TOO BIG TO FAIL: THE ROLE FOR BANKRUPTCY AND ANTITRUST LAW IN FINANCIAL REGULATION REFORM (PART I)

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

OCTOBER 22, 2009

Serial No. 111–60

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TOO BIG TO FAIL: THE ROLE FOR BANKRUPTCY AND ANTITRUST LAW IN FINANCIAL REGULATION REFORM (PART I)

THURSDAY, OCTOBER 22, 2009

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL
AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 11:05 a.m., in room 2141, Rayburn House Office Building, the Honorable Steve Cohen (Chairman of the Subcommittee) presiding.

Present: Representatives Cohen, Conyers, Maffei, Johnson, Chu, Franks, Jordan, Coble, and King.

Staff present: (Majority) Eric Tamarkin, Counsel; Adam Russell, Professional Staff Member; and (Minority) Daniel Flores, Counsel.

Mr. COHEN. Thank you. Thank you. This hearing of the Committee on the Judiciary, Subcommittee on Commercial and Administrative Law will now come to order.

Without objection, the Chair will be authorized to declare a recess of the hearing. Before I start I would like to recognize Ms. Chu, who is our new Member of the Subcommittee, and we welcome her to the Committee, and we would like to recognize you for any opening statement you would like to make or hear the Bruin fight song.

Ms. CHU. Well, I am very pleased to join this Committee and to have this as my first Committee hearing, so thank you very much.

Mr. COHEN. You are welcome, and we are honored to have you.

I will recognize myself for a short statement. Today we meet to consider the critical question of whether the Administration has met its burden of demonstrating that the bankruptcy code should be set aside with respect to large, non-bank, financial institutions that are critical to the Nation's financial system—too big to fail. In place of the regular bankruptcy process the Administration proposes that Congress grant enhanced resolution authority for such institutions, similar to the authority that the FDIC currently has with respect to banks.

This Subcommittee has not yet formed an opinion on the merits of the Administration's resolution authority proposal. Given, however, that this Subcommittee is charged with ensuring the effective functioning of the Nation's bankruptcy system and the three-part system of government that we have had for 200-and-something years, we take a keen interest in any move to go outside that system.

Additionally, a resolution authority proposal raises some antitrust concerns that my distinguished colleague, Hank Johnson, the Chairman of the Courts and Competition Policy Subcommittee will probably address in more detail. I thank Chairman Johnson for his willingness to allow this hearing to take place before this Subcommittee for scheduling purposes.

Proponents of enhanced resolution authority contend that the bankruptcy process is inadequate to handle insolvent but systemically important financial institutions. These proponents assert that bankruptcy law is too slow to address the imminent collapse of a systemically significant financial institution and that this lack of speed creates dangerous uncertainty in financial markets. Nevertheless, this is what the Constitution and the past statutes have dictated as the proper course.

They also contend that the mere act of a bankruptcy filing by a large, interconnected financial institution could have a destabilizing effect on the financial system because markets and investors react very badly to news of such filings. Proponents of resolution authority point to the chaotic aftermath of Lehman Brothers' bankruptcy filing as well as the ad hoc government financial assistance given to AIG to avert its imminent collapse. They maintain that what transpired served as proof that resolution authority for non-bank financial institutions in financial trouble is needed to provide a mechanism for the orderly restructuring, sale, or liquidation of such entities.

In response there have been some criticisms leveled at the proposed resolution authority. The President's critics contend that granting resolution authority to those financial firms deemed to be systematically significant may be interpreted as a guarantee of a future government bailout should those firms run into financial trouble, thereby encouraging continued irresponsible risk-taking by such firms.

Others, including Harvey Miller, one of our distinguished panelists, Lehman's bankruptcy council, note that some tweaks—with some tweaks the bankruptcy code is perfectly capable of dealing with insolvencies of systematically important, non-bank financial institutions. Additionally, according to Mr. Miller, the creation of a new resolution regime may, in fact, raise a host of transparency and due process concerns, all of which have constitutional issues involved.

A resolution mechanism independent of bankruptcy, if carefully crafted to avoid the creation of moral hazard and with sufficient elements of transparency and due process might be an effective way to save the systematically important institution, or also creating a means of orderly wind-down, should that be necessary.

The burden remains with the proponents of the resolution authority, however, to demonstrate to the satisfaction of Congress and this Subcommittee, in particular, that the bankruptcy system truly does not offer such a mechanism already with respect to non-bank financial institutions and that any actions of this creation would not violate constitutional authorities that have long held this country in great esteem and which are the basis of our oath of office.

I hope that this Subcommittee, which is charged to oversee the Nation's bankruptcy system, can gain some useful insight from our witnesses as it considers the merits of the resolution authority proposal. Accordingly, I look forward to receiving today's testimony.

I now recognize my colleague, the distinguished Ranking Member of the Subcommittee, Mr. Franks, for his opening remarks.

Mr. FRANKS. Well, thank you, Mr. Chairman. You know, Mr. Chairman, I know in many areas of this Committee, just the nature of the Committee means that we often have starkly different perspectives, and I am sure that there are going to be some of those things exhibited here today, but I want you to know that I appreciate you for holding this unusually important hearing.

I want to salute you for your leadership and that of the Chairman of the full Committee, because I really sense that there has been an effort to try to get at what is right rather than who is right here, and I am really grateful for that. And now I have to make a statement that seems to completely countermand everything I just said, but it doesn't change the sincerity of it in any——

Mr. COHEN. You don't have to do that.

Mr. FRANKS. Mr. Chairman, on the Judiciary Committee we, as I said, often grapple with issues that are among the most important in Congress, but even among those matters the issue today is singularly important. The question is, how will Congress respond to the near financial meltdown of 2008?

That crisis vaporized trillions of dollars in Americans' wealth. Through our globally interconnected economy it affected people all across the world. The wisdom of the Federal response to date still hangs in the balance.

Second guessing over the choices the executive branch and the Federal Reserve have made, particularly in September 2008, will of course continue for decades. But, Mr. Chairman, we don't really have the luxury of waiting for decades for those details to be manifested and sifted by time. Another crisis may come before we know it.

So we must choose. We must ask ourselves, what reforms should Congress press to guard the Nation against future calamity? And to help with that decision, Mr. Chairman, you have called this hearing, and once again I commend you for that.

Now, on what basis should we make this choice? I believe the answer is fairly clear: Unless we understand what triggered the crisis we cannot hope to answer it with the right reform or solution. And if we don't answer it with the right reform we may only launch the Nation toward the next crisis.

What, then, caused the financial crisis of 2008? And boiled down to the simplest answer, in my sincere opinion the answer is fairly straightforward: It was human errors of judgment in our government when faced with the choice of whether and how to intervene in our economy.

Beginning in the 1990's and continuing into this decade, Washington laid the conditions for financial disaster. Through the Community Reinvestment Act and its implementing policies our Federal Government fueled an unsustainable housing bubble.

Responding to government rules, government pressure, and easy Federal monetary policy, our financial system spread the bubble's risk throughout our economy and the world. It did so through risk-laden mortgages and secure ties to mortgage instruments that were built from and upon them.

In 2008 and 2007 the piper, unfortunately, came to call. As economic conditions deteriorated institutions realized that vast majority of vast mortgage-related instruments they held might not be worth the paper upon which they were written.

Financial institutions holding or responsible for insuring these interests were exposed to being called to honor debts they simply couldn't pay. In response, they hoarded their capital. Lending began to freeze up and the financial system began to grind to a halt.

As the crisis intensified, the government of the Treasury—the government, the Treasury, and the fed took upon themselves the unprecedented step of bailing out Bear Stearns. The market took note and began to believe the government would bail out any institution that was as large or larger.

When Lehman Brothers hung on the brink in September of 2008, the Treasury and the fed refused to bail them out. Now this, obviously—that expectation was dashed at that point. When Treasury and the fed reversed course days later to bail out American International Group, dashed expectations then changed to widespread confusion.

Then, when the Treasury and the fed declared that the financial system was on the verge—the edge, as it were—of the abyss and ran to Congress with only a two-and-a-half-page outline of a rescue plan, full-blown panic began to ensue. And we still, of course, are trying to recover to this day.

Now, the Obama administration proposes in response to revamp our system for resolving failing financial institutions like Bear Stearns, Lehman, and AIG. But instead of responding to what actually happened in 2008, the Administration rests on the myth that Lehman's insolvency and the simple need to deal with it in bankruptcy triggered the entire crisis, and acting on the myth, it would take the largest non-bank financial institutions out of the bankruptcy system, create a new authority for Federal agencies to intervene with them, and let those agencies—like the Treasury and the fed did in 2008—decide who survives and who does not. To fund the endeavor it gives the agencies a new bailout checkbook.

Now, Mr. Chairman, I really believe that this is a recipe for supercharging the disaster. It institutionalizes vulnerability to human error in the executive branch. It institutionalizes the temptation for large firms to take excessive risks, banking on government bailouts. And it concentrates risks in those same institutions by encouraging their consolidation and extending the competitive advantage of a safety net smaller firms will simply not have.

Mr. Chairman, that is exactly the wrong direction in which to lead this country. It is imperative that we on the Judiciary Committee press for the clear alternative option: strengthening the bankruptcy code so that fair, transparent, and impartial courts can be relied upon without question to resolve these firms' insolvencies.

Precisely that option is embodied in H.R. 3310, in which I join Ranking Member Smith as a cosponsor. Now, I look forward to discussing the bankruptcy option in depth with you today and to working together on the right path forward for America.

And thank you, Mr. Chairman, for your indulgence.

Mr. COHEN. Thank you, Mr. Franks, and thank you for your working with us on this. I was surprised you didn't have the section we agreed on, that ACORN was not going to be able to use this resolution authority at any time in the future.

Mr. FRANKS. I forgot that. We will get her in there.

Mr. COHEN. Right. And no abortions will be provided either.

Mr. FRANKS. Absolutely.

Mr. COHEN. That is right.

I now recognize the Chairman of the Committee, the distinguished Chairman from the State of Michigan and the city of Detroit, the Honorable John Conyers, for an opening statement.

Mr. CONYERS. Thank you, Chairman Cohen. We are privileged to have the distinguished panelists—the witnesses that are coming to help guide our discussion this morning. We are very pleased to have them both here—Mr. Barr, Mr. Krimminger, and the others that are coming afterward.

You know, Jim Jordan and I are in a very similar situation. As representatives of Ohio and Michigan we have been particularly hard hit by this downturn, and I want Trent Franks to know that we are looking very carefully at H.R. 3310.

And I would like to meet with you about it as soon as my staff has digested all of the intricacies of that measure. And I thank you for bringing it forward.

Last fall, our Nation's economy was on the edge of a financial meltdown. There is some that say we still are. I mean, this is not like a piece of history that has gone by and now everything is okay.

What caused the crisis was the mistaken belief shared by Republican and Democratic administrations in the past that the financial industry could be relied upon to regulate itself without significant government oversight. We had to learn this painfully before in 1929, which ended the Roaring '20's and ushered into a depression that has never been comparable to anything else our economic system has sustained.

In an oversight hearing last fall, our former colleague, then the SEC chairman, Chris Cox, finally admitted that voluntary regulation doesn't work. Well, that is wonderful, Chris. We had to take a nation to the edge and we made this profound economic discovery.

At the same hearing was the distinguished Alan Greenspan, who made a similar confession—admission—that you can't rely upon the industry to police itself. Well, that is wonderful. He apologized.

Who can you really, seriously rely on to police itself, anyway? Now, instead of demanding change from the financial industry and insisting that it work cooperatively with the regulators, we in the legislature did something amazing: We turned around and gave—and this was a string of multibillion dollar bailouts—we gave the first one at $700 billion.

Taxpayer funded, no strings attached, no requirement to even explain what you did with the money. $700 billion. Well, thanks, Chairman Paulson.

I voted no on it too, Trent, and it is now a part of American history.

He summoned the leaders of the Senate and the House into that room at night and laid down three sheets of paper and said, in effect, the following: Sheet one, I want new Treasury powers never before given to a treasury secretary in history—that is me, he said. Sheet two, I want $700 billion right now. And sheet three, if you can believe the arrogance, he said this sheet requires that there be no review in the courts or even the Congress over what we are doing.

Do you know, they signed that? This is what started us off.

And so the financial system, from this humble perspective, was temporarily stabilized on the backs of the American taxpayer. Your kids will be paying for that and they will be saying, “Hey Dad, why did you guys do that?”

“Well, we were at the edge. Don’t you know, the whole system was going to fall. We had to. We didn’t have any choice.”

In the meantime, we said, now, would you folks hold up on the bonuses? They said, “We can’t. We are contractually obligated to reward the people that have driven us to the edge of the precipice—$1 million bonuses, at that.”

And so most of the institutions that caused the crisis—many of them—shared in the bailout and are now working against the proposals of consumer protection and efforts to crack down on predatory and abusive lending practices, and also any additional regulatory oversight, while we are at it. I mean, let us continue business as usual.

And at the same time, the money is still drying up at the bottom. You still can’t get loans. You still can’t get—the credit is stuck. People with good credit cannot get small business loans right this minute, after trillions of dollars have been shoveled out.

And as the Troubled Asset Relief Program oversight panel reported, nearly—right now—2 million homes have already been lost to foreclosure in the United States. Five million mortgages are either in foreclosure or default. And the panel predicts another 10 million homes can or could be lost to foreclosure.

In Detroit, in the County at Wayne—I had to check the figure just now—it was 147 families every day go into foreclosure—they are served with eviction. It said here on my remarks 195, so I turned to Attorney Tamarkin. I said, “195? It is 147.” He said, “It has gone up.”

Every day, Monday through Friday, every week, 195 families in my city are served with eviction or foreclosure notices because they are behind in their mortgage payments. And so what the Committee on Commercial Administration Law is doing here today is raising the question of, how can we return fairness to the economy and how can we unwind out of this insolvency that surrounds financial institutions and how we can get the credit flowing again in our Nation, not just my state or Jim’s state, across the country? It is not much different—it may not be as bad as we are getting hit.

These massive financial institutions—this was caused—yes, the government should take some of the blame, but the government didn't plan the risky, risky, unregulated credit transactions that they dreamed up with exotic instruments.

And here is, Trent, where the government does kick in. We came up with a theory that you are too big to fail. Why do you have to give these people that caused the problem taxpayer money?

Well, Chairman, they are too big to fail. You have got to do it.

Well, I think that theory has been reexamined much more carefully. And then we hastily arrange a merger for Bear Stearns, but we said, "Oh, Lehman Brothers, let them go." And then turned around and hand $180 billion cash infusion to AIG.

And since you had to be big and powerful to get on the preferred treatment list, small banks failed at a rate not since seen since the savings and loan crisis in the 1980's while the 19 largest banks in the country were all deemed too big to fail. And I want our witnesses to comment on these theories that Chairman Cohen and Trent Franks and I have put forward.

And what did some of the big boys do? They bought out the healthy small banks. They had enough money, thanks to us, to go out and buy the biggies—to go out and buy the little ones.

Well, I will put the rest of my statement into the record and I thank the Chairman for his generously allowing me to take this time.

[The prepared statement of Mr. Conyers follows:]

PREPARED STATEMENT OF THE HONORABLE JOHN CONYERS, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN, CHAIRMAN, COMMITTEE ON THE JUDICIARY, AND MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

Last fall, our Nation's economy was on the edge of a financial meltdown. What essentially caused this crisis was the mistaken belief shared by past Administrations—both Republican and Democrat—that the financial industry could be relied upon to regulate itself without significant government oversight.

Unfortunately, the lessons our Nation had painfully learned in the market crash of 1929, which ended the Roaring 20s and ushered in the Great Depression, were forgotten over the intervening years.

At an oversight hearing last fall on the financial meltdown, the then SEC Chairman finally admitted that "voluntary regulation does not work."

Also testifying at that same hearing was former Federal Reserve Chairman Alan Greenspan, who likewise admitted he made a "mistake" in relying upon the industry to police itself.

But, instead of demanding change from the financial industry, and insisting that it work cooperatively with the regulators, Congress gave the industry a $700 billion taxpayer-funded, no-strings-attached bailout.

And with the financial system now stabilized on the backs of the American taxpayer, Wall Street is poised to hand out another round of hefty bonuses.

Meanwhile, most of the institutions that caused the crisis and then shared in the bailout are working against the Obama Administration's consumer protection proposals to crack down on predatory and abusive lending practices.

Many of these same institutions have been woefully slow in granting reasonable mortgage modifications to struggling homeowners facing foreclosure, while strenuously opposing my legislation to allow market-based judicial modification of mortgages.

As the TARP Congressional Oversight Panel reported earlier this month, nearly 2 million homes have already been lost to foreclosure, and more than 5 million mortgages are either in foreclosure or default. The Panel predicts another 10 to 12 million homes could be lost to foreclosure.

Let me put these numbers in some perspective. In my district, about 195 homes in Wayne County, Michigan are being foreclosed or entering into the foreclosure process each day.

With this worrisome backdrop, I am pleased that the Commercial and Administrative Law Subcommittee is considering how we can return fairness to the economy, and find ways to unwind insolvent financial institutions that present a systemically significant risk to our Nation's economy.

These massive institutions were allowed to precipitate an economic meltdown with their risky and largely unregulated credit transactions, then were all-too-often sheltered from the consequences of their behavior as "too big to fail."

The last Administration took an ad hoc response. They financed a hastily-arranged merger for Bear Stearns, then let Lehman Brothers collapse into bankruptcy, then handed a $180 billion cash infusion to mega-insurer AIG.

Since you had to be big and powerful to get on the preferred treatment list, small banks failed at a rate not seen since the savings and loan crisis in the 1980s, while the country's 19 largest banks were all deemed too big to fail.

FDIC Chairman Sheila Bair recently testified that big banks were able to use their size and reach to essentially "blackmail" the government.

The ironic result is even bigger banks, in an even more concentrated financial market.

So the Obama Administration's resolution authority proposal is a welcome response to the ad hoc approach and the financial blackmail.

It is a welcome response to the perverse incentives for too-big-to-fail entities to take on excessive risk, yet avoid moral hazard.

It promises to provide a practical mechanism to allow systemically significant companies to fail, while managing the ripple effects.

We can all agree that the current ad hoc system, where the American taxpayer is used as a backstop for too-big-to-fail corporations is not working.

However, as we consider next steps, the first question we have to answer is whether the Administration's resolution authority proposal is the best approach for addressing insolvent systemically significant nonbank financial institutions, or whether the Bankruptcy Code can be amended to handle failures of these institutions.

The Lehman bankruptcy, the largest in U.S. history, has been cited as the primary rationale for the need to create a new resolution authority.

Some have argued that bankruptcy procedure is too slow in the time of a fast-moving financial crisis. They have also argued that the bankruptcy process is "messy," and has a destabilizing effect on markets and investor confidence.

They have supported a resolution regime largely modeled on the FDIC's current authority to resolve failed depository banks.

Others maintain that the Lehman bankruptcy demonstrated that the bankruptcy process has unique flexibility that makes it better equipped to handle resolution of these companies.

With a few tweaks, they say, the bankruptcy system can handle the resolution of nonbank systemically significant financial institutions far better than an FDIC model.

I hope that our witnesses today will help Committee members better understand which approach would be the more effective.

Second, if Congress decides to pursue the Treasury's resolution authority approach, we should ensure that antitrust considerations are given their full account, so that the problem of institutions becoming too big to fail doesn't just get worse, with larger institution, less competition, and higher prices to consumers.

The Administration's draft resolution authority legislation would vest the FDIC and SEC with authority to seize and resell the assets of certain business entities. However, the draft proposal is unclear about the role of antitrust oversight by the Justice Department and the Federal Trade Commission.

In an environment where a few banking giants are dominating the market, it is important that we keep the antitrust laws at the forefront.

Third, if Congress decides that the bankruptcy process is the better course, then we must revisit which aspects of the Code should be amended to provide a better framework to deal with institutions too big to fail.

For example, we should scrutinize the use of the netting and safe harbor provisions, which were inserted into the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 at the behest of financial industry associations.

These provisions created a safe harbor that put derivatives, swaps, and securities transactions beyond the jurisdiction of the bankruptcy court.

Giving banks and brokers a free hand to offset mutual debts against each other through netting might sound like prudent risk management, it has been described as "chaotic" in practice, as evidenced by the Lehman case.

On the day before its Chapter 11 bankruptcy filing, Lehman utilized the netting provisions to offset various financial contracts it had outstanding.

Instead of resolving these financial contracts in a transparent manner under the framework of the Bankruptcy Code, Wall Street conducted a private trading session without any oversight. During this session, Lehman's assets were ravaged by its creditors.

We remain at a momentous crossroads in our economic recovery—the big banks propped up by the taxpayers are back to prosperity, but everyone else has been left behind.

I commend the collaboration between Commercial and Administrative Law Subcommittee Chairman Steve Cohen and Courts and Competition Policy Subcommittee Chairman Hank Johnson in putting together an important and thought-provoking hearing, and I look forward to the testimony.

Mr. COHEN. Thank you, Mr. Chairman. Your remarks are always welcomed.

And before I recognize my fellow Chairman, I think the opposite end of the Big 10 axis here, Michigan, Ohio State should be recognized for a statement. Mr. Jordan?

Mr. JORDAN. I thank the Chairman.

Thank the Chairman of the full Committee for his comments about the economic situation in the Midwest and Ohio and Michigan, and frankly across the country.

Let me just make this point: As the Chairman was going through the history of the TARP program, I do think it is important to remember, as well, that, you know, we gave this unprecedented authority to the government and the results have not been what we expected, not been—well, I guess some of us maybe expected, those of us who voted against it.

But think about what took place. That whole package was sold to the United States Congress that they were going to get this money and go in and purchase the troubled assets, free up the dollars that need to be put to use right now in our economy. And to date, they still haven't purchased the first troubled or toxic asset.

In fact, I would almost argue that—and we had hearings on this in another Committee—that when the program was sold to the Congress of the United States you wonder if there was any misleading going on, because 9 days after—this came out in testimony during the Bank of America hearings—9 days after the program passed the Treasury and the fed had already changed directions and simply went to injecting capital into these institutions.

And so I would be concerned about any new power we start giving to government in light of what took place in that whole scenario, which I think was just a wrong move and the wrong kind of approach to a tough situation we had to deal with last year.

And with that, Mr. Chairman, I would yield back.

Mr. COHEN. Thank you, Mr. Jordan. I appreciate your remarks.

We have got votes but we have got time for the opening statement from the Chairman of the Committee that has been so kind to work with us today, Mr. Johnson, of Georgia.

Mr. JOHNSON. Thank you, Chairman Cohen. Thank you for holding this important hearing. And I am glad that this Committee is taking the opportunity to look at the role of bankruptcy reform in financial regulatory reform.

