jon Leibowitz, Financial Crimes

Enforcement Network (FinCEN) Director Jim Freis and attorneys general from 12 states to discuss emerging trends and proactive strategies to combat fraud against consumers in the housing markets as well as best practices to bolster coordination across state and federal agencies.

In its October 9th report, the Congressional Oversight Panel recommended that Making Home Affordable address option ARM loans and negative equity, as well as unemployed borrowers. Let me briefly describe these issues.

Option ARMS

Some types of mortgage loans, like pay option ARMs, present unique challenges. The goal of HAMP is to reduce monthly payments to manageable levels, and place troubled borrowers into amortizing, fixed rate mortgages. Where borrowers on an option ARM are already having trouble paying the introductory low teaser rates – the relatively short initial fixed-rate periods when the option ARM bears an interest rate that is substantially below the "fully indexed" rate – it may be difficult to reduce the monthly payment and modify into an amortizing fixed rate loan. Despite these challenges, our current program permits borrowers with pay-option ARMs to use HAMP when they meet other eligibility criteria. In fact, the COP report showed that some borrowers with adjustable rate mortgages are getting modifications under HAMP.

Negative Equity

The Administration's plan focuses on affordability because achieving an affordable payment is essential to keep at-risk homeowners in their homes. Data from past cycles suggest negative equity alone is unlikely to be sufficient to cause default, and though this cycle could be different, there is little evidence suggesting a dramatic change in behavior. However, (Making Home Affordable) MHA recognizes and addresses the problem of negative equity as well. HAMP can help homeowners with negative equity reduce their mortgage payments to affordable levels. Servicers will be required to evaluate borrowers for a Hope for Homeowners refinance at the same time they are evaluated for a Home Affordable Modification, and to offer the Hope for Homeowners refinance if the borrower qualifies. The Department of Housing and Urban Development recently issued a mortgagee letter and other materials to assist implementation of Hope for Homeowners. Greater use of an improved Hope for Homeowners program will help to reach borrowers with negative equity and allow them to regain a positive equity position.

HAMP also uses incentives to servicers and investors to reduce borrowers' interest rates – or write down their principal, if the servicer chooses – to bring down the monthly payment to a level the borrower can afford. Additional incentives are available to borrowers to help them pay down principal more quickly. The Administration's goal is to maximize program participation in order to provide an affordable and sustainable solution for as many struggling borrowers as possible.

Unemployment

We recognize unemployment is a significant problem contributing to the ongoing foreclosure crisis. Rising unemployment and other recessionary pressures have impaired the ability of many otherwise responsible families to stay current on their mortgage payments. Unemployed borrowers that will receive at least nine months of unemployment benefits are eligible for a modification under HAMP. The COP report showed that this is working – the report showed that unemployed borrowers are receiving modifications through HAMP. We continue to study ways to help unemployed homeowners and we remain committed to meeting the challenges of reducing foreclosures and helping people maintain their homes.

Improving Transparency

The Panel recommended in its October 9th report that Treasury should increase transparency of MHA – in eligibility, reasons for denial and other issues touching homeowners, and in disclosure of performance data. We agree that borrowers should be provided with clear explanations for loan modification denials. For that reason, we established the denial codes described above that require servicers to report the reason for modification denials to Treasury, and we intend to require servicers to use those denial codes as a basis for sending written letters to borrowers who were evaluated for HAMP but were denied a modification.

We also agree that transparency of the Net Present Value (NPV) model – a key component of the eligibility test – is important. We are increasing public access to the NPV white paper, which explains the methodology used in the NPV model. We are also working to increase transparency of the NPV model, so that there can be a wider understanding of how the model works among housing counselors and borrowers.

We are working with participating servicers to establish operational metrics to measure the performance of servicers in responding to borrowers, such as average borrower wait time for inbound borrower inquiries, and response time for completed applications. We plan to publish these metrics on a servicer-by-servicer basis in our monthly public reports.

Streamlining HAMP Processes

The Panel also recommended that Treasury should implement greater uniformity and streamline processes in MHA. As described above, we have recently released the streamlined documentation program, which standardizes and simplifies the documentation required for modifications.