And I think one of the things that I am most proud of as a congressman in my sophomore term is my vote against the Wall Street bailout, also known as the TARP program. And the reason why I voted against it was because yes, I felt that there was a—our economy was freefalling, but I thought that the best way of addressing the issue was to start not on Wall Street but on Main Street.

Main Street needed the bailout. So many people suffering from foreclosure, suffering from medical bills that they could not pay, so many people had already lost their jobs, and I thought that we could put together a package that would help those people. And then once Main Street was stabilized, then we could address some concerns about Wall Street.

Used to be, in the old days I guess, that you preside over a company, you make billions of dollars in profit, and if something goes wrong your company goes into bankruptcy and your leadership resigns or is fired, either one. But that process was usurped by a new process in this Wall Street bailout situation. The very people who led us to impending doom were allowed to remain on board of their companies, continue to lead their companies, while at the same time they were given taxpayer money with no strings attached.

And with that money, instead of cleaning up toxic assets, cleaning up balance sheets, and getting rid of toxic paper, as it was called—and that would have, by the way, cleaning up that toxic paper probably should have entailed the Main Street stopping the foreclosures. That was what made the securities in which they were bundled valueless.

And so it was when people figured that out that, you know, we started to have these failures of these financial institutions. And so we didn't handle the $700 billion sudden request very well, in my opinion, and that is why I am proud of not having voted in favor of that.

And I will say that as Chairman of the Subcommittee on Courts—by the way, still find folks who made the billions of dollars, millions of dollars individually, presiding over the industry and its big players are the same people that are now prospering from the $700 billion that they have been given relatively few strings and in some cases no strings attached. And then, instead of buying up the toxic paper and doing the—clearing out balance sheets and that kind of thing, they used the money to acquire smaller entities, smaller financial entities.

So now it is like you have got three big great white sharks swimming in a body of water that is not that great and then all of the lesser fish, you know, they are getting ate up, or eaten up with reckless abandon. And it doesn't look good long-term for the great white sharks because they won't have any food to eat if they keep going at this pace.

And what they need is to be regulated, but not by a new entity. The bankruptcy laws, I believe, and—in other words, you fail, you file bankruptcy, you resign, you get terminated. Company then either comes back or it is permanently dead, liquidated.

And as Chairman of the Subcommittee on Courts and Competition Policy I consider the competition aspect or the antitrust aspect to be of great national importance. In fact, my Subcommittee held a hearing on this "too big to fail" issue, which we have multiplied now with the $700 billion bailout. We had a hearing on that and in that hearing we looked at whether antitrust laws should have prevented these "too big to fail" institutions from becoming so big and whether antitrust law was sufficient to review the competitive implications of the ongoing consolidations of the banking industry.

And to make a long story short, I want to—I look forward to hearing the testimony today from those pro and con as to this new entity that is being proposed. And I thank Chairman for this time.

Mr. COHEN. I thank Mr. Johnson.

Before we leave—adjourn—for about 35 minutes I want to recognize and accept the statement into the record, Mr. Lamar Smith. That will be done without objection. We will return in about 35 minutes, and we are in recess.

[The prepared statement of Mr. Smith follows:]

PREPARED STATEMENT OF THE HONORABLE LAMAR SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS, AND RANKING MEMBER, COMMITTEE ON THE JUDICIARY

The 2008 financial crisis riveted the world's attention on America's federal response to large, insolvent financial institutions. This response lurched from Bear Stearns to Lehman Brothers to AIG as one linchpin after another failed in our financial system.

Led by the Treasury Department and the Federal Reserve, the reaction to the crisis was driven by fear of a systemic, financial meltdown. Treasury's and the Fed's interventions, however, were hardly helpful. They were ad-hoc, inconsistent and left the federal government with unprecedented ownership of banks, insurance companies and other major institutions.

With the benefit of hindsight, few would say that the strategy Treasury and the Fed adopted ought to be repeated today. America needs to put in place a better strategy to address the next crisis, if one comes.

Before Congress acts, however, we must understand two issues clearly—what caused the 2008 crisis and what corresponding strategies may help prevent a future financial meltdown.

Many assume that it was the bankruptcy of Lehman Brothers that triggered the worst of the panic. As a result, some commentators advocate that we should not look to the Bankruptcy Code to deal with similar institutions in the future.

As the committee with jurisdiction over the Bankruptcy Code, the Judiciary Committee has a responsibility to dispel this myth.

Leading economists and academics have concluded that it was not Lehman Brothers' bankruptcy that caused the panic. Instead, the actions of government were at the root of the crisis.

An eminent Stanford University economist has pinpointed the immediate cause of the panic. It was not Lehman's bankruptcy filing—the market absorbed that event.

Instead, it was Treasury's and the Fed's subsequent actions that signaled to investors that the government anticipated a market collapse, but did not yet have an adequate plan of action.

First, Treasury and the Fed hastily announced a broad financial rescue package without revealing the details. Then, their officials appeared before Congress and demanded $700 billion with no more than an initial sketch of their legislative plan.

Though Congress criticized the plan and demanded more details and oversight protections, the Administration urged Congress to act immediately to prevent a collapse of America's financial institutions.

In a self-fulfilling prophecy, it was only after the Treasury and Fed spun everyone up into a panic that the market, indeed, panicked—not after Treasury's and the Fed's earlier decision to let Lehman Brothers go into bankruptcy.

The government's inconsistent treatment of Bear Stearns and AIG—which it bailed out—and Lehman Brothers, which it did not—added to the uncertainty that gripped the market, while underscoring the flawed approach of ad hoc government intervention decided behind closed doors.

Finally, of course, other government distortions of the market, from the Community Reinvestment Act to Fannie Mae and Freddy Mac and on, helped produce the 2007–2008 credit crisis that set the stage for panic.

The lesson of this history is not that America should avoid the Bankruptcy Code as a means to resolve failed financial institutions. It is that America should renounce government authority that lets federal agencies and government employees determine who lives and dies in our economy.

H.R. 3310, House Republicans' Consumer Protection and Regulatory Enhancement Act, takes both of these lessons to heart. It brings an end to billion dollar bailouts and establishes a new chapter of the Bankruptcy Code to resolve failed financial institutions other than banks.

Through its bankruptcy reforms, H.R. 3310 keeps the resolution of these firms in the transparent, predictable and fair arena of the bankruptcy courts.

It removes these cases from the closed-door world of government agencies and prevents back-room political favoritism towards struggling institutions. And it adds special provisions to better handle the bankruptcies of financial institutions so all that is possible to avert future crises may be done.

The Obama Administration has a different proposal, which only threatens to hasten our next crisis. The Administration institutionalizes billion dollar bailouts and the idea that some firms are "too-big-to-fail." Its special treatment of the biggest firms gives them competitive advantages, consolidates excessive risk-taking and lays the groundwork for the next meltdown.

And, once again, the Administration mistakenly gives government agencies—and the political appointees who head these agencies—the power to determine who survives.

Rather than abandon our bankruptcy system, Congress should strengthen it.

[Recess.]

Mr. COHEN. This is not working—there it goes. Good. Good.

We are back, and if any other Member would like to have an opening statement entered in the record, so will be allowed and have 5 days to enter that statement.

[The prepared statement of Mr. Johnson follows:]

PREPARED STATEMENT OF THE HONORABLE HENRY C. "HANK" JOHNSON, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF GEORGIA, AND MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

Chairman Cohen, Thank you for holding this important hearing. I am glad that CAL is taking the opportunity to look at the role of bankruptcy reform in financial regulation reform.

As Chairman of the Subcommittee on Courts and Competition Policy, I consider this an issue of national importance. In fact, I held a hearing on the "too big to fail" issue, from a competition perspective, in March 2009.

In that hearing, we looked at whether antitrust law should have prevented theses "too big to fail" institutions from becoming so big and whether antitrust law was sufficient to review the competitive implications of the ongoing consolidations of the banking industry.

In fact, these proposals raise competition concerns because they would give the FDIC and the SEC the authority to seize and resell the assets of business entities.

Compounding the problem is that the seizures would not be subject to any specific competitive review; in fact competition concerns are only one of several factors.

The agencies are directed to focus on keeping the market stable which could actually harm competition in the banking industry in the long run.

DOJ, the experts in evaluating mergers, is only given an advisory role and it is unclear whether DOJ will be able to challenge these transactions after the fact.

Our economy remains unstable. Hundreds of billions of taxpayer dollars have been spent and will be spent trying to revive our economy. Congress must act in conjunction with the Administration to help America recover.

But we must be cautious that we do not allow our antitrust laws to be trampled on in our attempt to fix the economy. If we do, we may face additional problems down the line.

I yield back the balance of my time. Thank you.

Mr. COHEN. We have a letter that we have received from—to Mr. Conyers—from Mr. Bernanke concerning this subject matter, and he has a different approach than several of the opening statements concerning the need for some type of resolution authority for the financial systems, and I will enter the letter in the record as delivered; he is unable to attend.

[The information referred to follows:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

October 21, 2009

BEN S. BERNANKE
CHAIRMAN

The Honorable John Conyers, Jr.
Chairman
Committee on the Judiciary
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Experience over the past two years clearly demonstrates that the United States needs a comprehensive strategy to help reduce and contain systemic risk and address the related problem of financial institutions that are deemed too big--or perhaps too interconnected--to fail. In light of the topic of the Committee's October 22 hearing, I will focus on one critical aspect of such an agenda for reform--establishment of a new resolution regime for systemically important financial firms.

The Federal Reserve believes that, whenever possible, the difficulties experienced by financial firms in distress should be addressed through private-sector arrangements, such as, for example, by capital injections from private sources, as many financial firms have done or by reorganization or liquidation under the bankruptcy code like other types of firms. However, in the midst of a crisis and when no private sector solution is available, authorities--acting in the public's interest--may need an alternative to the disorderly failure of a large, highly interconnected financial firm because of the risks such a failure would pose to the financial system, the broader economy, and ultimately households and businesses.

Large, complex financial institutions tend to be highly interconnected with other financial firms and markets. Indeed, in recent years the interlinkages within the financial system have become even closer as a result of, among other things, the integration of lending activities with financial markets through increased use of securitization, the expansion of derivative hedging and trading activities among counterparties, and the growth of arrangements--such as tri-party repurchase and securities lending arrangements--through which holders of securities can obtain short-term financing from risk averse investors through collateralized loans.

In light of these and other factors, the bankruptcy of a large, complex financial firm can have serious adverse consequences for other firms and financial markets, and, consequently, for the flow of credit and for economic conditions more broadly. Such spillovers may be particularly large at times when financial markets and institutions already are under stress and the economy is weak. In such periods, the disorderly failure of a large, interconnected financial firm may result in substantial pressures on other firms seen by investors as having similar exposures or business models, dislocations in a range of financial markets, and disruptions in the flow of credit to households and businesses. Losses sustained by other financial firms could erode their financial strength, limiting their ability to play their intermediation role, or even cause them to fail, reinforcing financial pressures. Moreover, the disorderly failure of a large, interconnected firm during a time of pre-existing financial and economic stress could undermine confidence in the U.S. financial sector more broadly, potentially triggering a widespread withdrawal of funding by investors and an additional tightening of credit conditions, which could, in turn, cause a further reduction in economic activity. Historical experience shows that, once begun, a financial panic can spread rapidly and unpredictably.

Indeed, this is precisely what happened following the bankruptcy of Lehman Brothers Holdings, Inc. (Lehman) in September 2008. At that time, the U.S. and global financial system had already been under significant strains for more than a year, strains that initially were triggered by the end of the housing boom in the United States and other countries and the associated problems in markets for mortgage-related assets. These developments had resulted in a sharp decline in the valuations of mortgage-related assets, widespread pressures in funding markets, tighter credit conditions for businesses and households, and substantial declines in business and consumer confidence around the world. Over the months leading up to Lehman's failure, a weakening U.S. economy and continued financial turbulence led to a broad loss of confidence in financial firms. These strains were punctuated by the government's decision in early September to place the government-sponsored enterprises Fannie Mae and Freddie Mac into conservatorship due to concerns about their solvency.

In this environment, the bankruptcy of Lehman on September 15 led to a substantial intensification of the financial crisis, with corresponding negative effects on the flow of credit and economic conditions more broadly, both here and abroad. Concerns about the potential direct and indirect losses that Lehman's failure could impose on other firms undermined confidence in wholesale bank funding markets, leading to further increases in bank borrowing costs and a tightening of credit availability from banks. Other investment banks, which were perceived to have weaknesses similar to those at Lehman, faced substantial pressures as investors pulled back from exposures to them, thus requiring the Federal Reserve to step up its provision of liquidity to such firms as well as to banking institutions. Nonetheless, in the following weeks, several large financial institutions failed, came to the brink of failure, or were acquired by competitors under distressed circumstances.

Moreover, on September 16, the Reserve Primary Fund, a money market mutual fund, announced that it "broke the buck" as a result of losses on its holdings of Lehman commercial paper. This announcement prompted investors to withdraw large amounts not only from the Reserve Primary Fund, but also from other so-called prime funds, which usually invest mainly in private debt securities and which were seen by investors as having exposures potentially similar to those of the Reserve Primary Fund. A severe run on much of the prime money market fund industry ensued, with withdrawals totaling hundreds of billions of dollars and more than 100 funds losing a substantial volume of assets in the span of just a few weeks. The magnitude of these withdrawals decreased only after the Treasury announced a guarantee program for money market mutual fund investors and the Federal Reserve established a new lending program to support liquidity in the asset-backed commercial paper market. Nevertheless, these massive outflows undermined the stability of short-term funding markets, particularly the commercial paper market, upon which corporations rely heavily to meet their short-term borrowing needs.

Against this backdrop, investors pulled back broadly from risk-taking in September and October. Liquidity in short-term funding markets vanished for a time, and prices plunged across asset classes. Securitization markets--a key source of financing for consumers and businesses--essentially shut down with the exception of those for government-supported mortgages. Reflecting in part these developments, economic activity dropped sharply in late 2008, with the pace of job losses accelerating, continued steep declines in housing activity, and widespread cutbacks in capital spending by business.

It was precisely to avoid these types of consequences that the Federal Reserve, with the full support of the Treasury Department, acted to prevent the disorderly failure of Bear Stearns in March 2008 and of American International Group, Inc. (AIG) the day after Lehman's failure.[1] While these actions were necessary in the environment then prevailing to address unacceptable risks to the global financial system and our economy, these actions have exacerbated the belief of market participants that some financial firms are too big to fail. This belief has many undesirable effects. While shareholders of Bear Stearns and AIG suffered significant losses, creditors of the firms were shielded from loss, creating an expectation among managers and investors of similar treatment going forward. This outcome reduces market discipline and encourages excessive risk-taking by financial firms that are perceived as being too big to fail. It also provides an artificial incentive for firms to grow in order to be perceived as too big to fail. And it creates an unlevel playing field with smaller firms, which may not be regarded as having the same degree of government support. Moreover, government rescues of too-big-to-fail firms can, as we have seen in the current crisis, involve the commitment of substantial amounts of public funds.

For these reasons, it is essential that policymakers make changes to the financial rules of the game to address the too-big-to-fail problem. This will require actions on two fronts. First, we must reduce the potential for large, highly interconnected firms to place the financial system at risk. To do so, policymakers must ensure that all systemically important financial institutions are subject to a robust and effective regime for consolidated supervision. Supervision also must be strengthened to better protect the safety and soundness of individual institutions and must be reoriented to better take account of the risks that an institution may pose on the financial system as a whole. The Federal Reserve has already taken a number of important steps to improve its

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[1] In light of the tools available at the time, the U.S. government was unable to prevent the failure of Lehman. The amount of available collateral at Lehman fell well short of the amount needed to secure a Federal Reserve loan of sufficient size to meet Lehman's funding needs for survival. Also, at the time of Lehman's demise, Treasury lacked the ability to inject capital into financial institutions to maintain financial stability because the Emergency Economic Stabilization Act of 2009 had not yet been enacted. Thus, when attempts to find a buyer for the company and develop an industry solution proved unavailing, Lehman's failure became unavoidable.

regulation and supervision of large financial groups along these lines, building on lessons from the current crisis.[2]

Second, and the focus of the Committee's hearing, a new, alternative resolution process should be created that would allow the government to wind down in an orderly manner a failing systemically important financial institution whose disorderly collapse would pose substantial risks to the financial system and the broader economy. Indeed, after the Lehman, Bear Stearns, and AIG experiences, there is little doubt that there needs to be a third option to the existing choices of bankruptcy and bailout for these firms.

In most cases, the federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose substantial risks to the financial system and to the economy. An alternative, orderly resolution regime already exists for banks: If a bank approaches insolvency, the Federal Deposit Insurance Corporation (FDIC) is empowered to intervene as needed to protect depositors, sell the bank's assets, and take any necessary steps to prevent broader consequences to the financial system. A similar regime should be established for systemically important *nonbank* financial institutions, including bank holding companies.

Such a regime should provide the government with the tools to restructure or wind down a failing systemically important firm in a way that mitigates the risks to financial stability and the economy and thus protects the public interest. For example, such tools should include the ability to take control of the management and operations of the failing firm; to sell assets, liabilities, and business units of the firm; to transfer the viable portions of the firm to a new "bridge" entity that can continue these operations with minimal disruptions while preserving value; and to repudiate contracts of the firm, subject to appropriate recompense. In addition, establishing credible processes for imposing losses on shareholders and creditors of the firm is essential to restoring a meaningful degree of market discipline and addressing the too-big-to-fail problem.

As I noted at the outset, financial firms--including those that might be considered systemically important--should be resolved under the bankruptcy code whenever possible. Thus, this new regime should serve as an alternative to the bankruptcy code only when needed to address systemic concerns, and its use should be subject to high standards and checks and balances. The Administration's proposal would allow the new regime to be invoked with respect to a particular firm only with the approval of multiple agencies, including the Federal Reserve, and only upon a determination that the firm's failure and resolution under the bankruptcy code or otherwise applicable law would have serious adverse effects on financial stability and the U.S. economy. These standards, which are similar to those governing use of the systemic risk exception to least-cost resolution in the Federal Deposit Insurance Act (FDI Act), appear appropriate. The Federal Reserve's participation in this decision-making process would be an extension of our long-standing role in fostering financial stability, involvement in the current

[2] See Ben S. Bernanke (2009), testimony before the House Financial Services Committee, Oct. 1.

The Honorable John Conyers, Jr.
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process for invoking the systemic risk exception under the FDI Act, and status as consolidated supervisor for large banking organizations. The Federal Reserve, however, is not well suited, nor do we seek, to serve as the resolution agency for systemically important institutions under the new framework.

As we have seen during the recent crisis, a substantial commitment of public funds may be needed, at least on a temporary basis, to stabilize and facilitate the orderly resolution of a large, highly interconnected financial firm. The Administration's proposal provides for such funding needs to be addressed by the Treasury, with the ultimate costs of any assistance to be recouped through the sale or dissolution of the troubled firm supplemented by assessments on financial firms over an extended period of time if necessary. We believe this approach provides the appropriate source of funding for the resolution of systemically important financial institutions, given the unpredictable and inherently fiscal nature of this function and the importance of protecting taxpayers from losses.

Thank you for the opportunity to provide the views of the Federal Reserve on these important matters. I hope this information is helpful.

Sincerely,

Mr. COHEN. Unlike everybody else, I think, that is here, I voted for the TARP, but the continued egregious and—conduct of the companies that received it in getting these bonuses so that Mr. Johnson's fish can be served at Masa and Nobu and be consumed through their salaries does make it difficult to continue to support such actions. But the letter will be admitted.

I would like to thank all the witnesses for participating in today's hearing. Without objection, your written statements will be placed into the record and we would ask that you limit your oral remarks to 5 minutes.

You will note we have a lighting system that starts with a green light. At 4 minutes it turns yellow, and then red at 5 minutes. When it gets to red you should have concluded your remarks or be wrapping them up. After you have presented your testimony Subcommittee Members will be permitted to ask questions, again with the 5-minute limit imposed.

I am pleased to introduce our first witness, Mr. Michael Barr. Mr. Barr was confirmed by the United States Senate on May 21 to serve as the Department of the Treasury's Assistant Secretary for Financial Institutions. As such, he is responsible for developing and coordinating Treasury's policies on legislative and regulatory issues affecting financial institutions.

Mr. Barr previously served during the Robert Rubin Treasury period as a special assistant and a special advisor to President Clinton, as an advisor and counselor on the staff at the State Department as well, and as a law clerk to the esteemed U.S. Supreme Court Justice David Souter, who I think the world of.

Thank you, Mr. Barr. Will you proceed with your testimony?

TESTIMONY OF MICHAEL S. BARR, U.S. DEPARTMENT OF TREASURY

Mr. BARR. Thank you, Chairman Conyers, Chairman Cohen, Ranking Member Franks, Members of the Committee. I appreciate the opportunity to testify today.

Just over a year ago the collapse of Washington Mutual, Wachovia, Bear Stearns, Lehman Brothers, and the extraordinary intervention in AIG severely tested our ability to respond to the financial crisis. In the panic that followed, our financial system nearly ground to a halt and the crisis revealed deep weaknesses in our financial system.

I want to begin today by briefly outlining how President Obama's comprehensive approach addresses the challenge of those firms whose failure could threaten the stability of the financial system and then focus on the Administration's proposed resolution authority.

In recent decades we have seen the growth of—significant growth of large, highly leveraged, substantially interconnected firms. These firms benefitted from the perception that the government could not afford to let them fail.

Of course, during the financial crisis the Federal Government did stand behind many of these firms. That action was necessary, but there is no question that unless we act meaningful reform of our financial system the problem will have been made worse. We must end the perception that any firm is too big to fail.

First, the biggest, most interconnected firms must be subject to serious accountable, comprehensive oversight and supervision. Second, we need tougher standards. The largest, most interconnected firms should face significantly higher capital and liquidity requirements. Through tougher prudential regulation we aim to give these firms a positive incentive to shrink, to reduce their leverage, their complexity and their interconnectedness, and we aim to ensure that they have far greater capacity to absorb their own losses when they make mistakes.

We need to make clear that being among the largest, most interconnected firms does not come with any guarantee of support in times of stress. Indeed, the presumption must be the opposite. Shareholders and creditors should expect to bear the cost of failure.

That presumption needs to have real weight. That means the financial system itself must be stronger and made more able to handle the failure of any financial firm. In this last crisis it was not.

And as part of our proposal we have also called for firms to prepare what have been called living wills, a credible plan for their rapid resolution in the event of distress. This requirement will leave us better prepared to deal with the firm's failure and will provide another incentive for firms to simplify their organizational structures and improve risk management.

By building up capital and liquidity throughout the system, by increasing transparency in key markets, our plan will make it easier for the system to absorb the failure of any given financial institution. In most circumstances, these precautions will be enough. Moreover, in the event that these firms do fail, we believe that these actions will minimize the risk that any individual firm's failure will pose a danger to broad financial stability, which is why bankruptcy will remain the dominant option for handling the failure of a non-bank financial institution, even very large ones.

The last 2 years, however, have shown that the U.S. government simply does not have the tools to respond effectively when failure could threaten financial stability. That is why our plan permits the government, in very limited circumstances, to resolve the largest and most interconnected financial companies outside the traditional bankruptcy regime, consistent with the approach long taken for bank failures.

This is the final step in addressing the problem of moral hazard. To make sure we have the capacity, as we do now for banks and thrifts, to break apart or unwind major non-bank financial firms in an orderly fashion that limits collateral damage to the system.

The resolution authority we have proposed allows the government to impose losses on shareholders and creditors without exposing the system to sudden disorderly failure that puts everyone at risk. Our approach is modeled on the longstanding regime for bank failure.

There are significant and tested safeguards in placed, modeled on the bank failure law to protect creditor rights. Creditors in the resolution process, moreover, are protected by the same system of judicial review that has existed for the FDIC and its predecessors for its receivership authorities for more than 75 years.

In our view, we need to have humility about the future and our ability to predict or prevent every systemic failure of a major financial firm. In a severe crisis if major firms fail and prudential measures and capital buffers prove inadequate, special resolution should be available.

Our proposals provide a way to end the firm, to wind it down without contributing to system-wide failure. Our proposals represent a comprehensive, coordinated answer to the moral hazard challenge posed by our largest, most interconnected firms, and the plan protects taxpayers and enables shareholders and creditors to take losses.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Barr follows:]

PREPARED STATEMENT OF MICHAEL S. BARR

Assistant Secretary Michael S. Barr
Written Testimony
Before the House Judiciary Committee
Subcommittee on Commercial and Administrative Law
October 22, 2009

Thank you Chairman Conyers, Chairman Cohen, Ranking Member Smith, and Ranking Member Franks. I appreciate the opportunity to testify today.

The topic before the committee today is central to the task of reform. Just over a year ago, the collapses of Washington Mutual, Wachovia, and Lehman Brothers, and the extraordinary interventions in AIG, severely tested our collective ability to respond to the financial crisis. In the panic that followed, our financial system nearly ground to a halt.

A swift response prevented a truly catastrophic collapse. But last September's events revealed deep weaknesses in our financial system.

It did not take long for the financial contagion to infect the real economy. When President Obama took office, America's growth rate had hit negative 6.3 percent, and monthly job losses had reached 741,000 - the worst in decades.

There are indications that we have moved back from the financial brink and are headed toward economic recovery. Important parts of the financial system are back to functioning on their own. Some of the damage to people's savings has been repaired. We have taken the first steps towards both reducing the government's direct involvement in the financial system and reducing the risks that taxpayers are bearing.

But we cannot ignore the urgent need for action: our regulatory system is outdated and ineffective, and the weaknesses that contributed to the financial crisis persist. Our citizens are paying the price everyday for the failures in our financial system. The progress of recovery *must not distract us* from the project of reform.

The Administration has put forward comprehensive reforms and we are working closely with Congress to enact legislation by the end of this year.

Our goals are simple: to give responsible consumers and investors the basic protections they deserve; to lay the foundation for a safer, more stable financial system, less prone to panic and crisis; and to safeguard American taxpayers from bearing risks that ought to be borne by shareholders and creditors.

I want to begin today by briefly outlining the Obama Administration's approach to financial regulatory reform, and in particular to explain the way that our plan addresses the challenge of those firms whose failure could threaten the stability of the financial system. Then I will address some of the key questions that have been raised about the relationship between the Administration's proposal for resolution authority and bankruptcy, and about the models used as a basis for this resolution authority.

In recent decades, we've seen the significant growth of large, highly leveraged, and substantially interconnected financial firms. These firms benefited from the perception that the government could not afford to let them fail. This perception was an advantage in the market place. Creditors and investors believed that large firms could grow larger, take on more leverage, engage in riskier activity – and avoid paying the consequences should those risks turn bad. It is a classic moral hazard problem.

Of course, during the financial crisis, the federal government did stand behind almost all of these firms. That action was necessary, but there is no question that, *unless we enact meaningful reforms*, the fact that the federal government intervened this past year will have made the problem worse. We take this moral hazard challenge very seriously. Our proposals for reform address it head on. We must end the perception that any firm is too big to fail.

First, the biggest, most interconnected financial firms must be subject to serious, accountable, comprehensive oversight and supervision. The idea that investment banks like Bear or Lehman or other large firms like AIG could escape meaningful consolidated federal supervision should be considered unthinkable from now on.

For the largest, most interconnected financial firms – for any firm whose failure might threaten the stability of the financial system – there must be clear, inescapable, single-point regulatory accountability. The scope of that accountability must include both the parent company and all subsidiaries.

In our view, the Federal Reserve is the agency best equipped for the task of supervising the largest, most complex firms. The Fed already supervises all major U.S. commercial banking organizations on a firm-wide basis. After the changes in corporate structure over the past year, the Fed now supervises all major investment banks as well. It is the only agency with broad and deep knowledge of financial institutions and the capital markets necessary to do the job effectively.

So the first part of our approach to the moral hazard problem is clear, accountable, comprehensive oversight and supervision.

The second part is tougher standards.

The days when being large and substantially interconnected could be cost-free – let alone carry implicit subsidies – should be over. The largest, most interconnected firms should face significantly higher capital and liquidity requirements.

Those prudential requirements should be set with a view to offsetting any perception that size alone carries implicit benefits or subsidies. And they should be set at levels that compel firms to internalize the cost of the risks they impose on the financial system.

Through tougher prudential regulation, we aim to give these firms a positive incentive to shrink, to reduce their leverage, their complexity, and their interconnectedness. And we aim to ensure that they have a far greater capacity to absorb losses when they make mistakes.

The third key element of our response to the moral hazard problem is to emphasize that being among the largest, most interconnected firms does *not* come with any guarantee of support in times of stress. Indeed, the presumption should be the opposite: shareholders and creditors should expect to bear the costs of failure.

That presumption needs to have real weight. That means the financial system must be able to handle the failure of any firm. In this last crisis, it clearly was not.

Leading up to the recent crisis, the shock absorbers that are critical to preserving the stability of the financial system – capital, margin, and liquidity cushions in particular – were inadequate to withstand the force of the global recession.

While the largest firms should face higher prudential requirements than other firms, standards need to be increased system-wide. We've proposed to raise capital and liquidity requirements for all banking firms and to raise capital charges on exposures between financial firms.

We've also laid out principles that we believe should guide regulators in setting capital requirements in the future. The core principle is that capital and other regulatory requirements must be designed to ensure the stability of the financial system as a whole, not just the solvency of individual institutions.

Beyond that, we've called for a greater focus on the *quality* of capital. We've called for capital requirements that are more forward-looking and reduce pro-cyclicality. We've called for explicit *liquidity* requirements. And we've called for better rules to measure risk in banks' portfolios.

As part of our proposal, we've called for firms to prepare what some have called "living wills." We would require major financial firms to prepare and regularly update a credible plan for their rapid resolution in the event of distress. Supervisors will make this a key component of regulatory oversight, both domestically and internationally as has been agreed in the G20. This requirement will leave us better prepared to deal with a firm's failure – and will provide another incentive for firms to simplify their organizational structures and improve risk management.

We've also called for measures to strengthen financial markets and the financial market infrastructure. For example, we've proposed to strengthen supervision and regulation of critical payment, clearing, and settlement systems and to regulate comprehensively the derivatives markets.

Our plan would require all standardized derivatives to be centrally cleared and traded on an exchange or trade execution facility – substantially reducing the build-up of bilateral counterparty credit risk between our major financial firms. We would require all customized OTC derivatives to be reported to a trade repository, making the market far more transparent. We would provide for strong and consistent prudential regulation of all OTC dealers and all other major players in the OTC markets, including robust capital and initial margin requirements for derivative transactions that are not centrally cleared.

We should never again face a situation – so devastating in the case of AIG – where the potential failure of a virtually unregulated major player in the derivatives market can impose risks on the entire system.

Taken together, the significance of these reforms should be clear: by building up capital and liquidity buffers throughout the system, and by increasing transparency in key markets, our plan will make it easier for the system to absorb the failure of any given financial institution. The stronger the system, therefore, the clearer it will be that there is *no such thing* as an implicit government guarantee.

Threats to Financial Stability

In most circumstances, these precautions will be enough. More comprehensive oversight, combined with stronger capital and liquidity standards and the other measures we've proposed, will minimize the risk that the largest financial institutions will face failure. Moreover, in the event that they do fail, we believe that these actions will minimize the risk that any individual firm's failure will pose a danger to broad financial stability, which is why bankruptcy proceedings will remain the dominant option for handling the failure of a non-bank financial institution, even very large ones.

The last two years, however, have shown that the U.S. government simply does not have the tools to respond effectively when failure could threaten financial stability. That is why our plan permits the government, in very limited circumstances, to resolve the largest and most interconnected financial companies outside of the traditional bankruptcy regime and consistent with the approach long taken for bank failures.

This is the final step in addressing the problem of moral hazard. To make sure that we have the capacity – as we do now for banks and thrifts – to break apart or unwind major non-bank financial firms in an orderly fashion that limits collateral damage to the system.

Bankruptcy is and will remain the primary method of resolving a non-bank financial firm. But as Lehman's collapse has showed quite starkly, and as I will discuss in some detail today, there are times when the existing options under the Bankruptcy Code are simply not adequate to deal with the insolvency of large financial institutions in times of severe crisis.

The resolution authority we have proposed allows the government to impose losses on shareholders and creditors without exposing the system to a sudden, disorderly failure that puts everyone else at risk.

To be clear, in those limited circumstances, the objectives of the resolution regime will differ from those of the Bankruptcy Code. The express purpose of the bankruptcy code is to reorganize or liquidate a failing firm "for the benefit of its creditors". Our proposed resolution regime is structured to manage the failure of a financial firm in a manner that protects taxpayers and the broader economy and promotes stability in the financial system. This purpose is explicitly different than the purposes of the Bankruptcy Code, but that is why the Administration's proposal is narrowly tailored to situations in which there are exceptional threats to financial stability. It is not intended to replace bankruptcy in any but the rarest circumstances.

In order for a company to find itself subject to our proposed resolution regime, the Secretary of the Treasury must determine, in consultation with the President, that: (1) the financial company is in default or in danger of default; (2) the failure of the financial company would have serious adverse effects on financial stability, and (3) use of the proposed regime would avoid or mitigate such adverse effects.

Moreover, that determination may only be made after such a finding has been recommended by both the Federal Reserve Board and the appropriate federal regulator (either the FDIC or the SEC).

Furthermore, those recommendations may only be made with the consent of two-thirds of the Federal Reserve Board and two-thirds of the Board or Commission of the appropriate federal regulator.

This strict mechanism for invoking the resolution regime would require significant consensus. Moreover, inherent in the determination that use of this authority is necessary is that the ripple effects of the potential losses will go far beyond the immediate creditors and counterparties of the affected firm. In those instances, therefore, it is appropriate that a broader set of tools are available to prevent widespread harm to the financial system and the real economy.

Claims Priorities and Existing Models

Our approach is modeled on the long standing regime for bank failure. There are significant and tested safeguards in place modeled on the bank failure law to protect creditor rights.

The claims disposition process under the Administration's proposal will protect secured creditors, as under bank failure and bankruptcy laws.

For unsecured claims, the priority system contained in the legislation is also generally modeled after those contained in the Federal Deposit Insurance Act and under the Bankruptcy Code with one exception. To protect the interests of taxpayers and to guard against moral hazard on the part of unsecured creditors and shareholders in the covered bank holding company, claims of the United States are given priority over these stakeholders, just as the Bankruptcy Code gives some preference to unsecured claims of the government over unsecured creditors and shareholders, for certain types of taxes and penalties, as well as to parties providing credit to a debtor during the period of its administration under the Bankruptcy Code.

Finally, creditors in the resolution process are protected by the same system of judicial review that has existed for the FDIC (and its predecessors) for its receivership and conservatorship authorities for more than 75 years. Our proposal seeks to respect the Bankruptcy Code's fundamental principles of fairness and equity among similarly situated stakeholders. As is the case under the Bankruptcy Code's best-interests test and under the model in place for bank resolution, in the limited circumstances where we permit deviation from those principles our proposal expressly guarantees that stakeholders will be made no worse off by a regulator's use of resolution authority than would be the case in a liquidation. The legislation also maintains the right of an affected company to seek judicial review following the appointment of a receiver or conservator and a claimant's right to challenge a regulator's disallowance of its claim.

As with any new proposal, the first and most central questions are: how would this work? How would it be different than what is possible today? So let me close with a brief overview of how these authorities could come together if the U.S. government were once again faced with situations like those of last September.

First, firms would have prepared a "living will" embodying a resolution strategy. Second, such firms would have large capital buffers in the event of failure, and stringent conditions imposed on the use of "hot" money funding. Regulators would have the authority to supervise the firm for system-wide risks and to impose tough prudential measures. But we need to have some humility about the future and our ability to predict and prevent every systemic failure of a major financial firm. In a severe crisis, if major firms fail, and prudential measures and capital buffers prove inadequate such that bankruptcy is not an option, special resolutions should be available.

A conservatorship or receivership under this authority would have four essential elements that would improve execution and outcomes relative to the tools that were available last fall: (i) swifter replacement of board and senior management with new managers selected by the FDIC; (ii) a temporary stay of counterparty termination and netting rights to mitigate the adverse consequences to the company's liquidity, avoiding the cross defaults and cascades that otherwise, create a vicious cycle leading ultimately to financial collapse; (iii) the ability to provide the firm with secured financing to fund its liquidity and capital needs during the conservatorship or receivership to mitigate the "knock on" effects of any firm's failure and to fund its operations, pending its sale or winding down.; and (iv) the creation of one or more bridge bank holding companies in the case of a receivership to preserve the business franchise, deal with counterparty claims, and protect viable assets of stronger subsidiaries pending their sale. This would end the firm – wind it down – without contributing to system-wide failure.

In 1933, following an uncomfortably familiar chain of events, the failure of one bank bred panic and market disruption so great that Congress sought to insure that such events would not be repeated. In its wisdom, Congress created the FDIC and endowed it with the authority to resolve troubled banking institutions with the swiftness necessary to maintain the stability of the financial system of the time. Again in the wake of the thrift and bank failures of the late 1980s, Congress enacted reforms to enhance the FDIC's ability to manage the unprecedented scale, scope and complexity of modern bank failures. Our proposal does little more than apply to covered bank holding companies, under rare circumstances, the same model that Congress has developed, that the FDIC has executed, and that courts have respected, over the course of more than three-quarters of a century.

Our proposals represent a comprehensive, coordinated answer to the moral hazard challenge posed by our largest, most interconnected financial institutions: strong, accountable supervision; the imposition of costs, both to deter excessive risk and to force firms to better protect themselves against failure; a strong, resilient, well-regulated financial system that can better absorb failure. The proposals for resolution authority borrow from established law and practice and are narrowly tailored to the extraordinary needs of the financial system and the economy during periods of crisis. The plan protects taxpayers and enables shareholders and creditors to take losses.

Together, these proposals give us a clear and credible argument that, as the President said two weeks ago in New York, "Those on Wall Street cannot resume taking risks without regard for consequences, and expect that next time, American taxpayers will be there to break their fall."

Thank you.

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Mr. COHEN. Thank you, Mr. Barr. I appreciate your staying within your 5 minutes and pardon your microphone. We will work on it.

Second witness is Mr. Michael Krimminger, Special Advisor for Policy to the Chairman of the FDIC, especially involved in issues involving regulatory restructuring and resolution authority, mortgage market developments, banking charter and capital, international and large bank resolution initiatives, derivatives, and other similar financial contract developments and assorted issues. He chairs the Basel Committee on Banking Supervision's Cross-Border Resolutions Working Group, which recently issued a recommendation for international infrastructure improvements and the international working group that developed core principles for effective deposit insurance systems.

Mr. Krimminger, proceed please.

TESTIMONY OF MICHAEL KRIMMINGER, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. KRIMMINGER. Chairman Cohen, Ranking Member Franks, and Members of the Subcommittee, thank you for the opportunity to testify on behalf of the FDIC today.

The current crisis has caused tremendous hardships for millions of Americans and shaken confidence in our institutions and financial system. Our system has proven resilient, but at great cost.

To restore market discipline and prevent future bailouts, we must adopt reforms with the goal of ending "too big to fail." These reforms must focus on strengthening market discipline while protecting the public, and this should include strengthened oversight and capital requirements for our largest and most interconnected financial firms, creation of an oversight council to identify and address emerging systemic risk, more effective protections for consumers, and tightened regulation of derivatives.

However, improved supervision and regulation alone cannot prevent the next crisis. Fundamentally, we must end "too big to fail" as an approach for dealing with the largest financial firms when they are failing. We need a resolution process for these firms that can be used in a crisis to close the firm while a receiver maintains critical operations to prevent a broader catastrophe for innocent businesses and consumers.

This new process would only apply after a systemic oversight council decided that an exception to bankruptcy was essential to prevent systemic risk to our financial system. This is no bailout. In fact, shareholders and creditors absorb the losses and the firm's assets are later sold to private firms. However, the ability to preplan the resolution, transfer key contracts to a bridge institution, and temporarily maintain critical financial operations will prevent the market disarray that could occur if the firm collapsed.

To underline our goal of preventing future bailouts, we would recommend that the law ban special assistance targeted to specific open institutions. In a free economy there are winners and losers. When a firm cannot continue it should be closed.

However, today we have a system in which the largest financial firms appear immune to market discipline. Bankruptcy provides the right process for the vast majority of insolvent companies. However, the current crisis has reminded us that there are fundamental differences between our largest financial firms and commercial or industrial companies. Large financial firms fulfill critical functions in providing financing for businesses and individuals, settling cash payment, intermediating liquidity and access to capital markets, and even providing the infrastructure and financing for the government securities market.

The functioning of our markets depends on ready liquidity, confidence among market participants, and financial assets whose value is tied to the intermediation of market, credit, and other risks. To end "too big to fail," we must have a resolution process that market participants know can be implemented without causing disarray in the markets. They must know the process will actually be used in a crisis.

What the solution should entail, first and foremost, is the swift and orderly closing of the firm while keeping its key functions operating. Like the bank resolution process, this requires extensive preplanning and developed expertise in dealing with complex financial operations.

The immediate power to take charge of the firm and pass critical operations to a newly-created bridge financial institution will protect the public by avoiding market uncertainty and ensuring continuity. This will allow the receiver to stabilize the market, retain going concern value, and avoid dumping financial contracts in already illiquid markets. The well-established checks and balances that protect stakeholders in the bank receivership process should apply here as well.

In conclusion, the proposed resolution process is not a challenge to the important role that bankruptcy plays in the U.S. system. It simply offers an alternative in a financial crisis so that regulators can realistically close the largest firms while protecting the public from a market collapse and from future bailouts.

I would be happy to answer any questions. Thank you.

[The prepared statement of Mr. Krimminger follows:]

PREPARED STATEMENT OF MICHAEL KRIMMINGER

STATEMENT OF

MICHAEL KRIMMINGER
SPECIAL ADVISOR FOR POLICY
FEDERAL DEPOSIT INSURANCE CORPORATION

on

TOO BIG TO FAIL: THE ROLE OF BANKRUPTCY AND ANTITRUST LAW IN FINANCIAL REGULATION REFORM

before the

COMMITTEE ON THE JUDICIARY
SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW
U.S. HOUSE OF REPRESENTATIVES

October 22, 2009

2141 Rayburn House Office Building

Chairman Cohen, Ranking Member Franks and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on issues relating to the failure of systemically important financial firms. My testimony addresses the role that a new resolution process for potentially systemically significant financial institutions can play in a set of integrated reforms designed to reduce the likelihood of any future financial crisis.

The current crisis has caused tremendous hardships for millions of Americans and shaken confidence in our institutions and financial system. Our system has proven resilient, but at great cost. We believe that targeted reforms can greatly improve the strength of the financial and regulatory system, while ending the possibility of future taxpayer bail-outs. These reforms should include strengthened oversight of our largest and most interconnected financial institutions, an oversight Council to identify and address emerging systemic risks, and tightened regulation of derivatives. However, improved supervision and regulation cannot prevent the next crisis. Fundamentally, we must end "too big to fail" as an approach for dealing with the largest financial firms in a crisis.

A fundamental problem has been the lack of a credible resolution mechanism for the largest financial firms, such as large bank holding companies, that addresses the need for speed, predictability, and continuity to avoid a disorderly collapse. Integrated with a proposed financial services oversight Council, this resolution mechanism would only apply when the Council determined that it was essential to protect against a systemic risk during a crisis in our financial system. While our antitrust and bankruptcy laws will continue to play a key role in ensuring robust competition in our free economy, a new resolution mechanism for the largest financial firms is essential.

There are fundamental differences between our largest financial firms and commercial or industrial companies. Large financial firms fulfill critical functions in providing financing for businesses and individuals, settling cash payments, intermediating liquidity and access to the capital markets and even providing the infrastructure and financing for the government securities market. The functioning of our markets depends on ready liquidity, confidence among market participants, and financial assets whose value is tied to the intermediation of market, credit, and other risks. To end "too big to fail" we must have a resolution process that can be applied in a crisis to protect the public interest, ensure that shareholders and other creditors absorb the risks and losses, and prevent interruption in a firm's system-critical financial operations. This is no bail-out – in fact, the resolution process we recommend would prohibit any special assistance targeted to specific open institutions.

The Problem of Too Big or Too Connected to Fail

As the current crisis abates, a key issue that must be addressed is how to end government bail-outs for financial firms considered too big or too interconnected to fail. In our current system, large systemically important financial firms (those the market believes are "too big to fail") are able to raise huge amounts of debt and equity and are given access to the credit markets at favorable terms without adequate consideration of the firms' risk profile. In turn, they leverage these funds and become even larger. This process makes investors and creditors ever more complacent and even more likely to extend credit without fear of losses. In some respects, investors, creditors, and the firms themselves are making a bet that they are immune from the risks of failure and loss. They believe, and have been proven correct so far, that the government will not allow these firms to fail for fear of repercussions on the broader market and economy.