In addition, within the next few weeks, the Treasury expects to implement internet capabilities that will allow borrowers to fill-in, download, and print these standardized documents to send to their servicer. As we continue to enhance the Making Home Affordable website, we look forward to providing borrowers with a centralized location through which they can access borrower documents, apply directly for a modification, and ultimately communicate with their servicer to track the status of their modification.

Making Program Enhancements to HAMP

The October 9th report recommended that Treasury should consider program enhancements to HAMP, such as localizing NPV models, and lowering the debt-to-income (DTI) eligibility test. Servicers are permitted to enter in their own variables for several elements of the NPV calculations. For this process, servicers rely on standardized home price valuation products and service providers that can accommodate housing data as granular as street-by-street pricing information.

Foremost among Treasury's efforts to localize the NPV models has been the Home Price Decline Protection (HPDP) incentive payment. The HPDP payments provide lenders additional incentives for modifications where home price declines have been most severe and lenders fear these declines may persist. These incentives will encourage servicers to undertake more modifications in areas hard hit by home price declines.

Improving Servicer Accountability

The Panel also recommended that Treasury should ensure rigorous compliance and accountability with strong sanctions for non-compliant servicers. Freddie Mac, Treasury's compliance agent for HAMP, began servicer reviews in July. Recognizing that many of the servicer's processes are newly developed and most modifications are still in their trial periods, these reviews have focused on the servicer's implementation activities, looking to identify process improvements at this early stage. As loans move into the official modification status and as servicers' processes mature, Freddie Mac's reviews will focus more on risk-based activities and compliance trend issues.

Freddie Mac also began a "second look" review process, where Freddie Mac will audit servicers to review a sample of HAMP modification applications that have been declined by the related servicers. This "second look" process began in August, and is designed to minimize the likelihood that borrower applications are overlooked or that applicants are inadvertently denied a modification. In addition, the second look program is examining servicer non-performing loan (NPL) portfolios to identify eligible borrowers that should have been solicited for a modification, but were not.

Following these reviews, Treasury will receive performance assessments of each servicer's program compliance as prepared by Freddie Mac, and we plan to institute substantial penalties for non-compliance. These penalties may include withholding or reducing payments to servicers, requiring repayments of prior payments made to servicers with respect to affected loans, or requiring additional servicer oversight.

Furthermore, Treasury has recently developed a compliance committee for HAMP to review and understand servicers' compliance results and determine appropriate remedies. The compliance committee's actions range from requiring improperly rejected loans to be modified, to operational enhancements to monetary actions.

We recognize that any modification program seeking to avoid preventable foreclosures has limits, HAMP included. HAMP does not, nor was it ever intended to address every delinquent loan. For those who fail the NPV test, but fall within HAMP's eligible population, Treasury is finalizing guidelines that would provide incentives for borrowers and servicers to pursue alternatives to foreclosure through a deed in lieu or short sale transaction.

We remain committed to helping American families during this crisis and will aggressively continue to build on our progress to date. Sustained recovery of our housing market, and the mitigation of foreclosures, is critical to lasting financial stability and promoting a broad economic recovery. Consequently, we appreciate your suggestions for improvement to HAMP and we look forward to working with you to help keep Americans in their homes, restore stability to the US housing market and ensure a sustained economic recovery.

<u>Conclusions</u>

It has been over a year since the most devastating financial crisis since the Great Depression. In the panic that followed, our financial system nearly ground to a halt. Congress' swift response in enacting EESA and approving the TARP funds prevented a truly catastrophic collapse. Fortunately, we have moved back from the financial brink and are headed toward economic recovery, thanks in part to the programs we have enacted under EESA. Nevertheless, risks remain. We must make sure the financial recovery continues to take hold. In particular, sustained recovery of our housing market and of small businesses is critical to lasting financial stability and promoting a broad economic recovery. We look forward to working with you to help keep Americans in their homes, restore stability to the US housing market and to the financial system, help ensure small businesses have access to credit, and ensure a sustained economic recovery.