In order to end too big to fail, we must find ways to impose greater market discipline, while avoiding the potential damage to our financial system that would result from a disorderly collapse of one of these firms in a crisis. We must provide a resolution process that instills confidence, both in the market and with policymakers, that closing these institutions will not lead to a systemic collapse. The solution must provide, first and foremost, a legal mechanism for the orderly resolution of these institutions similar to that which exists for FDIC-insured banks. This solution should ban assistance to specific open institutions to avoid any future bail-outs of these firms. The goal is to stop bail-outs and, thereby, enhance market discipline, while permitting the swift and orderly dissolution of the firm and the absorption of its assets by the private sector as quickly as possible.

The ad-hoc response to the current banking crisis was inevitable because no playbook existed for taking over an entire complex financial organization. The disruptions that occurred in the aftermath of the Lehman Brothers bankruptcy filing, including illiquidity in major credit markets, made market participants and policymakers wary of using the bankruptcy process for major financial holding companies or financial firms. Bankruptcy can create dangerous uncertainty about the resolution of a systemically significant financial firm because the process entails negotiated solutions that, as in the Lehman bankruptcy, may leave hundreds of thousands of contracts unresolved for months. While the bankruptcy process works well for the vast majority of commercial insolvencies, it can engender broad disarray in the markets if the debtor's financial interconnections extend throughout the credit, derivatives, and other financial markets around the globe. Following the Lehman Brothers filing, the commercial paper market stopped functioning and the resulting decrease in liquidity threatened other financial institutions and businesses.

One explanation for the freeze in markets was that the Lehman failure shocked investors. Following Bear Stearns, investors assumed Lehman was too big to fail and its creditors would garner government support. Simply put, because investors did not consider that there was a possibility that Lehman would file for bankruptcy protection, investors were willing to make "moral hazard" investments in the high-yielding commercial paper of large systemic institutions.

Another explanation is that the bankruptcy process was not designed to achieve the level of certainty needed for financial firms, like Lehman. In such firms, the value of the business and its assets are dependent on its relationships with other market participants. Those relationships, in turn, depend on financial market contracts that require immediate and continuous access to vast quantities of liquidity. Rumors about Lehman's liquidity problems, and the subsequent bankruptcy filing, triggered asset fire sales and destroyed the liquidity of a large numbers of claims held by Lehman's direct counterparties as well as of claims held by counterparties several steps removed from those having claims directly against Lehman itself. This led to an abrupt collapse of liquidity as the ability of parties throughout the market to complete settlements was placed into doubt.

While the underlying causes of the market disruption that followed the Lehman failure will be debated for years to come, both explanations point to the need for a new resolutions scheme for systemically important non-bank financial institutions which will provide clear, consistent rules for closing and resolving systemically important financial institutions, as well as a mechanism to maintain key systemic functions during an orderly wind down of those institutions.

Under both explanations, we are left with the same conclusion – we must have a resolution mechanism designed to deal with a small, but critical, subset of complex financial firms. This is essential so that regulators can end "too big to fail" while avoiding the financial disruptions that could devastate our financial markets and economy. We must ensure that this process is effective so that the U.S. taxpayer will never again be called upon to prop up failed financial firms. Had a credible resolution mechanism been in place to resolve financial entities like Lehman prior to its bankruptcy filing, investors would have paid the price of betting on a government rescue. Market liquidity would have been maintained and markets would not have reacted so negatively to the shock of a failure because they would be assured of an orderly and efficient wind down process.

The Role of Bankruptcy

Bankruptcy has a long and honored history under U.S. law. For the vast majority of the business bankruptcies in the United States, the current system has worked very well. In fact, the U.S. bankruptcy process is aptly considered a strength of our commercial and economic system. Many thousands of businesses have been successfully reorganized or liquidated under the Bankruptcy Code for the benefit of the creditors of that enterprise. The bankruptcy process has even been an effective tool for restructuring large companies such as General Motors and Chrysler.

However, experience has shown that it does not work well for the largest financial companies where their inability to complete settlements, or access liquidity, can trigger widespread market uncertainty. There are four key reasons for adopting a new resolution process for our largest financial firms. First, protection of the public interest must be paramount in designing an insolvency process for firms whose failure could, if not properly handled, trigger broader disruptions in our economy. The bankruptcy process focuses on resolving creditor claims and not protection of the broader public interest. For almost all insolvencies, this is the appropriate focus, but not for our most complex financial firms. Under the proposed resolution process for systemically significant financial firms, creditors would not determine the shape of the resolution, incumbent management would be replaced, and the resolution would be designed to protect the public, while ensuring that shareholders and other responsible parties bore the losses first. That is, the parties responsible for taking on the risks that destroyed the firm would be made to pay the price for their decisions, not the taxpayers.

Second, a resolution of these financial firms requires pre-planning and cannot depend on administration by a debtor in possession, a newly appointed trustee, or a creditors' committee. An essential element in the FDIC's process for resolving failed insured banks virtually overnight is extensive pre-planning of the resolution and the ability to develop expertise in quickly implementing a resolution that preserves critical financial operations once the bank is closed. In fact, without the ability to pre-plan for the closure of an insured bank, the FDIC could not achieve success in giving insured depositors virtually immediate access to their deposits. This factor, so critical to preserving liquidity for even the smallest failed bank, is self-evidently indispensible to avoid broader market and economic disarray in the resolution of the largest financial firms in a crisis. While the bankruptcy process works effectively for reorganizing or winding up commercial firms, it is critical that an intervention into the innumerable financial connections of a major financial firm be well-planned in advance. Since these firms, in the past, have tended to fail abruptly due to a liquidity collapse, pre-planning and the ability to act quickly and efficiently is vital.

Third, a resolution of the most complex financial firms must be implemented quickly and in a predictable way. A resolution process using a governmental receiver that has developed expertise in the financial operations of large firms can provide the certainty needed by the financial markets. It is essential that the receiver have the power to act quickly and decisively to take over the business, preserve systemically significant financial operations, establish a bridge institution, and provide continuity for those critical operations. A governmental receiver can provide certainty by issuing regulations or statements of policy addressing key issues. Speed and predictability allows the markets, both domestic and international, to make investment, pricing and liquidity decisions with greater certainty and reduces the likelihood of market disruptions. The uncertainty about the settlement of hundreds of thousands of financial market contracts following Lehman's bankruptcy filing last fall substantially contributed to the ensuing liquidity crisis as investors and other market participants drew back from exposures in the market.

Fourth, a resolution process must provide continuity to critical financial functions. We have recommended that a special resolution process for systemically significant financial firms include an option to create a bridge financial institution. This tool, which is available as well in bank receiverships, allows the receiver to transfer assets and contracts from the failed firm to the bridge institution in order to retain franchise value and to avoid dumping financial contracts on the markets. Under the proposed resolution process, financial market contracts could be transferred to the bridge institution run by the governmental receiver without triggering netting and liquidation rights. This could prove vital to avoid a market melt-down.[1] The bridge financial institution also can maintain other systemically significant functions such as payments processing, securities lending, and the settlement of ongoing government securities or other transactions. Most critically, the bridge financial institution allows time to avoid a sudden loss of critical services and promotes market confidence.

The bridge financial institution option, and the continuity it can provide, requires access to liquidity for ongoing operations. To achieve this, the proposed special resolution process includes ready access to liquidity for the bridge financial institution from a resolution fund provided from assessments paid by the industry. In contrast, under the Bankruptcy Code, a Chapter 11 debtor who will incur post-petition expenses to maintain operations must often borrow from lenders, usually at unfavorable rates. Debtor in possession financing can be particularly costly, or unavailable, for large financial firms in bankruptcy since their assets are so dependent on market liquidity and confidence and the bankruptcy filing itself greatly reduces their asset value. The result is that there may be less funding to preserve valuable ongoing operations for sale. According to some commentators, the lack of debtor in possession financing following the Lehman bankruptcy filing led to many possible Chapter 11 reorganizations becoming Chapter 7 liquidations. Under the proposed resolution system for systemically significant financial

[1] Professor Jay Westbrook noted in his testimony before the Subcommittee on Sept. 26, 2008, that the exemption of financial assets from bankruptcy proceedings poses difficulties in implementing a comprehensive process for creditors. While we agree that parties to financial contracts should retain some "skin in the game," an equally important part of the problem is that these contracts rapidly lose value if they are tied up in insolvency proceedings. To retain their value for creditors and to mitigate market disruptions if they are immediately liquidated, the bridge institution option allows the receiver to avoid immediate netting and liquidation, continue the contracts, and minimize the potential for spreading disruptions in the financial markets.

firms, the bridge option with its access to liquidity will provide continuity, while better preserving the value of financial assets for the benefit of creditors.

The FDIC's current authority for insured banks and thrifts to act as receiver and to establish a bridge bank to maintain key functions and sell assets offers a good model. A temporary bridge bank allows the FDIC to transfer needed contracts to the bridge bank and preserve key banking operations, which can be crucial to stemming contagion. At the same time, by closing the bank and placing it into receivership, the FDIC assesses the losses against shareholders and market participants who should appropriately bear the risk. By preserving the going concern value of the financial assets, it also encourages interest by other firms in purchasing the operations and assets of the firm, which can reduce losses to the receivership.

Addressing Special Risks Posed By the Derivatives Markets

One of the major risks demonstrated in the current crisis is the tremendous expansion in the size, concentration, and complexity of the derivatives markets. While these markets perform important risk mitigation functions, financial firms that rely on market funding can see it dry up overnight. If the market decides the firm is weakening, other market participants can demand more and more collateral to protect their claims. At some point, the firm cannot meet these additional demands and it collapses. Under both the Bankruptcy Code and bank insolvency law, the counterparties to insolvent firms can terminate and net out derivatives and sell any pledged collateral to pay off the resulting net claim. During periods of market instability -- such as during the fall of 2008 -- the exercise of these netting and collateral rights can increase systemic risks. At such times, the resulting fire sale of collateral can depress prices, freeze market liquidity as investors pull back, and create risks of collapse for many other firms.

In effect, financial firms are more prone to sudden market runs because of the cycle of increasing collateral demands before a firm fails and collateral dumping after it fails. Their counterparties have every interest to demand more collateral and sell it as quickly as possible before market prices decline. This can become a self-fulfilling prophecy -- and mimics the depositor runs of the past.

However, a significant difference between the Bankruptcy Code and bank insolvency law, as contained in the Federal Deposit Insurance Act (FDIA), allows the FDIC to address these risks in a bank failure and should be incorporated into the proposed resolution system for systemically significant financial firms. The difference is that under the FDIA, the counterparties to derivatives – called Qualified Financial Contracts in the FDIA - with a failed bank in receivership cannot terminate and net their contracts until after 5 p.m. on the business day following appointment of the FDIC as receiver. During this "window," the FDIC can repudiate the contracts and pay more limited damages, or it can transfer the derivatives intact to another bank or to an FDIC-operated bridge bank. This power is critical to providing continuity to financial operations as well as to preserving value in derivatives to the benefit of the bank's creditors. It also illustrates the important interplay between different recommended insolvency powers - such as those to create bridge banks and transfer derivatives - needed to deal with the rapidly changing conditions affecting large financial institutions.

Other Powers Needed by a New Resolutions Entity

There are other resolution powers that are important to an effective resolution process for systemically significant financial firms. For example, the new resolution entity should be independent of the firm's prudential supervisor. In creating a new resolution regime, we must clearly define roles and responsibilities and guard against creating new conflicts of interest. No single entity should be able to make the determination to resolve a systemically important institution – there should be procedural and oversight checks and balances. For example, the current statute requires that decisions to exercise the systemic risk authorities for insured depository institutions must have the concurrence of several parties.[2] For this reason, we have recommended that the oversight Council have the power to decide that the resolution of a systemically significant financial firm poses such a great risk to the public and financial system that it should be resolved through this new process, and not under the Bankruptcy Code. The Council would define why it chose to act, report to Congress on its action, and appoint the statutory receiver for the insolvent firm. The checks and balances in this process, as well as the right of shareholders to challenge the closing in court, prevent precipitous action and preserve market expectations.

[2] The FDI Act permits the FDIC to take action or provide assistance as necessary to avoid or mitigate the effects of a perceived systemic risk. In order for this to occur, the Act requires that there be a finding of systemic risk by the FDIC's Board of Directors, concurrence of the Board of Governors of the Federal Reserve System and a subsequent determination of systemic risk by the Secretary of the Treasury, following consultation with the President.

Once the decision to resolve a systemically important institution is made, the resolution entity must have the flexibility to implement this decision in a way that protects the public interest and limits costs. This flexibility in implementing the resolution is critical because there will be many complex decisions to be made, even under a well-developed statutory and regulatory framework, to quickly take over one of the largest financial firms and ensure that it can continue to operate critical payments and other financial functions. However, this flexibility is not unlimited and the receiver would remain liable for damages in an action in federal court should it deny a valid claim by a creditor.

As receiver for failed insured banks and thrifts, the FDIC has the authority to terminate contracts after the failure, including contracts with senior management whose services are no longer required. Through its repudiation powers, as well as enforcement powers, termination of such management contracts can often be accomplished at little cost to the FDIC. Moreover, when the FDIC establishes a bridge institution, it is able to contract with individuals to serve in senior management positions at the bridge institution subject to the oversight of the FDIC. The new resolution entity should be granted similar statutory authority as in the current resolution of financial institutions.

These additional powers would enable the resolution authority to employ what many have referred to as a "good bank -- bad bank" model in resolving failed systemically significant institutions. Under this scenario, the resolution authority would take over the troubled firm, imposing losses on stockholders and unsecured creditors. Viable portions of the firm would be placed in the good bank, using a structure similar to the FDIC's bridge bank authority. The nonviable or troubled portions of the firms would remain behind in a bad bank and would be unwound or sold over time. Even in the case of creditor claims transferred to the bad bank, these claims could be made partially liquid very quickly using a system of "haircuts" tied to FDIC estimates of potential losses on the disposition of assets.

The proposed resolution system will not upset settled commercial or creditor expectations. Creditors will receive payment according to a statutory priority system - virtually identical to that found in the Bankruptcy Code. Likewise, lien and other contract rights, as in FDIC receiverships, will have specific statutory protection. Like the current FDIC receivership process for failed insured banks, the proposed insolvency mechanism for systemically significant financial firms would provide for resolution of claims through an administrative claims process followed by de novo access to the federal courts for shareholders and creditors of the firm. In short, the proposed resolution system addresses how to protect the public interest, while preserving the rights of creditors.

Who Should Resolve Systemically Significant Entities?

As the only government entity regularly involved in the resolution of financial institutions, the FDIC can testify to what a difficult and contentious business it is.

Resolution work involves making hard choices between competing interests with very few good options. It can be delicate work and requires special expertise.

In deciding whether to create a new government entity to resolve systemically important institutions, Congress should recognize that it would be difficult to maintain an expert and motivated workforce when there could be decades between systemic events. The FDIC experienced a similar challenge in the period before the recent crisis when very few banks failed during the years prior to the current crisis. While no existing government agency, including the FDIC, has experience with resolving the largest systemically significant financial firms, probably no agency other than the FDIC currently has the kinds of skill sets necessary to perform resolution activities of this nature.

In determining how to resolve systemically important institutions, Congress should only designate one entity to perform this role. Assigning resolution responsibilities to multiple regulators creates the potential for inconsistent resolution results and arbitrage. While the resolution entity should draw from the expertise and consult closely with other primary regulators, spreading the responsibility beyond a single entity would create inefficiencies in the resolution process. In addition, establishing multiple resolution entities would create significant practical difficulties in the effective administration of an industry funded resolution fund designed to protect taxpayers.

Conclusion

The evidence from this financial crisis demonstrates the need for changes in the way the failures of systemically important financial firms are handled. The failure of a systemically important financial firm can be devastating to financial markets, businesses, and all Americans. It is essential that we put an end to "too big to fail" by imposing greater market discipline on systemically important institutions. The FDIC believes that the solution must involve, first and foremost, a legal mechanism for the swift and orderly resolution of systemically important financial firms in a crisis and that the FDIC's resolution powers as the receiver of failed insured depository institutions provide a good model.

The FDIC stands ready to work with Congress on this critical issue.

Mr. COHEN. Thank you, Mr. Krimminger. I appreciate your testimony.

And I now recognize myself for 5 minutes of questioning.

First thing I want to ask, I guess, is Mr. Barr, and I am not sure if you can answer this or not, but a lot of people feel that Mr. Paulson chose his friends at Goldman Sachs and other friends in the financial market to take care of and let other friends die. The laws are supposed to be applied fairly, and the bankruptcy code is a fair, due process, transparent system where people—there are laws and the judges are supposed to work in that.

How can you assure the public and those of us who voted for the TARP, although reluctantly, that if we have such a resolution authority formed that there will be fairness and transparency rather than favoritism played when it is outside of the bankruptcy system, which has fairness build into it?

Mr. BARR. Thank you very much, Mr. Chairman.

Under the regime that we have proposed—the resolution regime we proposed—it is modeled on the long history under the Federal Deposit Insurance Act, that if the FDIC acts as receiver under such cases, under the Administration's proposed approach for the largest, most interconnected firms, the same process would be used.

So the FDIC would act as receiver, there would be judicial review as there is today of the FDI's decision with respect to the appointment of a receiver, there would be judicial review with respect to the FDIC's decisions with respect to the payment of claims, and so there are important safeguards very much built into the basic structure of resolution in our regime.

Mr. COHEN. Thank you.

And Mr. Krimminger, maybe you would answer this but maybe Mr. Barr would if—it is just it is FDIC. In FDIC, when a bank needs protection does every bank have the same—is dealt with the same way, or is there any subjectivism on the judgment on the part of the FDIC on which banks and how they deal with them?

Mr. KRIMMINGER. Well, the banks are dealt with—under the FDIC's current law we are required to apply the least cost test. In other words, we have to choose the resolution process for that particular bank that is the least costly to the deposit insurance fund. So in other words, it is determined in some ways by the assets of the bank, but not by the character of the bank management or any other types of influences. We simply bid the bank out to resolution and then the winning bidder—the highest bidder, essentially, then acquires the bank's assets.

The proposal we are talking about here would essentially create the same process so that you might have to temporarily, with the largest firms, create a bridge financial institution in order to bridge that process so that there wouldn't be an immediate collapse, but nonetheless there would be a bidding process that would be open and transparent so that other financial firms could bid for the assets and operations of that bank once it were stabilized—for that institution once it were stabilized.

Mr. COHEN. Mr. Barr, I might have missed it, but I think you said something about the largest financial institutions. Is there a definition of what the largest financial institutions would be so that they would all be within the same class and not be determined by favoritism?

Mr. BARR. So, under our proposal, Mr. Chairman, the Federal Government, through the agencies, the Federal Reserve, with input from the counsel of all the regulators, would make a determination that a firm that is large, interconnected, and highly leveraged such that its failure would pose a threat to financial stability could be designated for stricter, tougher, more stringent forms of supervision with higher capital standards, higher prudential requirements, the requirement of the living will, the tougher set of standards I outlined very quickly in my testimony.

That designation itself would have due process protections in it. It would have a provision with respect to notice and an opportunity to be heard and to rebut the designation. And that process would be open.

Mr. COHEN. It may not be—it is not directly relevant to this, but Mr. Barr, do you have anything to do with the Treasury's decisions on bonuses and this outrageous system that we have now?

Mr. BARR. I do not. That is not directly within my responsibilities. I am certainly aware that the Treasury is involved in such cases, but it is not core to my responsibility.

Mr. COHEN. Okay. Mr. Miller, who is going to testify later, has suggested Lehman's biggest problem was lack of liquidity and a need for stay protection. Have you read Mr. Miller's testimony, Mr. Barr?

Mr. BARR. I have, just before this hearing.

Mr. COHEN. And what do you believe about his suggestion that the problem was its lack of liquidity and the suggestion that the Treasury's authority be expanded in certain circumstances and that we needed to amend the bankruptcy code to eliminate safe harbor provisions for derivatives and other types of transactions?

Mr. BARR. In our judgment, whatever is done with respect to the bankruptcy code, it is absolutely essential that we have resolution authority for the failure of the largest, most interconnected firms that might pose a risk to the system. The resolution authority is designed to meet different objectives from the bankruptcy code. The bankruptcy code, as you know far better than I, is focused on the process with respect to creditors. The resolution regime is really designed to protect all of us, to protect the economic system from the collapse of a significant financial firm that blows through its capital buffers.

So we think whatever the Committee decides to do with respect to bankruptcy, it is absolutely essential that we have resolution authority.

Mr. COHEN. Thank you, Mr. Barr.

And before I recognize Mr. Franks, the problem we have got—and I concur with much of what you have said and what Mr. Bernanke says and Mr. Geithner—but when you said that the resolution authority is to protect all of us, with that as a belief, you know, I tepidly push the green button. But it is so difficult to do that when you see what the people on Wall Street are doing with the money, and how well they live, and how arrogant they are, and it is hard to think it is really us. It is about them; it is their crowd, it is not our crowd.

Mr. BARR. If I would, Mr. Chairman, I think that people are rightly outraged at that kind of behavior. I know I certainly am as well. I think, though, that it is incumbent on us to design a system in the future that protects us from excessively risky behavior, that requires firms to pay their own way, and by that I mean having big capital cushions so they take their own losses, and I also mean if there is any financial trouble in the future that the largest firms are the ones that pay for it, not us.

Mr. COHEN. And do you think there should be something in your legislation—in the legislation so we don't have to come back later and fight another special interest group when we have it as an individual bill to have some control over executive compensation maybe in the bill, when somebody comes into your authority that it has already drafted as part of that law that there is no allowance of these particular types——

Mr. BARR. We have made legislative suggestions with respect to executive compensation. Those have passed in the House with respect to stay on pay and the independence of compensation committees, and we have been strongly in favor of regulators taking into account compensation in the firm not just for the highest paid executives but throughout the firm in judging the firm's risk management practices. So I do think those are important principles.

Mr. COHEN. They are important principles, and I think there ought to be something specifically in your legislation if you hope to pass it that makes the public realize it is not going to be another fight.

Mr. BARR. I would agree, Mr. Chairman, and there are these two provisions that would be essential to the reform package we have put forward in a legislative manner.

Mr. COHEN. Thank you, Mr. Barr.

I now recognize the Ranking Member for 5 minutes, Mr. Franks.

Mr. FRANKS. Well, thank you, Mr. Chairman. Mr. Chairman, the Chairman of the full Committee asked, I think, a very pressing question related to how organizations police themselves. And I think he is right; I think it is very difficult for any group to police themselves even though I think they have a responsibility to do so. But ultimately it is wise to have a third disinterested party as referee.

And I am concerned that what I am hearing here would put an awful lot of power into the executive branch or into your bureaucratic branch of government to the extent that it would be difficult for them to police themselves any better than anyone else. I mean, in this week's news the White House pay czar is slashing corporate pay by 90 percent. The TARP inspector general says we won't get our TARP funds back. Unemployment is up in 49 of 50 states, and kind of the surreal events in our economy, the list sort of goes on.

And now what I hear—an all due respect, because I know you guys are here to advocate a position and there is no personal disrespect intended—but what I hear is that you are asking us now to give the government new power to seize Citigroup and the Bank of America and the rest of the largest financial institutions we have. And I just think on the basis of both the Bush and the Obama administrations in the last year I don't know how we can possibly trust government—the bureaucratic aspect of government—to use that authority without blowing it up again in everyone's faces.

And I guess I am convinced that unless we get back to some basics and make sure that these financial institutions have basic requirements to where they are the ones that are at risk when they make these decisions there will never be enough policemen to take care of it. The way to get organizations to police themselves, as Chairman Conyers said, I think is to create a tremendous incentive on their part—selfishly on their part—to do so.

Now, in 2008 two of the ostensibly foremost financial authorities in the world—Ben Bernanke and Hank Paulson—I think they made a critical mistake when they were inconsistent in responding to Bear Stearns and Lehman Brothers. Later I think they made another mistake when they came to Congress and declared that the financial system would collapse if they were not granted this rescue authority. But they failed to present a full, thought-out rescue plan, in my judgment; two-and-a-half pages is what they brought us.

Now, John Taylor, of Stanford, and other eminent economists say that those two mistakes played a major role in triggering the all-out financial panic after September 19. So if we couldn't trust these two experts to make two decisions in the course of a month to avoid a systemic panic, how do we entrust the entire future to the same experts again working with lesser experts in the FDIC and the SEC? I know that is kind of a convoluted question, but I am just suggesting—what I hear Mr. Krimminger saying, you know, about the process of how you would administer the end-of-life decisions of a major company, as it were, they sound an awful lot like the bankruptcy process.

And I am just wondering, how does the executive branch feel like that without any practice in regard all of a sudden that they are going to be able to handle it better than the bankruptcy process?

So I guess I will start with you, Mr. Krimminger. Take a shot at it.

Mr. KRIMMINGER. Well, I appreciate the chance to respond. I mean, I think the—what we have developed over the last 75 years is a fairly stabilized process, or a very stabilized process for dealing with failed banks. What we are suggesting with the resolution authority is that when an institution is at the point of death, where it is in default on its obligations, or would be subject to a Chapter 11 proceeding, that the council or that the, you know, key authorities would have the ability to take that institution and put it into a resolution process that is very much like the bankruptcy process.

The difference is that we would have this process designed to make sure that you could have the continuity that is available at times during a Chapter 11 reorganization but have the access to the liquidity resources that would allow that continuity through a bridge financial institution and would allow it to continue while you are in the process of selling off the assets——

Mr. FRANKS. I don't want to interrupt you, Mr. Krimminger, but why can't that process—what you are talking about sounds good, but why can't that occur under bankruptcy?

Mr. KRIMMINGER. Well, right now one of the difficulties with the largest financial institutions is that you need to have preplanning, build up a level of expertise in dealing with the types of financial contracts we are talking about, that you need to be able to have the ability to continue those without having to rely upon debtor in possession financing, which at times, as in the crisis last fall, can be difficult to acquire. So this would allow for some backup liquidity financing.

But let me emphasize one point that I think is very important—it is very important to us. We would not be allowing, under what we would propose, would not be allowing open bank assistance or assistance for specific open institutions. This would be a situation where you would close the institution, put it into a receivership or a resolution, but make sure that the public interest was protected by continuing those key financial operations.

Mr. FRANKS. Mr. Chairman, I guess I would just—my time is up but I would just like to suggest that if I am a financial source to one of these companies and they are going into this process I would be much more likely to give money or to encourage the process to continue under a bankruptcy setting than I would on sort of an uncharted, untested bureaucratic takeover of the process.

It simply doesn't make a lot of sense to me because I think that the whole process becomes politicized and those critical resources that are necessary to even animate a process like this become completely uncertain about doing anything, and I think they take a hands-off approach. That is just my opinion, and I yield back.

Mr. COHEN. Thank you, sir.

I now recognize the gentleman from Wayne County, Michigan, Wayne State University, dean of the Judiciary Committee, Mr. Conyers.

Mr. CONYERS. Thank you, Mr. Chairman.

I appreciated the line of questions that you engaged our distinguished witnesses in, and for Trent Franks I want to say that I appreciated his line of questioning especially. We are making momentous decisions about how we get out of the problem that we are in. And so it is very critical to minimize finger-pointing because that always deteriorates down to personalities.

But there are a lot of apologetic bureaucrats, economists, government officials that are lining up here, Trent. Chris Cox was very sorry about how he misapprehended the problem in his executive branch position. Alan Greenspan, the guru of American economic policy for decades, apologized about how he misunderstood it. Hank Paulson has made some remarkable about-faces about things that he has done.

But wait. There is Ben Bernanke, who now—you know, these guys just didn't drop out of the sky. They have been in this business for a long time. Do you know what Tim Geithner was doing before he came to Washington? He was in New York. What was he doing there? Heading up the Federal Reserve.

And what about Larry Summers? You think he has been the head of Harvard? Is that all you think he has done? No.

You know, there have been—it would be very interesting for us to track all the about-faces that have been made in their careers, and it is not to say that if you find out that you are wrong and you admit you are wrong—I think it is the thing to do. I have had to do it. But I didn't affect the American economic system when I made a mistake.

Who among us hasn't cast a vote that, on reflection, you might have not voted that way at all? So, you know, this father-knows-best attitude, this know-it-all approach—and I want to say here and now that the resolution authority risks creating a new generation of companies that are too big to fail. Now you can't find anybody in Washington that doesn't realize that this "too big to fail" crap was just that.

Oh, we all know that now. We didn't know it until just very recently, though. And so for one, I haven't heard anybody yet suggest that the Department of Justice controlling antitrust questions, bankruptcy questions, should be given at least equal authority to block any asset sale that would harm competition.

Look, you don't have to agree with me, but not to discuss it—it is one thing if we have a discussion and we don't reach agreement. It is another thing that it is not even on the table for discussion. None of you have indicated—of our distinguished witnesses—have indicated anything like the direction that the Chairman, the Ranking Member, myself are moving in, and I would like you to explain this difference of economic analysis that we are in.

Mr. BARR. Mr. Chairman, if I could just try. I think first I would agree with both Chairman Conyers and Ranking Member Franks that the absolutely essential first step, important step, is that firms pay their own way. We need to have firms taking risks, having big capital buffers so in the event that they fail their owners suffer. We need to make sure that we have a system of tough prudential supervision of the largest firms with respect to their capital positions, their liquidity positions, their activities, engagement with merger and acquisition activity, management interlocks, the full range of tools available to address the problem of too big to fail.

We do need to end the perception of too big to fail. It is an absolutely critical element. I think we are in agreement on that. I think we need to have tougher standards to do that.

The question is, what do you do in the event of extremists in a crisis? And I think our judgment is, consistent with Ranking Member Franks' earlier statement, we need to be humble about the ability of regulators; we need to be humble about the ability of managers of large firms. People are going to make big mistakes and you need to have big buffers in the system when they do so that taxpayers aren't on the hook.

So in our resolution regime, this is a regime to end big firms if they have made big mistakes, but to do it in a way that doesn't bring down the system. And if any financing is needed to do that, the industry—the large firms in our industry, in the financial industry have to be on the hook for it. They have got to be—in the legislation there has got to be an assessment on them so that in the event any financing is required or any working capital is required, that the largest firms are required to pay, not the taxpayer. That is an essential part of our reform.

That also means those other big firms are going to have a big incentive not to have any firm go into resolution, because they are going to pay. So you get the system right, the incentives are right, you have people watching each other.

I would agree with both Chairman Conyers and Ranking Member Franks that we don't want to have a system where we just trust the regulators or trust the banks. You know, I think Ronald Reagan famously quoted the old Russian proverb, "We need to trust, but we have got to verify, too." And that is why we have to have a system of rules, we have to have transparency, we need judicial review of the like that has existed for the FDIC for the last 75 years.

Mr. KRIMMINGER. If I could just note in kind of continuation of that point, that at least looking at it from the perspective of the FDIC, in our current resolution authority there is a process, of course, where Department of Justice review of the antitrust implications of mergers and acquisitions as a result of a resolution. That is something that we have applied for many, many years.

There certainly are checks and balances that are put into place to make sure that shareholders have the opportunity to object to the appointment of a receiver. It is not purely an administrative process.

There are checks and balances in place so that if someone disagrees with our decision on their claim they have the right to go for a de novo review before Federal district court so that we are not in any way making the decision about claims willy-nilly but are subject to oversight as well as, of course, the totally appropriate oversight from the Congress and from our inspector general and others. But there is judicial oversight of the decisions on claims and the decision to appoint the receiver.

Mr. COHEN. Thank you, Mr. Chairman. I appreciate your questions.

And I now recognize Mr. Coble, the distinguished gentleman from the Tar Heel state. He will not take his 5 minutes because he never does. Thank the gentleman.

Mr. COBLE. I thank the gentleman from the Volunteer State. Thank you, Mr. Chairman.

It is good to have you on with us today, Mr. Barr. When can we expect the TARP to wind down and our reimbursements to TARP being used to pay down the national debt?

Mr. BARR. I am sorry, sir. I couldn't hear the end of your question.

Mr. COBLE. And our reimbursements to TARP being used to pay down the national debt?

Mr. BARR. Let me just say, Mr. Coble, that the TARP program is not directly within my responsibilities. The department has begun to wind down many of the major programs in the TARP with the recognition that we are beginning to see some signs of financial stability.

I think there are important—it is important to maintain the flexibility to act in the future. I do believe that—I do believe that we will be able to protect taxpayers in that process and help over the long haul in deficit reduction, but we need to make sure that we have the flexibility while the financial system is still recovering and don't want to take any precipitous action in that area.

Mr. COBLE. Thank you, Mr. Barr. Now, Mr. Barr, when you say wind-down, is that synonymous with reimbursement?

Mr. BARR. Again, I don't want to spend too much of your time on this because it is not directly within my area of responsibility, but we are seeing repayments coming into the Treasury Department.

Mr. COBLE. Okay. Thank you, sir.

Mr. Krimminger, what is the current fiscal health of FDIC and is its solvency expected to increase or decrease in the coming years?

Mr. KRIMMINGER. The FDIC deposit insurance fund—I am sorry, did I interrupt you, Congressman?

Mr. COBLE. No.

Mr. KRIMMINGER. Okay. The FDIC's insurance fund today, as of the end of the second quarter, and those are the most recent numbers we have, including the DIF balance, deposit insurance fund balance, as well as our loss reserves has about $42.4 billion in it. We are taking steps, of course, to replenish the fund and have put out for public comment a plan to have the fund replenished by having institutions pay in advance some of their deposit insurance assessments to provide additional liquidity to the fund.

We do expect that the fund will continue to have the liquidity to meet all of its obligations, but very important to note is that we have the ability to immediately draw on $100 billion line of credit from the Treasury as well as additional authority that was granted by Congress to pull down a total of $500 billion with the consent of the secretary of the Treasury.

Mr. COBLE. I thank you, and I will put this question to either or both: What is the rationale, if you know, for proposing a permanent TARP-like program and why has the Administration selected the FDIC to oversee the program in lieu of the Treasury, if you know the answer to that?

Mr. BARR. Maybe I might just say a word and then Mr. Krimminger could, of course, join. We in no way have made that kind of proposal. The proposal that we have is a proposal designed to make firms pay their own way, to internalize the cost they pose on the system, to make sure that taxpayers are protected, to cause assessments to be paid by the largest firms in the event that financing is needed.

And we have a system of checks and balances in our proposal among the FDIC, the Federal Reserve, and the Treasury designed to ensure that resolution is only used in rare circumstances. And when it does, the FDIC has a 75-year history with resolution and we thought it was appropriate to ask them to take on the responsibility of resolving these firms.

Mr. COBLE [continuing]. Mr. Krimminger?

Mr. KRIMMINGER. Yes. Congressman, we would in no way support a proposal that would provide for open bank assistance, we call it, or assistance for open institutions, and I think that was kind of one of the key elements of the TARP program.

What we have proposed, or what we have supported—and Chairman Bair has stated this in testimony—is a resolution process that literally does close down the institution and terminates its existence going forward so that—but one that allows for the continuation of critical financial services during a bridge financial institution.

So as I said, we have made very clear in our testimony before other Committees that we would not support open bank assistance or that type of support but would support a closing process that, as Assistant Secretary Barr mentioned, was designed to make the firms pay their own way and that they would pay any sums that were necessary.

Mr. COBLE. Thank you, gentlemen.

And I see my red light has appeared, and I will yield back.

Mr. COHEN. Thank you, sir. Let me follow up and use Chairman's prerogative.

Mr. Barr, I think what Mr. Coble asked about is the TARP money being used to pay down the debt—I think he was—I know it is not your area, but I think the answer is, "No, it is not. It is going back into the TARP." Would that not be correct and you all are continuing to use the money that is being repaid for other TARP-type ventures?

Mr. BARR. The funds that come back into the TARP program, to the extent that they are not used for financial assistance, are held at the Treasury Department and the response I gave to Mr. Coble was to say those funds, to the extent that they are not needed in the event of financial crisis, would help reduce the debt. But in our judgment it is important to retain some flexibility while the system is still recovering.

So I do think that—I do think that there will, in the long term, be advantages for debt reduction from the program, but in the short term we are quite focused on making sure that there is an ability to act, if necessary.

Mr. COHEN. Right. And about the whole program, is that just because of the whole approach that this is going to make the economy better and save us from disaster or is it because you think there will actually be some dollars reserved—returned to the Treasury to be used for debt reduction?

Mr. BARR. There will be, unless we see a significant further crisis point in the coming year, which is possible but certainly doesn't seem likely right now, but if there is such a downturn then you would want to have flexibility available. If we don't see that additional crisis then there would be remaining funds, both through repayment as well as unexpended amounts, that would be available to help reduce the debt over time.

Mr. COHEN. Do you have any idea how much is unexpended?

Mr. BARR. I am sure that the department would be happy to respond to the Committee with that. I don't have that figure in my head.

Mr. COHEN. Okay. And you don't have an idea about how much has been repaid either, do you, and how much interest has been accrued?

Mr. BARR. I would have to have the department respond to you, Mr. Chairman. It is just not within my area of responsibility. I have rough senses of sizes, but not enough to really be able to answer for you in a thoughtful way and I would prefer the department respond.

Mr. COHEN [continuing]. Mr. Barr, thank you.

Mr. Johnson, you are recognized.

Mr. JOHNSON. Thank you, Mr. Chairman.

Federal Reserve Chair Ben Bernanke earlier this month noted that the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a non-bank financial firm. Do either one of you know exactly what problems that Mr. Bernanke sees in the bankruptcy process insofar as these large non-bank financial firms are concerned? And also, does the United States government have power to force a—such an institution into an involuntary bankruptcy?

Mr. KRIMMINGER. Let me address, if I may, Congressman, address the first question first. One of the issues that exists under the current bankruptcy code is something that has been highlighted by other witnesses before this Committee and I think is highlighted by the second panel, is that under the current bankruptcy law there is a provision that provides for the immediate termination and netting of derivatives contracts or other types of financial contracts upon the filing of the bankruptcy petition.

There is also the need to have access to immediate liquidity funding for continued operations, so in the past in the bankruptcy that could be obtained through debtor and possession financing. Of course, last year after the Lehman Brothers insolvency debtor in possession financing became very difficult or very costly if you could obtain it at all.

So the primary reason that we have supported suggestions for a resolution authority or resolution process for the very largest systemically significant financial firms is simply to make sure that you could impose a process that would have the credibility to be imposed while making sure that the shareholders and creditors absorb the losses from that insolvency, just as they should in bankruptcy, as well as making sure that you maintain continuity in some of those critical functions. For example, many——

Mr. JOHNSON. Okay. Well, now before you go off there I am trying to stick within my 5 minutes. Any ability of the government to force an involuntary bankruptcy?

Mr. KRIMMINGER. Under current law I do not believe so. The proposal that Treasury has provided would provide for the authority of the secretary of the Treasury, with the concurrence of two-thirds majority of the board of the FDIC and the Federal Reserve to create or to decide that an institution should be placed into this kind of special systemic authority, and it would be triggered by, effectively, the same circumstances that will lead to a filing of bankruptcy.

Mr. JOHNSON. All right. There is no reason why that could not be done to the bankruptcy process to enable it to be of service in these kinds of situations. Yes or no?

Mr. KRIMMINGER. I would respectfully indicate that I think the difficulty with the bankruptcy process would be two-fold. Number one, we believe we need a process that focuses on the public interest of maintaining these systemic functions while also making sure that the losses would be imposed and making sure that you have the ability to create bridge financial institutions so that there could be the continuity to avoid a liquidation of assets.

Mr. JOHNSON. Well, that can be done within the context of a regulatory entity and let bankruptcy do its thing, in my opinion. I haven't heard why that would not be a viable alternative to setting up a new public agency, another layer of government.

How do you respond to critics who would suggest that with a resolution authority acting in a sudden emergency situation would be able to provide for the transparency and things like notice to creditors, an opportunity to be heard—not necessarily by creditors, but—who are interested parties? How would that be worked out?

And last, but not least, I am concerned about the competition concerns of your proposal that would give the FDIC and the SEC the authority to seize and resell the assets of business entities. And with the fact that we have only a few—we have only a few great white sharks in the pool, wouldn't that process cause them to get bigger because they would be the entities that would be eligible and able, financially, to take over one of these competitors?

Mr. KRIMMINGER. If I could just respond to—I will start with the first part of your question first. I think that the—we need to make one thing very clear: We, the FDIC, are not supporting nor do I think Treasury is recommending the creation of a new agency or a new authority. The proposal would be that it would be an obligation that the FDIC could take on for most entities, similar to its resolution authority.

As far as transparency, similar, again, to the bank resolution process. There is full transparency with regard to that process. The benefit of the bank resolution process compared to the bankruptcy process for banks in part is the ability for the receiver to act quickly, to be able to sell assets and be able to continue the business operations so that communities are not deprived of credit, are not deprived of deposits, et cetera.

The transparency is provided because there is a full right—there is a full claims process that is provided so people can file claims with the receiver, and if the claim is determined against their interest or they don't like the decision they have the full right to go to Federal court to litigate that claim with a complete new look at that case without any deference at all to the FDIC's receiver's decision. So there is tremendous transparency there, plus we, of course, provide reports to Congress on what we are doing with receiverships; we, of course, provide reports to our inspector general's office as well——

Mr. JOHNSON. What would be the difference in a sudden emergency?

Mr. KRIMMINGER. In a—I am sorry——

Mr. JOHNSON. A sudden emergency. What would be the——

Mr. KRIMMINGER. There would be no difference. The key thing is to be able to move quickly to make sure there is not a collapse of the markets that might be caused by the lack of liquidity or the lack of completing certain transactions.

But you would still have the ability, as a creditor, to challenge the claim decision by the FDIC in court. You would still have clear checks and balances so even the shareholders could challenge the appointment of a receiver in court. That is the way it is today under existing law. So all those protections and checks and balances on what we do would still be in place.

Mr. JOHNSON. And the last question?

Mr. KRIMMINGER. I think your last question was relating to the competition——

Mr. JOHNSON. Yes.

Mr. KRIMMINGER [continuing]. Issues. We do have, under banking law today, the obligation when we are doing a bank resolution to consult with the Department of Justice for an antitrust review, or a competition review, of the merger and acquisition transaction.

I think one of the key things that we believe is crucial and one of the reasons for proposing a new resolution regime is to make sure that market discipline is actually brought to bear on the largest great white sharks out in the financial sector so that, indeed, they will have to bear the same risk as the smaller fish they are swimming with.

I think that is going to have a much greater impact because they are now—the pricing of their debt, the pricing of their equity, the pricing of their liquidity and credit is going to be subject to market impacts in a way that they, in many cases, are immune today because they are not expected to be closed.

Mr. JOHNSON. All right. Thank you.

Mr. KRIMMINGER. Thank you.

Mr. COHEN. Thank you, Mr. Johnson.

I now recognize our rookie Member for her initial questioning, a historic moment, Ms. Chu.

Ms. CHU. Well, I certainly would agree that after the Lehman and AIG experiences there is little doubt that we need a third option that—between the choices of bankruptcy and bailout for non-bank financial firms and that we have to end the expectation that certain financial institutions are too big to fail. But my question is, what would be the threshold for intervention by the resolution authority? I am assuming that you are not suggesting that there be intervention for every non-bank financial firm that fails, and who would determine that threshold?

Mr. BARR. That is a terrific point, and I think that it is absolutely critical, as you said, that the resolution authority that we are proposing is not supposed to be used, won't be used, can't be used broadly in the economy for non-bank financial firms. It is a narrow authority. It is only to be used for the largest, most interconnected, highly leveraged firms. It is only to be used in the event that no other option is going to be able to work for the financial system to preserve financial stability for the system.

It is designed to be, again, a proposal that in the main, the largest firms will have their own capital buffers, pay their own way, and go into receivership in the bankruptcy system. The resolution authority is really just for the cases where the criticality to the system of what is going on, the fact that the capital buffers and prudential requirements have not been sufficient—in that rare circumstance you would be able to place that firm into special resolution to prevent widespread harm to the American economy.

The decision would be made with checks and balances between the Federal Reserve, the Treasury, and the FDIC, as receiver, in order to make sure that it is only used in the rarest of circumstances.

Ms. CHU. I heard Mr. Krimminger say that the FDIC should be this authority, but Mr. Barr, I didn't hear what your opinion was on that.

Mr. BARR. We think the FDIC is the natural place to play the receivership function. They have had 75 years experience acting as receiver of the largest firms. There may be circumstances when it is absolutely critical for the SEC also to be involved with respect to a broker dealer, but the expertise with respect to receivership really does lie with the FDIC.

There would be no need to create a new entity or a new bureaucracy or a new group of individuals involved; the FDIC is there, it is in place, it is a well respected, well trusted institution and I think Americans have come to see the important role that the FDIC has been playing for three-quarters of a century. So I think that is how we would proceed.

Ms. CHU. How would the Administration's resolution proposal guarantee that stakeholders would be no worse off by regulators' use of this authority than would be in the case of a liquidation?

Mr. BARR. We would put a floor on recovery at liquidation value, so it would just, by operation of law, require that system.

Ms. CHU. Okay. Thank you.

Mr. COHEN. Thank you, Ms. Chu.

Let me ask a question of Mr. Krimminger—a couple. I was the initial person to suggest we should raise our FDIC rates here in Congress. We did it. Would you concur that it was a good idea and that it should be continued on to give investors—depositors assurances that their money is safe?

Mr. KRIMMINGER. You are referring to the guarantee of the——

Mr. COHEN. Two-fifty.

Mr. KRIMMINGER [continuing]. Level? We think that certainly that has been extended now through 2013. We would want to look at that point as to whether that is appropriate to continue. We have not made any recommendation on that thus far.

Mr. COHEN. Can I ask you why it would possibly not be important to continue when it was set at $100,000 in 1981 and then if you take the—you know, figure it out pro rata, it should be at least $250,000 now. Why would it not be appropriate to keep it at the same level as it was in 1981?

Mr. KRIMMINGER. Chairman, I wouldn't want to really express an opinion on that, but certainly we have looked—we have done some analysis and looked and yes, there has been, obviously, quite a bit of inflation since 1980 when it was raised to $100,000 initially. We initially felt that it was appropriate to put it up to $250,000 during the crisis, and we just simply want to work with Congress and do some analysis to support whether $250,000 is the appropriate level or some different level.

We have certainly talked about it in the past, even before—long before the crisis—about having it be $100,000 level adjusted based upon inflation changes in order to make sure that it provided appropriate protection.

Mr. COHEN. And let me ask you another question: Major financial institutions move ungodly amounts of money—trillions of dollars—across global economies and affect—in many countries. Considering the amount of money that these major financial institutions move and across so many countries, does the FDIC have the capacity to resolve all these big institutions if they get into a crisis situation?

Mr. KRIMMINGER. Well, we certainly would believe that we have. This is something that we have been doing for a long time, is resolving banks. Banks are involved in many of these complex financial transactions. We were very heavily involved in helping to resolve several very large banks last year.

I will fully agree with you that the types of institutions we are talking about are much more complex and much larger in size. But the type of expertise related to the derivatives products, which we have dealt with quite a bit in bank failures, and other types of financial contracts, we believe put us in a good position to help deal with the resolution of the largest banks and bank holding companies.

That is the area that we think is most crucial that we would be involved in, and we think that we do have the expertise to move forward——

Mr. COHEN. And adequate personnel as well?

Mr. KRIMMINGER. We have a long history, Congressman, of increasing size if necessary. We would increase size somewhat with this authority. We are now about 6,300 employees; we have increased the size of our staff by a little over 1,500 employees in the last year. And I think we have the ability to call on the expertise of many others outside of the FDIC through contracts in order to provide special expertise for particular institutions, which we have used quite a bit with some of the bank failures we have already had.

Mr. COHEN. Thank you, Mr. Krimminger.

Does the Chairman have additional questions?

I recognize Mr. Conyers.

Mr. CONYERS. Thank you. Thank you, Chairman Cohen.

Am I correct to assume that you two gentlemen, from your respective authorities, have created this new resolution authority idea?

Mr. BARR. Mr. Conyers, Mr. Chairman, the Treasury Department submitted a proposal to the Congress with respect to resolution authority that is under—will be under consideration by the Congress. The FDIC is an independent agency and reaches its own judgments with respect to any legislation it might support or would not support. And certainly I was quite involved in that process, but it is ultimately a departmental decision.

Mr. CONYERS. Your modesty is appropriate, but this is largely your idea.

Mr. BARR. Mr. Chairman, I can say not only with humility but with honesty that there are a lot of people who worked on this proposal, and it is really a departmental judgment about the appropriate path forward with respect to resolution.

Mr. KRIMMINGER. If I might just simply—I could even claim more modesty, because it was primarily something developed through the Treasury Department. Certainly we have had a lot of contact with Treasury and other regulators——

Mr. CONYERS. I will get to your modesty in just a minute. Let us go into the secretary's modesty.

You are the secretary for financial institutions for the Department of the Treasury.

Mr. BARR. Yes, sir.

Mr. CONYERS. Right. Well, who would be putting this kind of thing together—somebody over you did this and gave it to you?

Mr. BARR. I am sorry, Mr. Chairman. I don't mean to be absenting myself from the decision-making processes. I just wanted to make clear that it is a departmental judgment. I share that judgment. I certainly was quite involved in that judgment, and it is my responsibility to work to get that judgment enacted. And you can hold me accountable if you don't——

Mr. CONYERS. All right. Let us look at it like this: Treasurer Geithner wrote this up and gave it to you and you and maybe one other person, and we have got it now. It is okay to admit it here.

Mr. COHEN. You have a right to a lawyer. You have the right to remain——

Mr. BARR. I don't especially need one. I am happy to have you hold me accountable for anything I say up here about the resolution authority. It certainly, in my judgment, it is the right course of action. And please, any questions you may have about it, I am happy to answer.

Mr. CONYERS. Well, I am glad that you are happy to answer them. I am happy to give them to you.

Now that we are all happy, let us—somebody wrote this. This didn't drop out of the air, or somebody walking, a window rolled down in a limo and a sheaf of papers were handed to you.

Mr. BARR. Mr. Chairman——

Mr. CONYERS. Somebody wrote it, and you are the one that wrote it.

Mr. BARR. I am not trying to avoid responsibility, Mr. Chairman. You can hold me accountable for it. It is the department's position. I worked on it with our general counsel's office. We have a terrific team of people there, and I am happy to have you hold me accountable for any of the words in it.

Mr. CONYERS. Well, look, I will hold your secretary accountable then, or the guy in the office next door to you.

Mr. BARR. No. Please hold me accountable, sir.

Mr. CONYERS. Well, that is what I was trying to do. So why are you trying to——

Mr. BARR. I apologize, sir. I am not——

Mr. CONYERS [continuing]. What is with the modesty? I hold you accountable and you accept accountability.

Mr. BARR. Yes, sir.

Mr. CONYERS. All right, now that that is straight. Now we are getting somewhere.

Now, over in the Federal Deposit Insurance Corporation, where modesty is the mode, Mr. Krimminger, and you have already asserted your modest role in this, where does the relationship between FDIC and Treasury come in here? In other words, they wrote it and you are here supporting it, right, this new resolution authority?

Mr. KRIMMINGER. It was Treasury's bill. We are here because we support the concept of having a new resolution authority. We do not support every provision of the bill and we have had discussions about some areas that we do have concerns about. So I think that is the completely honest and completely fair way of expressing our view.

Mr. CONYERS. Well, that is all we are trying to do is identify the—look, we are all in the same government working on behalf of the same citizens, and—but you are here to support the Treasury's position, and there are some reservations that you have. Okay. Now that we have got that, we are through with this and the modesties and the assuming responsibility parts have all been handled.

Now, in this new proposal of resolution authority there comes with it a dismantling of some of the protections that have already existed. Is that not correct?

Mr. BARR. Mr. Chairman, in our judgment the bill preserves important protections—key protections—for firms, for shareholders in the firm and for creditors in the firm, while providing the government with the appropriate tools to engage in resolution authority subject to judicial review of their actions with respect to the appointment of a receiver or the adjustment of claims, as Mr. Krimminger has previously outlined.

Mr. CONYERS. I see. That is not so good.

Mr. Krimminger, let me try the same question on you: Doesn't this proposal anticipate and include certain dismantling of some protections that already exist?

Mr. KRIMMINGER. Chairman, I do not believe it does because it simply—the only change that it really creates is that the initiation of an insolvency proceeding that would be initiated through an administrative process rather than through a court-filed insolvency process through the bankruptcy code. The types of protections that would be available to creditors and shareholders to challenge that process and challenging the decisions through a court action would all remain in place.

Mr. CONYERS. Are you a lawyer?

Mr. KRIMMINGER. Yes, sir.

Mr. CONYERS. And Mr. Barr, are you an attorney?

Mr. BARR. Yes, sir.

Mr. CONYERS. Oh, okay. What about the dismantling of—you both not agreed with my assertion. What about bankruptcy code protections currently in existence?

Mr. BARR. So again, Mr. Chairman, with respect to——

Mr. CONYERS. No dismantling?

Mr. BARR. With respect to firms that are subject to the special resolution regime, those firms would be subject to the resolution process that the FDIC uses for bank failures. Those bank failure protections provide important protections for creditors and shareholders with the appropriate opportunity for judicial review, and those same sets of procedures would be used with respect to these firms. So in our judgment it doesn't dismantle protections; it provides protections that are available under the bank failure regime and provides those protections in the context of firms that are subject to the special resolution regime.

Mr. CONYERS. Okay. Attorney Barr, that is very good.

Now, let me try Attorney Krimminger. Same question.

Mr. KRIMMINGER. I think, Chairman, we—in the FDIC's resolution process we provide the same types of protections for creditors. For example, there is protection under the bankruptcy code for secured creditors; there is protection under the FDI Act for secured creditors. In fact, in some ways there is even more protection under the FDI Act for secured creditors because secured creditors are not subject to cram down, as there can be some circumstances under the bankruptcy code.

Another example is that for existing contracts of the failed bank or the failed institution, there is protection for those existing contracts. There is a bankruptcy trustee who has the power to reject or affirm certain contracts under the bankruptcy code. So does the FDIC as receiver has the power to reject or, as it was referred to in our statue, repudiate those types of contracts.

But damages recoveries are available to those whose contracts are rejected. If they disagree with the decision on the repudiation or disagree with the amount of damages that the receiver determines to be due to them they can file for a de novo review, or actually a de novo case, in the Federal district court of the jurisdiction of the bank or in the District of Columbia.

Mr. CONYERS. Well, let us take antitrust safeguards. Attorney Barr, antitrust safeguards—are they compromised, diminished, or dismantled, from your perspective, under this new extended resolution authority idea?

Mr. BARR. In our judgment the proposal mirrors the procedures that are used with respect to bank failure laws. So in the event of the need for merger and acquisition, there is a process for appropriate Department of Justice review. As under existing bank failure law there are emergency exceptions to that; those would apply also in this case.

Mr. CONYERS. So the answer is no?

Mr. BARR. In our judgment they are, again, Mr. Chairman, the same as currently provided under bank failure law. We are extending the exact type of regime that exists today with respect to antitrust review to this narrow context. In our judgment that is appropriate.

Mr. CONYERS. Let me try a new tactic with Mr. Krimminger.

Yes or no?

Mr. KRIMMINGER. With regard to the antitrust protections?

Mr. CONYERS. That is right.

Mr. KRIMMINGER. With regard to the antitrust protections, Assistant Secretary Barr stated it accurately. There typically—yes, there is a requirement to go through Department of Justice review on bank failures, but there can be exceptions.

Mr. CONYERS. But there is no dismantling or diminution of antitrust safeguards? Your answer is, like Attorney Barr's, no?

Mr. KRIMMINGER. In a systemic context there can be cases in which there is an override of the anticompetitive consequences, yes.

Mr. CONYERS. Wait a minute.

Well, let us talk about union contracts. Are they protected under the bankruptcy code?

Mr. KRIMMINGER. My understanding, and I would consult with counsel on this because I have never been involved in a bankruptcy proceeding involving union contracts——

Mr. CONYERS. Well, they are all in back of you. Just take a moment. We are in no hurry——

Mr. KRIMMINGER. But nonetheless, in a Chapter—I think a Chapter 11 proceeding is somewhat distinct from a Chapter 7 liquidation proceeding. A bank receivership, where they—I can just give you the experience that I have with bank receiverships. In a bank receivership the claims under the union contract would be due to be paid in accordance with the priority system for the bank receivership, because once the bank is closed the charter is pulled—charter is terminated.

There is no longer a right, of course, to the employment because we are in a liquidation mode in a bank receivership. But any claims that are due from the bank to the union or to the union employees would be paid in the priority system, in that liquidation priority system.

Mr. CONYERS. So you can break the contract?

Mr. KRIMMINGER. The institution in that case, Chairman, is no longer in existence. I have no employer to provide. And I understand from counsel that there are similar protections and similar rights to reject certain union contracts under Chapter 11 provisions of Title 11, of course with certain protections in place. Chapter 11 proceedings, of course, are reorganization proceedings, whereas Chapter 7 is a liquidation and the resolution of a bank is the closing of the bank so that there is no longer a reorganization of that specific bank but the sale of its assets over to other private entities.

Mr. CONYERS. Lawyers, are retiree benefits and pensions protected as they are—would they be protected under the resolution authority concept that you bring to us as they are under the bankruptcy code?

Mr. KRIMMINGER. I believe they would be protected, Chairman, in the same way that they would be protected in a Chapter 7 liquidation proceeding. You are entitled——

Mr. CONYERS. Wait a minute. Could we start off with a yes or no and then the explanation?

Mr. KRIMMINGER. Yes, they would be protected in the same way as under a Chapter 7 liquidation proceeding. As in a liquidation proceeding, there is a winding up of the affairs of the entity and its assets are then sold to others in order to recover money to pay off the creditors. That is the same situation in a bank failure.

Mr. CONYERS. Now, Attorney Barr, what is your response to that same question?

Mr. BARR. I am afraid, Mr. Chairman, I would have to defer to Mr. Krimminger's expertise on that.

Mr. CONYERS. Sure.

I am sorry, Mr. Chairman, but this is some of the most fantastic questioning and responses that I have received in a long time here in the Committee. I apologize for taking so much time.

Now, in bankruptcy the non-bank would be in a Chapter 11 and not break the contract without negotiations and approval. That is not true under the FDIC. Is that a true statement?

Mr. KRIMMINGER. I would defer, Chairman, to your counsel with regard to what the bankruptcy provides. But what the FDI Act provisions provide is that, just as in a Chapter 7 liquidation, we have a insolvent closed entity that no longer continues in operation.

Our goal with the resolution authority that we would support is to end the "too big to fail" so that the entity is propped up in some fashion, either temporarily or permanently, from government or taxpayer dollars. So we would be closing the entity, just as in a bank receivership, and it would be then—its assets would then be recycled, if you will, into the financial system.

Mr. CONYERS. Is that a long way of saying yes?

Mr. KRIMMINGER. I say I would defer to counsel—your counsel——

Mr. CONYERS. My counsel says yes.

Mr. KRIMMINGER. I do not know the bankruptcy provision on that specific provision, but we are not talking a Chapter 11 proceeding. We are talking about the closure of the institution, the pulling of its charter, and then the maintenance of the functions that are systemic, not the actual firm in a Chapter 11 reorganization. So it is a different situation.

Mr. COHEN. Mr. Chairman, if I could do something out of the ordinary, I would like to ask Mr. Miller to come up to the panel—not be recognized, because I think everybody has recognized him in the past; he is kind of our Black's Law Dictionary on bankruptcy sometimes—and ask him without introduction if he can give us his basis of his knowledge on bankruptcy to respond to some of the questions the Chairman has asked and the witnesses have demurred on.

Mr. Miller, please?

The question is an assortment of questions that the Chairman asked. He may want to ask you directly about bankruptcy law and how it might be distinguished from resolution, and as far as union protection, as far as Justice Department and antitrust, as far as pensions, et cetera, et cetera. Are there more opportunities to the bankruptcy court to protect rights of individuals that might be under this new legislation?

You need to hit your mike.

TESTIMONY OF HARVEY R. MILLER, WEIL, GOTSHAL & MANGES LLP

Mr. MILLER. As I understand the testimony, the concept of the FDIC is that because the charter of the bank is terminated there is no longer an employer and therefore there is no longer a union contract, and all of these other contracts have effectively been terminated. Under the bankruptcy code, if it is a Chapter 11 bankruptcy, there are protections for pensions, there are protections for labor contracts, and very specific procedures that have to be followed.

And a Chapter 11 does not have to be a reorganization. Many Chapter 11s today are liquidations with those protections under 1114 and 1113 in place. So there are extra protections under the bankruptcy code.

Under Chapter 7, which is a liquidation, those provisions do not apply. But if a Chapter 7 trustee wanted to sell the assets to another company or a purchaser who wanted to run that business, there is still the possibility for a trustee to assume the union contract and transfer it to the purchaser. So I would submit there are greater protections which are being proposed in the resolution regime.

[The prepared statement of Mr. Miller follows:]

PREPARED STATEMENT OF HARVEY R. MILLER

Testimony of

Harvey R. Miller [1]

before the

Subcommittee on Commercial and Administrative Law

of the

House of Representatives Committee on the Judiciary

111th Congress, 1st Session

for Hearings on

Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform

October 22, 2009

I greatly appreciate the opportunity to testify in these oversight hearings as to the role of bankruptcy law and the bankruptcy courts in achieving a balanced approach to safeguarding American values in responding to financial crises.

I am a practicing attorney and a senior member of the international law firm of Weil, Gotshal and Manges LLP ("WGM") that maintains its principal office in New York, New York. For the past 50 years,[2] I have specialized in proceedings relating to debtor-creditor relationships, with an emphasis on restructuring, rehabilitating and reorganizing distressed

[1] Senior Partner, Weil, Gotshal & Manges LLP, New York, New York. The views expressed in this testimony are expressed solely on behalf of myself and not on behalf of any other person or entity.

[2] During the period of September 1, 2002 to March, 2007, I was a Vice Chairman and Managing Director of Greenhill & Co., LLC, an investment banking firm located in New York, New York.

business entities. I created the Business Finance and Restructuring Department at WGM. I have represented debtors, secured and unsecured creditors, trustees, creditors' committees, and I have served as a trustee and attorney in cases under the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa et seq.).[3] Currently, I am the lead bankruptcy attorney for Lehman Brothers Holdings Inc. and its affiliates ("Lehman"), and for Motors Liquidation Corporation f/k/a General Motors Corporation and its affiliates, in their respective cases under chapter 11 of title 11 of the United States Code pending in the United States Bankruptcy Court for the Southern District of New York.

I am currently an Adjunct Professor of Law at the New York University School of Law, where I have taught a seminar on chapter 11 bankruptcy and reorganization law since 1975. I also am an Adjunct Lecturer in Law at Columbia University School of Law, where I have taught a course on Corporate Reorganization and Bankruptcy Law for the past ten years.

It is my understanding that the Subcommittee is seeking to ascertain the implications and difficulties of dealing with the potential failure of a first tier financial holding company comparable to Lehman, a non-bank financial holding company that failed on September 15, 2008, and the options that should be available to deal with such situations.

In a statement dated October 1, 2009, submitted to the Committee on Financial Services of the U.S. House of Representatives, Ben S. Bernanke, as Chairman of the Board of Governors of the Federal Reserve System (the "Federal Reserve"), in support of an improved resolution process for failing, systemically important financial firms, stated:

> "In most cases, the federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, the bankruptcy code does not sufficiently protect the

[3] Since approximately 1973, I have been a conferee and member of the National Bankruptcy Conference and I also am a fellow of the American College of Bankruptcy.

> public's strong interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose substantial risks to the financial system and to the economy. Indeed, after Lehman Brothers and AIG experiences, there is little doubt that we need a third option between the choices of bankruptcy and bailout for such firms.[4]

Neither Chairman Bernanke nor the United States Department of the Treasury (the "Treasury") has elaborated on the experiences referred to in respect to Lehman and AIG that have led them to the conclusion that the financial distress of a non-bank financial holding company presents only two options, i.e., bankruptcy and bailout. However, based upon that conclusion, Chairman Bernanke urges that it is necessary to create a new resolution regime with extraordinary powers, a new infrastructure and a new administrative process to deal with such situations that would include imposing "losses on shareholders and creditors of the firm." No rationale is given for why the existing bankruptcy law and bankruptcy courts could not deal with the resolution of such financial crises, provided that the bankruptcy code is amended to restore the applicability of the bankruptcy code's automatic stay to derivatives, swaps and other securities transactions.[5] Specifically, I am referring to amendments that were made to the bankruptcy code as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 that created safe harbors that put derivatives, swaps and securities transactions beyond jurisdiction of the bankruptcy court. Those amendments have made a particularly negative impact on the administration of the Lehman chapter 11 cases.

The essence of a chapter 11 bankruptcy case, initially, is to preserve the status quo. This is accomplished by enjoining creditors from taking any remedial or other actions that

4 Bernanke statement, October 1, 2009, page 7.

5 *See* Act of July 27, 1982, Pub. L. No. 97-222; Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353; Act of June 25, 1990, Pub. L. No. 101-311; Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8.

would impede or interfere with allowing a debtor a reasonable period of time to pursue rehabilitation and reorganization or, alternatively, if in the best interests of the economic stakeholders, liquidation in an orderly fashion under the supervision of the bankruptcy court. The automatic stay of the bankruptcy code enables a debtor and its creditors the time to develop plans to preserve and maintain the value of the debtor's assets and, possibly, enhance values by avoiding the drastic consequences of a forced, unplanned liquidation that significantly depresses values to the prejudice of all economic stakeholders.

Unfortunately, under the current state of the bankruptcy code, a Lehman-type firm does not get the protection of the automatic stay and would be subject to the ravages of counterparties in respect of its securities and structured finance contracts. These circumstances make bankruptcy difficult and costly, but can be cured by taking some of the proposals for the new regime and incorporating them by amendment into the bankruptcy code. In that context, is the true lesson of Lehman that bankruptcy is not an adequate option?

It is important to keep in mind that until the weekend of September 12-14, 2008 the belief that Lehman would be the subject of a bankruptcy was beyond comprehension. Lehman was the fourth largest investment bank in the United States. It reported consolidated assets of over $600 billion and liabilities of almost that amount. It operated a massive, global business on a 24/7 basis. Through its highly developed network of subsidiaries and affiliates, and 25,000 employees, Lehman conducted hundreds of thousands of transactions each day at the speed of light and on a world-wide basis. It moved billions of dollars around the world for itself and its customers each and every day. If ever there was an institution that might have been deemed "too big to fail," Lehman was a prime candidate.

However, the week of September 8, 2008 was a horrendous and traumatic time for Lehman. A growing lack of global confidence was gripping the financial markets precipitated by the fall of Bear Stearns and the more recent takeover of Fannie Mae and Freddy Mac, as well as the growing enormity of the subprime crisis. Lehman's market capitalization was declining precipitously as rating agencies indicated potential downgrades and short selling increased, all causing Lehman's liquidity to severely contract as its clearing banks demanded more and more and greater amounts of collateral security. Between September 8 to September 12, Lehman was compelled to provide its clearing banks with billions of dollars in cash collateral, causing an insurmountable burden on its ability to operate its business – a business which had been built in major part on high levels of leverage.

The combination of low levels of liquidity and deteriorating economic conditions resulted in downward pressure on the value of financial assets. Such global and national economic conditions, in the aggregate, depressed both the valuations of Lehman's inventory positions as well as transactional volumes and market activity levels. Thus Lehman became a national and global problem. Lehman's problem, however, was nothing extraordinary. What Lehman needed was liquidity, and if it could not find liquidity, it needed the benefit of the bankruptcy code's automatic stay so that it could have the breathing space originally contemplated by the Bankruptcy Reform Act of 1978[6] to find a third party source of liquidity or to conduct an orderly, supervised wind down of its business and assets. Had the government and the bankruptcy code been able to offer liquidity and stay protection, Lehman might have had what it needed to survive, or at least to experience a soft landing, rather than the unfortunate, systemically challenging crash that occurred on September 15, 2008. The circumstances

[6] Pub. L. No. 95-598.

surrounding Lehman, from my point of view, establish that what is needed is not an entirely new resolution regime, but rather: (i) an expansion of the Treasury's authority, in exigent and compelling circumstances, to extend loans to financially distressed non-bank financial holding companies; and (ii) an amendment of the bankruptcy code that would eliminate the safe harbor provisions for derivatives, swaps and securities transactions that were added to the bankruptcy code and would restore the protection of the automatic stay for such financial holding companies. Implementation of those proposals would prevent the consequences of a Lehman type failure and allow distressed non-bank financial holding companies and their creditors the time to consider and evaluate the alternatives of rehabilitation and reorganization, or the most efficient and least intrusive methods to wind down a distressed entity.

The Experience of Lehman

Confronted with an extreme liquidity crisis and the growing loss of confidence, during the weekend of September 13 and 14, 2008, Lehman desperately turned to the Federal Reserve Bank of New York and the Treasury to assist it in facilitating a sale of its business or otherwise support its operations to avoid the cataclysmic and potential systemic consequences of Lehman closing its doors. To some extent Lehman relied on the past history of Wall Street assistance and bailouts going back to the Great Salad Oil Scandal of 1963, the broker/dealer crises of 1970 that led to the enactment of the Securities Investor Protection Act of 1970, the S&L crisis of the 1980s, the bailout of Bear Stearns in March 2008, and the conservatorships for Fannie Mae and Freddy Mac in September of 2008. Unfortunately, from the very inception of the meetings that took place over that weekend, and predominant through all the meetings, was the overarching principle expressed by Mr. Paulson as Secretary of the Treasury, that there would be not one dollar of federal money expended to rescue or assist in the resolution of the issues presented by Lehman, despite the potential systemic consequences of a Lehman failure. The result was the recommendation of the Federal Reserve Bank of New York and the Securities and Exchange Commission (and, by implication, the Treasury) that Lehman initiate a bankruptcy case by 12 midnight of September 14, 2008. Perhaps the motivation was to set an example or educate the financial markets that distressed financial holding companies could not rely upon any "bailout" by the Treasury or the Federal Reserve. Ironically, only a day later, that position had to be reversed with the rescue of AIG and the initial infusion of $85 billion into AIG on that day.

Nevertheless, for Lehman, the negotiations failed. Their was no rescue or non-bankruptcy option offered. The basis for that decision was not fully explained at the time and the subsequent rationalizations have not been fully satisfactory, particularly in light of the almost $145 billion which was advanced by the Treasury to provide liquidity to AIG.

In the context of the Lehman experience, it appears beyond reasonable controversy that it is in the best interests of the country and the global financial system for the Treasury and the Federal Reserve to have the authority to utilize federal funds to avoid potential systemic failure. Had the Treasury and the Federal Reserve provided Lehman with the liquidity or the backstop that it needed in order to continue operating, it may not have survived indefinitely, but it would certainly have been able to arrange a soft landing rather than the crash that shook world financial markets.

The Automatic Stay Is Inadequate for Financial Institutions

Lehman was forced to seek the shelter of the bankruptcy court in order to protect whatever assets it could from being ravaged by its creditors. Most bankruptcy cases begin this way. While the filing of a bankruptcy petition has several aims, ranging from an orderly liquidation to a reorganization that saves a business and the communities that depend on it, the first and most immediate aim is to provide a safety net: to provide the debtor a breathing spell from creditors and avoid a race among creditors to dismember a debtor's assets in a manner that dissipates or destroys their value. Regardless of how a case ends – whether or not it ends with a reorganized business – the initial focus is to avoid a crash and burn scenario, and if necessary, to guide the business towards a soft landing. The automatic stay is meant to facilitate this. As stated by the bankruptcy code's legislative history, the automatic stay "stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy." S. Rep. No. 95-989, at 54-55 (1978) *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5840-41.

However, most of the relief that is typically available to debtors was not available to Lehman for two reasons. First, Lehman's most dire liquidity needs were at its broker-dealer, Lehman Brothers Inc. ("LBI") – an entity that may not be a debtor under chapter 11. LBI's broker-dealer and fixed income business were among Lehman's most valuable assets. Nonetheless, its value depended on Lehman's ability to assure its clients and customers of its financial and operational integrity. In the circumstances surrounding Lehman's bankruptcy, it could not instill that assurance in its clients and customers.

Second, as the fourth largest investment bank in the United States prior to its demise, Lehman engaged in derivatives trading with some of the largest counterparties in the world. These contracts represented another substantial asset for Lehman. Most derivatives, swaps and securities contracts, however, do not benefit from the protection of the automatic stay. As a result of the safe harbor provisions of the bankruptcy code, non-debtor counterparties to such contracts are permitted to exercise certain contractual rights triggered by a debtor's chapter

11 case or financial condition, including the right to terminate the contract and take advantage of positions in their favor, and leave in place contracts in which they owe money to the debtor. The debtor usually has no right to terminate and remains exposed such contracts. This caused a massive destruction of value for Lehman. As of September 15, 2008, the bankruptcy date, Lehman's derivative counterparties numbered approximately 930,000, of which approximately 733,000 sought to terminate their contracts.

A Solution Is Needed For Truly Global Enterprises

Despite the above limitations, on September 15, 2008, Lehman commenced the largest bankruptcy case in the history of the United States. Lacking the full benefit of a "breathing space" within the contours of the bankruptcy code, the days that followed were a period of perpetual crisis. This crisis was exacerbated by the precipitous nature of Lehman's filing. No arrangements had been made to prepare Lehman's international operations for a coordinated international restructuring. As negotiations resumed with Barclays Capital Inc. for a sale of a portion of Lehman's business in an effort to salvage some value and protect customers and employees, Lehman's subsidiaries in the United Kingdom and elsewhere were compelled to commence their own insolvency proceedings to protect their assets. These companies were an integral part of Lehman's worldwide financial reporting system. When a major subsidiary entered into insolvency administration in the United Kingdom, the systems that Lehman entities shared for inter-company financial information were shut down, causing a total breakdown of the financial reporting system not only in the United States, but worldwide. With access to the financial reporting system terminated, knowledge of trades, location of securities and other information was no longer accessible.

As Lehman was struggling to preserve its assets, more and more of its foreign subsidiaries began to fall all around the globe. As each subsidiary ran out of cash, administrators, receivers, and liquidators took over. As a result, subsidiaries who had previously worked together with Lehman and shared information, became adverse to each other. First in Europe, then in Asia, Lehman's subsidiaries initiated or were forced into insolvency proceedings. Lehman's internal financial system, which had previously worked as an integrated entity-wide operation, was walled off by foreign jurisdictional imperatives.

The collapse of Lehman's global financial reporting system, and the myriad of local insolvency proceedings that were commenced throughout the world, have had an enormous impact on Lehman's ability to generate information, liquidate assets in an efficient, economic fashion, and identify a clear path to realize maximum value. The amount of information that Lehman has attempted to marshal is unprecedented. All of the accumulated information in Lehman's systems totals 2,000 terabytes of data, an amount that would completely fill 20,000 computers to the maximum. This vast sea of information spreads across 2,700 software applications and is dispersed throughout ledger accounts in numerous subsidiaries across the globe. Ultimately, this means that Lehman's inter-company balances do not simply appear at the push of a button. They cannot be produced simply with reference to a single general ledger. The financial information must be retrieved from among these thousands of dispersed global accounts, and collated and cross-referenced with alternate sources and ledgers to ensure accuracy and consistency.

Apart from encouraging cooperation with foreign regulators, the proposed resolution authority fails to address the total absence of a viable cross-border solution for the resolution of truly global institutions, and the inevitable breakdown that occurs – and has occurred with Lehman. If a global institution is forced to break apart into worldwide jurisdictionally fragmented global insolvency administrations, little in the way of safeguards will have been achieved. While I do believe that the bankruptcy code has the ability to deal with the resolution of a financial institution such as Lehman on a domestic scale, such institutions will almost always be global in nature and structured in ways that will optimize returns while in compliance with a global patchwork of legal, regulatory, and tax requirements. The global fragmentation that has characterized the international side of Lehman's bankruptcy is an inevitability that is not adequately addressed by the proposed resolution regime. Other than encouraging cooperation with foreign resolution authorities, the proposal does not effectively offer any substantive relief from what occurred in Lehman.

The only remotely viable solution that has been proposed for dealing with the multinational resolution of a institution such as Lehman is one that would resemble the so-called "living wills" proposed by the UK's Financial Services Authority. The general idea, as I understand it, is that regulators would agree ahead of time as to how they would resolve an institution that has a presence in multiple jurisdictions. If this approach were to be endorsed, it appears that non-bank financial holding companies would be required to formulate living wills – processes somewhat similar to the "stress tests" designed for banks – that would have to be continuously updated and approved by a consortium of national regulators. This requirement would be beneficial not only as a means for dealing with the cross-border aspects of resolving these institutions, but domestically as well. Clearly on the domestic front, having a draft "exit plan" on the shelf that is periodically updated and reviewed would be helpful if a Lehman-like institution needs to consider restructuring solutions either through government assistance or the bankruptcy courts, or a combination of both.

Conclusions

One year into Lehman's bankruptcy, the days of perpetual crisis are over, the enterprise has been stabilized, and the administration of the bankruptcy case is on a path towards ultimate resolution under chapter 11. Clearly, had the government been confident in its authority to provide financial assistance to Lehman, and had Lehman had the benefit of the "breathing space" that is typically available at the initial stages of any chapter 11 case, the massive amount of value that was destroyed in the months after September 15, 2008 may have been saved. Lehman might have experienced the "soft landing" that the bankruptcy code is meant to provide.

There is precedent for the use of chapter 11 to avoid the systemic failure of a particular industry. The Treasury's support for the chapter 11 cases of Chrysler LLC and General Motors Corporation ("GM") demonstrates how chapter 11 may be used as an option to support a sale and rehabilitation of a distressed entity and potentially save an industry. After the government had resolved to rescue GM's business in order to preserve and avoid systemic failure in the domestic automotive industry and other sectors of the economy, the Treasury first prevented GM's immediate shutdown and liquidation by providing GM with a total of $19.4 billion in financing, sufficient to prevent the crash and burn that would have systemically impacted the U.S. economy. Later, when it became clear that the only feasible manner of preserving GM's going concern value was to cause a de-leveraging and an expeditious sale of all of GM's viable assets pursuant to section 363(b) of the bankruptcy code, the Treasury again stepped in and sponsored the sale of GM's business to a Treasury-sponsored entity, now General Motors Company LLC. This transaction provided the means for GM to preserve and maximize the value, viability, and continuation of the survivable business and, by extension, preserve and provide jobs for GM's employees and its dependent supplier entities, as well as enhance the interests of all such economic stakeholders. The Chrysler and GM transactions were possible because of the flexibility of the chapter 11 process and the recognition by the federal government of the need to avoid systemic failure and to preserve the domestic automotive industry.

The government decided not to provide similar support when Lehman critically needed it. That experience does not necessarily lead to the conclusion that the bankruptcy code is simply not an option for non-bank financial institutions. There is an alternative option between bailout – whatever the definition of bailout is – and the commencement of a bankruptcy case to avoid systematically dangerous results. The action taken by the Treasury in rescuing the automotive industry is a vivid example of what could be done to use the bankruptcy process in a constructive way to safeguard the national interests.

It appears that the primary objective of the proposed new resolution regime is to clarify and authorize the use of federal funds. This explicit authority to provide emergency assistance in the form of government guarantees and loans might have allowed Lehman to forego bankruptcy, or in the alternative, enabled the effective use of the bankruptcy process to provide an orderly wind down of Lehman. In contrast, the creation of an FDIC-type agency to administer distressed non-bank financial institutions is problematic. Non-bank financial holding companies such as Lehman are quite different from depository banks who engage in limited trading activities for customers and themselves. At this juncture, it is questionable whether the FDIC has the expertise to deal with a Lehman type collapse. Further, the proposed resolution regime appears to have aspects of a covert organization that may be accused of violating due process in dealing with the assets and business of the insolvent non-bank financial holding company to the prejudice of its creditors. Of course, transparency may result, potentially, in more litigation, but it is an inherent aspect of our judicial and governance system.

What the bankruptcy court does provide, however, is transparency and compliance with due process of law. The proposal does not provide for those attributes. A receiver or conservator, as proposed, would, in effect, be empowered to take over an institution, manage its properties, sell or transfer its assets, avoid transactions, enforce or reject contracts, and above all, decide whether and to what extent creditor claims will be accepted or rejected, without ever offering creditors or other stakeholders the opportunity to object, and without ever being subject to judicial review. Creditors would appear to have no means to object to the treatment of their claims, and contractual counterparties have no ability to challenge the enforcement or rejection of their contracts in order to ensure that their contractual interests are adequately protected.

Assuming that the proposed resolution regime could be successful in transferring parts of Lehman's derivative book and other valuable assets to a bridge institution, what would the resolution regime be doing today to preserve and maximize the value of those assets that remained with the defunct institution, or to deal with the multitude of stakeholders whose rights and interests are intertwined with the rest of the entity's assets? This is a massive endeavor. How would the FDIC-modeled resolution authority be any different from what Lehman itself is competently doing as a debtor in possession under chapter 11 of the bankruptcy code? Beyond the ability to provide immediate financial assistance, and to preserve the value of an institution's derivative contracts, the proposed resolution authority does not appear to possess any greater ability for resolving the issues and problems of a distressed institution than the bankruptcy court has within the framework of the bankruptcy code. Further, the bankruptcy code does impose the losses on creditors and shareholders by virtue of the application of the principle of absolute priority.

If we have learned anything yet from our experience with Lehman, it is that there should be as many options available to the government as necessary to avoid the failure of a systemically important institution such as a Lehman. The most important reform that could be made would be to make it clear that the Federal Reserve has the ability to make loans in the exigent circumstances of systemic failure. Flexibility to deal with distressed institutions with potentially systemic consequences should be effectuated to the maximum extent possible. Thus, if there must be legislation to effectively legitimize what we have all come to refer to as a "bailout," it should include within it the concept of providing the means to effectuate a sale of the distressed institution, or otherwise provide financial support for an orderly wind-down, with or without resort to bankruptcy.

Once a bankruptcy is commenced, however, the bankruptcy court does have the ability, within an amended bankruptcy code, to deal with a distressed institution such as Lehman – indeed, the Lehman case has proven this, as have several other large and complex recent chapter 11 cases. Clearly, the bankruptcy court would be more capable of dealing with a financial services firm such as Lehman if the safe harbor provisions were repealed, or if an exception were created for institutions whose core business depends on the value of their derivative contracts. The bankruptcy code does provide a uniquely flexible means for dealing with the resolution of failed business entities and, in particular, as stated, for causing the first losses to be incurred by stockholders and so on, through the principle of absolute priority.

Finally, the proposed resolution authority is predicated on events that occur maybe once in a generation. The circumstances that would require its implementation are, by definition, extraordinary. There may not be a cycle of events as cataclysmic as these until long after the drafters of such legislation have left these halls. How can anyone propose an entire set of tools for an event that occurs once, maybe twice in a lifetime, and expect anyone to have the necessary knowledge and expertise to implement them?

The restructuring or liquidation of a Lehman type institution should be driven and overseen by the professionals and institutions that have the most experience with complex restructurings or liquidations. While such a proceeding is likely to be a rare and extraordinary event, it will nevertheless resemble the restructuring of a large and complex corporate enterprise. The FDIC may have applicable experience in the liquidation of insured depositary institutions, but these liquidations are far simpler than the restructuring or liquidation of highly complex non-bank financial institutions that engage in a variety of businesses. Their rescue will require the experience, expertise, and decades of legal precedent and highly qualified judges that have been developed among this country's restructuring professionals and bankruptcy courts. We are fortunate to have developed a body of laws dealing with the consequences of failure. We should rely upon this foundation and continue to build upon it, rather than hastily construct a framework that will remain untested and appear foreign to us when the next crisis occurs.

Once again, I want to express my appreciation for the opportunity extended by the Subcommittee to testify at this Hearing.

Mr. KRIMMINGER. May I respond briefly?

Mr. COHEN. Yes, sir.

Mr. KRIMMINGER. Just to be clear about this, if you have a Chapter—if you have a bank resolution and you create a bridge bank, yes, the existing contracts can be terminated by the fact that there is no further employer, but you can also transfer a contract. That is one of the powers of the receiver when one of us talk about continuity. The receiver would have the authority to transfer those contracts over to the bridge bank intact so that, just like a Chapter 11, there are to be similar types of protections for union, pension, or other contracts if that were viewed as being important to maintain the going concern value of the entity in a bridge bank structure or a bridge financial institution structure under the proposal, or the operations and prevent a systemic risk that was the concern that led to the use of this extraordinary power in the first place.

So you can transfer contracts. That is why I am saying it is very similar, in many ways, to bankruptcy law. You can transfer contracts by the receiver over to the bridge bank. You can also terminate, reject, or repudiate, depending upon your preference for terms, those contracts as well so that they don't flow over to the bridge banks.

Mr. CONYERS. It doesn't seem like you concur completely with Mr. Miller.

Mr. KRIMMINGER. No, I don't, because there is also the power to continue those contracts into the bridge bank, and I would just simply humbly suggest that perhaps that is something that hasn't been considered.

Mr. MILLER. If I may, Mr. Chairman, that assumes that the FDIC will find a buyer. What we are talking about here are first-tier financial holding companies of a huge size. I would look to the Indymac situation, where the FDIC was unable to find another bank to transfer those accounts to. And in the context of the testimony, that would mean those union contracts, those pension plans are terminated.

Mr. KRIMMINGER. Well, look, if I may respond as well—may I?

Since the reference was made to the Indymac situation, the Indymac situation did involve, effectively, a bridge bank structure created. The contracts and primary—all of the operations of Indymac were transferred to that bridge bank structure and then that entity was sold virtually intact from the bridge bank. Of course you leave some claims that are of no value down in the receivership, but that institution was sold virtually intact and is now operating as One West Bank in California by a new set of investors.

Mr. MILLER. Yes, sir, which can also be done in bankruptcy if you are going to have a bridge bank that is being financed by a Federal agency. You can also do it in Chapter 11 without any Federal assistance.

Mr. KRIMMINGER. And may I respond as well?

The Indymac receivership and bridge bank, since we are referring to that one, had no special assistance other than a protection of the depositors, which is, of course, the charge of the FDIC. There was not other Federal assistance provided at all.

Mr. CONYERS. Well, there seems to be a problem in the minds of some of the Members of this Committee about whether these guarantees are diminished or improved through this resolution authority idea. I am a little bit concerned, and this is why we are having this discussion, of course, isn't it?

I mean, after all, this is a draft that is not in final form, is it, Mr. Barr?

Mr. BARR. That would be up, of course, to the Congress to determine.

Mr. CONYERS. Well, sure, and we wouldn't do anything without consulting with you and Mr. Krimminger. And so we are concerned about whether or not we would be dismantling many of the bankruptcy code protections that apply to non-bank financial institutions and the antitrust safeguards that apply to them.

That is a valid concern, and that is a big concern, Mr. Miller.

Mr. BARR. Again, Mr. Chairman, in our judgment it made sense to use the system that is in place for bank failures, which has a long history and established protections in it and to decide in particular circumstances that are rare that should be extended to a further category of institutions that would have then a regime that has the same protections that have been used in bank failure law for many, many years.

Mr. MILLER. Thank you, sir.

I suggest that we should not forget that what is the fourth-largest non-bank financial holding company is currently in bankruptcy and is being administered in bankruptcy very efficiently and without a single dollar of Federal assistance, in a proceeding in which, as the prior panelists have said, was able to sell assets within a period of 5 days, did not need debtor and possession financing, has been running this estate—this huge, complex estate—for well over a year, and if it had the protection of the automatic stay in connection with the derivative contracts, would be a much more valuable estate today.

I would submit to the Committee that this whole problem of derivatives is so complex that three-quarters of the people on Wall Street still do not understand what a derivative is. And where you have almost a million counterparties in these derivative transactions, many of whom took full control because of the way the statute is written.

I don't believe the FDIC has ever had any experience with derivatives and how you unpeel them and how you unwind them. And there are billions and billions of dollars involved in that process.

Mr. CONYERS. We can't disagree with that, can we, Mr. Barr?

Mr. BARR. If I could, Mr. Chairman——

Mr. COHEN. Well, Mr. Krimminger, that is the reason I asked you the question about, is the FDIC equipped to take on these global economic situations with these multi-country—I mean, you all do like the bank of, you know, Tucum Karey—you are talking about doing the bank of the Semi-world.

Mr. KRIMMINGER. Like WaMu and some other substantial institutions. Yes, I think it would be a challenge but I think the——

Mr. CONYERS. You have never done it before.

Mr. KRIMMINGER. Well, I don't know—our point is that there is value to preplanning and value to planning these types of insolvencies in advance. There were some consequences from the Lehman failure that were created by the drying up of liquidity. I am not going to say that was all caused by the Lehman failure, but certainly there were consequences to that failure that created substantial problems in the financial system.

Our judgment, which we would agree with Treasury on this, is that it is important to have an alternative system where you have the most—the largest financial firms involved in a potential collapse. We have had experience working with derivatives. We have dealt with a lot of major counterparties around the world.

My work, as illustrated by the Chairman's introduction, as a co-chair of the international working group looking at these issues, we have been working with international colleagues for months and years to try to deal—to try to find better ways of dealing with these issues.

One of the recommendations in our working group report, which was published on the Bank for International Settlements Web site on September 17, was the need to have an insolvency system that could be consistent across both banks and the very largest non-bank financial firms in order to allow for greater coordination to prevent there from being cross-border consequences that can cause significant problems.

And it is certainly not a secret that there certainly have been substantial cross-border disagreements with regard to everything from information sharing, with regard to the treatment of certain creditors and certain claims, and with the preferential treatment alleged by some of certain creditors and claims in the Lehman Brothers bankruptcy.

So I wouldn't want to sit here and say that it is an easy problem to solve, but I don't think we can sit here and say that the bankruptcy resolution is an easy problem to solve for these very largest institutions either.

Mr. CONYERS. Well, we beg to apologize for undervaluing the extensive global experience that the FDIC has accumulated over the years. I wasn't fully appreciative of that fact.

Mr. BARR. If I could, Mr. Chairman, I think that the bankruptcy proceeding that Mr.—is referring to is successful only in the narrowest sense. So we have a responsibility, I think all of us, not just to have a system that works with respect to the process of bankruptcy and the creditors in that bankruptcy, but really with respect to the stability of the financial system as a whole and the protection of taxpayers.

And the decisions that were made last year and the results of which, since the tools were so limited available to the Federal Government, the Lehman bankruptcy was maybe okay for the narrow proceeding that it is engaged in, but was absolutely horrible for the financial system, and American taxpayers, consumers, and businesses are paying for it every day. And I don't think we want to set up a system in the future that is narrowly procedurally successful and brings down our financial system.

Mr. CONYERS. But aren't we creating a super—a powerful super-regulator with so-called resolution authority that we have never created before?

Mr. BARR. Not in my judgment, Mr. Chairman. We have a long-standing system of resolution for bank failure, we have particular——

Mr. CONYERS. Am I right? Are we creating a—or maybe I am wrong. When have we ever created any kind of authority with the power that is being contemplated now that the Treasury—that Mr. Barr, particularly—has handed us to consider? Is this routine?

Mr. MILLER. Absolutely not, sir. Absolutely not. I don't believe we have ever done that before.

Mr. CONYERS. I don't know about it.

Mr. BARR. Mr. Chairman, we have a longstanding history, we have a bank failure regime that has been in place for three-quarters of a century. It is a special resolution regime for financial firms. We are talking about applying that in rare circumstances to an additional group of companies whose failure could really bring down the system. And so in our judgment really we have a long history of established practice and we are applying it in this context.

Mr. CONYERS. Well, all I have to do is take my medicine and get more rest and I will learn that this is what we do regularly for almost a century. This has been going on all the time, Chairman Conyers, you just didn't know about it. It slipped my attention completely. A super-regulator authority with this authority to get rid of many of the safeguards of due process for unions, pensions, for secured and unsecured creditors that are all covered in the bankruptcy code now.

Attorney Harvey Miller?

Mr. MILLER. Yes, sir.

Mr. CONYERS. It is all there.

Mr. MILLER. It is all there. I think Mr. Barr, sir, is referring to two different things: one, what caused the failure, which is an entirely different subject. There are many factors that precipitated Lehman's collapse which were—included excessive risk-taking, which should have been subject to some regulation, poor regulation, and a general economy which was suffering from the takeover of Fannie Mae and Freddie Mac, and as well as the growing enormity of the subprime crisis. And you can trace back the subprime crisis, many of the problems.

What I was addressing myself to was, when failure occurs, how do you deal with that failure? And the bankruptcy code and the bankruptcy courts allow you to deal with that failure with all of the protections which Congress has already put in, and if you amended the code to deal with this derivatives problem we would have a much more efficient Administration.

And even though Lehman was an unplanned Chapter 11, it was something that, responding to Mr. Johnson's comments, the Federal Reserve Bank and the Treasury and Mr. Cox told the board of directors of Lehman, "You should file a bankruptcy petition by midnight on September 14." And while they said it is in the discretion of the board, it was pretty much a command.

And then the question was, how do you deal with that failure? I believe that the Chapter 11 bankruptcy in Lehman demonstrates that you can deal with it and we have dealt with it. And in fact, Lehman owns two banks. And it is through the Chapter 11 proceeding where, in the full light of the sunshine, full transparency, the Lehman estate has invested money in those to banks to keep them in compliance with the FDIC. And you have an administration there where everybody is involved and the stockholders are being wiped out.

Mr. CONYERS. Would you agree with that, Mr. Barr?

Mr. BARR. I don't, sir. With respect, I think it is very hard to hold up the failure of Lehman Brothers and the way it was managed as a model of how we want to deal with financial crises in the future. It was horrible for the system, it is horrible for taxpayers, it is horrible for consumers, it is horrible for workers, it is horrible for our economy.

We have to set up a system that is designed to bring——

Mr. CONYERS. What should we have done?

Mr. BARR. I think we need to have tougher regulation. Mr. Miller and I are in agreement on that. As I said at the outset, we need to make sure that these largest financial firms that are complex and interconnected have tougher regulation, higher capital requirements, more stringent activities and restrictions alike, but we have to have a system of special resolution.

If they fail we have to have humility about getting that right and the system we have in the past, where our choice is sending that firm into the bankruptcy or not, is insufficient and it has really hurt the system. We can't do it again.

Mr. CONYERS. But isn't the Miller description, Mr. Krimminger, a valid one?

Mr. KRIMMINGER. Well, I think what the Miller description fails to recognize is that you have the light of day. You have transparency in the bank receivership process as well. You have access to the courts, you have determinations by Federal judges about whether or not claims were accurately paid or not.

So while I understand Mr. Miller's understanding of the bankruptcy code, I think you have to look at what has actually been done in the bank receivership laws as well. There are protections, contrary to what he said, for secured creditors. There are protections for unsecured creditors. There are protections for all types of——

Mr. CONYERS. Maybe he hasn't studied this carefully enough to know that.

Mr. MILLER. I agree with a lot of the things that Mr. Barr said and what we do need, but in a context of saying that if you disagree with the FDIC and how they are handling things in autocratic fashion you can start an action in the Federal district court, a plenary action, it is not like going to the bankruptcy court, which has hearings regularly, somewhat informal. Starting a plenary action to complain about the FDIC requires a great deal of financial backing, and that——

Mr. BARR. We are talking about the largest firms in the country.

Mr. KRIMMINGER. And that is why you have an administrative process first to hear those claims and have a determination of them, then there is the right, if you are dissatisfied with that determination, to go to court in which there is no deference given to the FDIC's views.

Mr. CONYERS. Well, let us see. What is it that we agree on collectively? These are three of the finest legal minds in the country. What is it that we can agree on here and what is it that needs to be discussed a little further?

Mr. BARR. I think that we can all agree we need to end the perception of "too big to fail." I think we can all agree we need tougher capital requirements, tougher liquidity requirements, more stringent forms of supervision on the largest, most interconnected firms.

I think that we need to come to an agreement but we apparently don't have one with Mr. Miller that the——

Mr. CONYERS. Or this Committee.

Mr. BARR [continuing]. Bankruptcy regime is sufficient. In our judgment, the bankruptcy regime is not designed for the purpose of protecting financial stability. It is not designed for the purpose of protecting the taxpayer. It is designed for the purpose of ensuring process with respect to creditors. That is too narrow a vision. I think we have a deeper responsibility.

Mr. CONYERS. What do you say, Mr. Krimminger?

Mr. KRIMMINGER. Well, I think that we do agree on the need for reform across the regulatory and supervisory realm, which I mentioned both in my written statement and my oral statement. But what we also—we think that there does need to be a special resolution regime, if you will, only to be used in those rare cases where the—going through the normal bankruptcy process could create additional systemic risk.

So I concur with Assistant Secretary Barr that it is important that in that narrow scope of issues that we have the ability to go through a process that is designed to make sure there is speed, make sure there is continuity in these key contracts so that contracts where the liquidity is so crucial can be maintained through the bridge financial institution. That is simply what we are proposing, not some other—not a Federal bailout—because we believe that we do need to end "too big to fail."

The problem is that there was not an interest by both, in some cases policymakers but certainly in the case of also creditors, in many cases, of putting some of these largest firms through a bankruptcy proceeding because of the fear that there would be a massive dumping of these financial contracts on an already illiquid market. That is a danger that we need to avoid, and we can avoid it without having to have a taxpayer bailout as the only alternative.

Mr. CONYERS. Attorney Harvey Miller?

Mr. MILLER. I agree with almost everything Mr. Barr has said, but when he refers to stability I need a definition for stability. I said in my statement that Lehman's primary problem, putting aside its other problems, the immediate problem on the weekend of September 12 was liquidity. The liquidity had been drained out of Lehman by a series of different events, and finally the clearing banks just demanding more and more collateral.

If you were looking for stability at that point in time, the government, the Federal Reserve Bank, or the Treasury could have done a bridge loan. And there was a request for a bridge loan to get Lehman assistance to get to a sale.

The Treasury decided against that, and that resulted in the unstable conditions that happened. There is no prohibition in using the bankruptcy process, and if it is appropriate for the Treasury or whoever, in the interest of stability, to do a bridge loan it can be done in bankruptcy and it can be done in the bright light of full transparency.

Mr. CONYERS. Now, you don't need to qualify that statement do you, Mr. Barr?

Mr. BARR. I think that—I think again, with respect to Mr. Miller, it is too narrow a perspective. We are not focused on the success of failure of Lehman. We are focused on financial stability overall.

I think that the Lehman process obviously occurred in the context of a massive inflow of—followed by a massive inflow of liquidity provided into the system. There was a massive inflow of liquidity in the system from the Federal Reserve before. There was an enormous amount of government action taken in and around the Lehman bankruptcy.

The Lehman bankruptcy itself is a narrow slice of what we need to look at, and I think we have broader responsibilities. I think we need to have a special resolution regime because we are looking out for the taxpayer and the system and not just for the creditors or the firm.

Mr. CONYERS. Mr. Krimminger, you have less criticism of the Miller evaluation.

Mr. KRIMMINGER. I wish that I could provide concurrence, but I will say again that what the Miller evaluation fails to recognize, I think, is that the simple process that are provided by current bankruptcy code provisions, of requiring or allowing parties to terminate and net their contracts immediately onto an illiquid market creates a great deal of risk of destabilization.

A bridge loan would not necessarily solve that, but let us presume for a second that we also adopted the Miller proposal, say that these financial contracts were subject to the automatic stay. That is going to create nothing but illiquidity and concern by creditors of other entities that might be in trouble around the financial markets that their contracts will be subject to delay and they won't be able to get out of the contracts.

As much as the netting provisions cause problems, they were put in place in part to help deal with the potential destabilization that could occur by immediate—by having contracts tied up in a bankruptcy proceeding or other type of proceeding. That is why the Congress, in its wisdom, did give us the power to transfer these contracts over to a bridge financial institution so that they could be maintained and wound down slowly rather than being terminated immediately.

Mr. MILLER. Referring to the last comment, that is what should be in an amendment to the bankruptcy code, and that is exactly what, as I understand it, the resolution regime would want—the ability to assume or reject these contracts rather than allowing the counterparties to terminate them and take advantage of a declining market.

The other issue that I would raise is, in response to Mr. Barr, how are you going to protect this country against the same decision that was made on the weekend in which the Treasury decided, "We are not going to do a bridge loan or anything for Lehman," and then on Tuesday the 16th advanced $85 billion to AIG? How do you check that decisions?

Mr. CONYERS. How can you explain that?

Mr. BARR. Mr. Chairman, obviously I was not in the government at the time of those decisions. I don't really have a particular judgment with respect to weekend activities. I will say that I think it is absolutely critical—and here I think Mr. Miller and I agree—that we change the basic nature of regulation in our system so that there are big buffers and we can internalize the costs. I think those are important——

Mr. CONYERS. But he wants to put the law into bankruptcy and you want to put it into a super-regulator.

Mr. BARR. I don't want to put it into a super-regulator, sir. I think that these institutions need to be toughly, confidently supervised at the consolidated level. I think there need to be important checks and balances in the system for the use of resolution authority with three keys, as under the systemic risk approach—the Federal Reserve, the Treasury, and the FDIC in agreement.

I think there does need to be transparency in the process once the firm is in resolution with the opportunity for judicial review. So I don't agree with the characterization of this as a super-regulator.

And again, with respect, I think that we need to have broader system interests in mind and not just the interests of creditors of the firm.

Mr. COHEN. The Chair is temporarily going to ask Chairman Conyers to assume the Chair and recognize the Ranking Member as well to continue this questioning. And if the Chair would take the Chair for just about 5 or 10 minutes, I would appreciate it. And I will return shortly. But Mr. Franks has some questions, but I will leave that to the Chair to recognize Mr. Franks.

Mr. CONYERS. [Presiding.] Recognize Mr. Franks.

Mr. FRANKS. Well, thank you, Mr. Chairman.

You know, I guess just fundamentally here I think Mr. Miller's testimony has been very compelling to me. My original question was, what is the primary difference between what you are doing and the bankruptcy protocol that is already set up? And I understand that the big difference is who is in charge here.

And I have got to tell you, I want to be very respectful to Mr. Barr and Mr. Krimminger because I know that you are here, you know, at the behest of others, but you are in a position of having to defend what I think is almost an indefensible situation here because there is the reality of a super-regulator, like the Chairman suggests. This is putting this into an entirely new environment, kind of a bureaucratic environment, and you are trying to write a whole century of law here in a short period of time. You are trying to create an entirely new mechanism; you are trying to essentially replace what the bankruptcy system already accomplishes in most cases.

I have not heard any particular, clear, specific advantages that this would offer over the bankruptcy system. I just haven't. So let me just say that one of the things that concerns me is under the legislation here it says—this is verbatim—no judicial review of determination pursuant to the subparagraph. No court may review the appropriate Federal regulatory agency—that would be you—determination subject to subparagraph D to disallow a claim.

In other words, the gentleman, Mr. Miller, is absolutely correct. You could go into a Federal court and make a big statement—I will call on you in a moment—and I just think that you are talking about a modicum of chaos here, and there is a lot of hubris I am hearing here that if the right people were in charge it would all work out okay.

And, you know, I am looking at some graphs here and there is an indicator where, when the bankruptcy by Lehman occurred there was a little hiccup in the graph, but when the Bernanke-Paulson testimony came and TARP was announced, boom, it was disaster time. And I am convinced that the inept intervention by the department is most of what catalyzed the panic. Now, I am not suggesting that it was at the cores substance of what the underlying problem was, but it catalyzed the panic.

The same thing here with the Dow. When the Lehman bankruptcy occurred it bounced a little and bounced back up, but when this announcement of this two-and-a-half-page plan to save the world occurred the Dow just went—bottomed out because the market couldn't understand how the bureaucrats were going to come along and save the day.

Now, what I hear happening here is that somehow you are going to all of a sudden have, under the FDIC, the ability to have the same transparency, the same protective rules, the same wisdom, the same experience as the entire bankruptcy court mechanism that has been going on for so long. And I know I am being a little rough on you here, but let me ask a couple questions.

First of all, it seems to me that the additional strain and resource demand on the FDIC of this proposed new regulation would weaken the confidence in the FDIC's existing brand as a guarantee and the resolver of depository institutions and a single measure failure here by the FTC to resolve a bank holding company, for example, Citigroup, under the new proposed resolution would undermine the market confidence in the FCID. And wouldn't a loss of confidence then accomplish the same tragedy here where there is a run on the banks?

So let me ask you both, if you have got Goldman Sachs over here on one hand, now a bank holding company, and you have got your largest covered bank under FDIC, and both of them go into disaster at the same time, which one is your priority? And I will address it to Mr. Barr first.

Mr. BARR. Thank you very much, Mr. Franks. I guess I would respectfully disagree with respect to the characterization of the activity we are doing as creating this kind of entity you described. What we are talking about doing is applying for a narrow class of the largest, most interconnected firms in the country the opportunity to apply, in narrow circumstances, special resolution authority to be administered by the FDIC, an institution that has carried out the same procedures through the same protections for three-quarters of a century in the narrow additional class.

In my judgment the FDIC would have the capacity to engage in the kind of necessary approach to preserve the stability of the financial system while also taking care of deposit insurance——

Mr. FRANKS. But you are suggesting that it would be a new—you know, you would have additional responsibilities? I hope I could get that, because if I can't get that I am——

Mr. BARR. Yes, sir.

Mr. FRANKS. Okay. So what would be the main—and you haven't told me where your priorities would be. Would it be with Goldman Sachs or your largest bank—covered bank?

Mr. BARR. It is not a question of——

Mr. FRANKS. Well, that is my question.

Mr. BARR. Yes, sir. I believe that the FDIC has the judgment and the capacity to take appropriate steps to protect depositors with respect to a bank and also to take appropriate steps to wind down large firms and to preserve through that mechanism financial stability in the system.

Mr. FRANKS. Well, could you understand a potentially large bank's reticence to see this situation when maybe Goldman Sachs, which would be largely represented in the department, and all of a sudden it looks to me like that they would say, "Hey, you know what? These guys might favor Goldman Sachs over the banks here because of the large political representation that is there." And I am not making any—I am not challenging anybody's loyalty here, I am just suggesting that the market is going to consider that and what you are doing is you are politicizing the whole process.

You have got sort of a "bailout on demand" mechanism here and you are widening the ability of executive government, of bureaucratic government, department government to intervene in these areas that it really—that has pretty much been determined to be what was the catalyst of a lot of the panic in the first place. And I mean, can't you understand why the business community would say, "Well, they screwed it up once. Why should we all of a sudden have this great confidence that they can come along and rescue everything now?"

Mr. BARR. Mr. Franks, in fact I agree that we shouldn't care at all what Goldman Sachs thinks or any other firm thinks about anything we all do up here. The point is to develop a system that protects the taxpayer, protects our economy, and makes sure that we have the tools available to we need to end "too big to fail," to regulate the largest firms, to have higher capital requirement and liquidity requirement on it, and we have to be humble about that.

We have to know that sometimes that is not going to work. If it doesn't work we need to have the option, other than a bailout or bankruptcy, that is actually going to be able to resolve the firm in a way, wind it down in a way that is not disruptive to the system. And our judgment is that——

Mr. FRANKS. It just occurs to me that, you know, if you have got this additional process, that the market doesn't know whether to trust it or not and the firms, then they think, "Oh, well then our issue is not whether we get a bailout or a bankruptcy. We have got this other possibility that we may try." And all of a sudden there is an entirely new calculus in the minds of some of the business leaders. And it just occurs to me that this is a recipe for absolute confusion.

And I still haven't heard a major advantage in the process that you are talking about that would not be—and I am sure there may be some—but that would not be already available under what Mr. Miller has talked about in a Chapter 11.

Mr. BARR. Could I suggest, sir, that I think that the ability to act quickly and decisively with respect to changing the management, with respect to providing financing for liquidity functions, with respect to the ability to reduce risks to financial system as a whole through knock-on effects to counterparties, and the ability to take that kind of decisive action, not with respect to protecting the narrow interests of the firm but with respect to preserving taxpayer interests and having the ability to assess on the industry as a whole to make sure that the largest firms pay for any financing improves market discipline and preserves the ability to strengthen our financial system. I do not believe that bankruptcy is adequate to doing that.

Mr. FRANKS. So getting back to the one question that I asked, just as clear as you can, I know—what happens if Goldman Sachs and your largest bank blow up on the same weekend? What happens? What do you do?

Mr. BARR. You resolve the depository institution according to existing bank failure law and you resolve the large financial holding company according to the special resolution procedures as described in our proposal.

Mr. KRIMMINGER. May I respond to the section of the FDI Act that you read from a moment ago?

Mr. FRANKS. Sure.

Mr. KRIMMINGER. That section simply means that there is no, like, administrative procedure act type of review of the decision by the receiver. That is why I was saying before, there is a de novo judicial review of the decision.

The court can't review the decision and give deference to it; they have to review it without giving deference. And the subsequent provision of the FDI Act, which provides specifically for the ability to go to court, file your claim, and get that resolved by the court. So there is a judicial review of the claim, the decision——

Mr. FRANKS. But the ultimate impact is that the process then has less transparency in the long run because, you know, you can't possibly suggest to me that you are going to—under this new modicum here where you don't have 50 years of developed transparency with the bankruptcy court, you can't suggest to me that there is the same transparency.

And Mr. Miller, would you suggest——

Yes. We have given you plenty of time here, guys, but I want to—because my time is short too.

Mr. MILLER. Thank you, Mr. Franks. There is nothing that Mr. Barr has said that could not be done as a complement to bankruptcy. I believe Mr. Barr is—and I think simply saying that the Chapter 11 bankruptcy has a very narrow focus is understating, because if there is exigent in circumstances, certainly there is going to be a lot of public interest in it.

In terms of bridge financing and all of that, that can be done. Now, I hate to use Lehman as an example all the time, but before Lehman filed, the Federal Reserve and the Treasury went to all of the major money-center banks and the major street—Goldman Sachs and Morgan Stanley and Merrill Lynch, when Merrill Lynch was still there—and nobody was prepared to do anything. What do they do in those circumstances?

Mr. BARR. I think that Mr. Miller is exactly right that no one was prepared to do anything. Our financial system was teetering on the brink. And I think it is ironic to say the least to hold up the failure of our financial system last fall as the model for the kind of financial system we want to have in the future. We can't have that kind of system in the future.

Mr. MILLER. Well, I would just suggest that, you know, the entire foundation of the crash was loans that did not perform as those who rated them said they would perform, because whether it is derivatives or whatever it might be, that was the basis. If those loans had performed as they would have traditionally, until we changed the rules and government in the middle of it all, then the entities would have had much more to lose and their own stockholders, all of these systems—even Fannie Mae and Freddie Mac—their stockholders would have said, "What? You are underwriting loans that you don't know whether the person has a stated income, no credit history, no big down payment. What are you doing?"

All of a sudden the traditional judgment would have entered into the process, but when government comes in and says, "Well, we are guaranteeing it because we are really smart; we know how to make it all work," and I will suggest to you that this is the same mistake that has littered the highway of histories where government comes in and feels like they can make better judgments than the market and those who are in business and the foundational productivity sector are.

Now, let me just suggest here, the assistance that is talked about in this legislation for a bank holding company—this would be Goldman Sachs—this would allow you to come in, make loans or purchasing any debt obligation, purchasing assets of the covered bank, assuming or guaranteeing the obligations of the covered bank, acquiring any type of equity interest in the covered bank, taking a lien on all assets of the covered bank, selling or transferring all or any part of the covered bank. That is a recipe for you just coming in and just taking them over, and I don't know how you think that you are going to do a better job than most of the private sector has done without putting the responsibility on them to perform or go bankrupt.

Mr. KRIMMINGER. May I make a comment with regard to that provision?

As I indicated before, we have not—we at the FDIC have not—supported every provision in the proposed Treasury proposal. We do not support provisions that would provide assistance to open institutions. That is why our focus is on the institution needs to be closed and needs to go through an insolvency process and not be bailed out prior to closure.

Mr. FRANKS. Well, the Chairman has been very kind to me and I want to give you, Mr. Barr, a last thought and Mr. Miller a last thought, then I am finished. But obviously you could probably guess here that I am a little bit not convinced here.

Mr. BARR. Mr. Franks, I would agree with you that we need to be humble. We need to be humble about the ability to have regulators. We need to be humble about the ability of managers of large firms.

And I think that is why it is absolutely critical that we build up large buffers in the system in the event of failure. It is why we need tough rules on these institutions in advance.

And I think what we are talking about is just a narrower question of, do you want a process through the bankruptcy process, which involves a set of individuals working in the government, or do you want a special resolution process which involves a set of individuals working in the government to decide the nature of the resolution? And in our judgment the bankruptcy process is set up, designed for a different function. It works well for most of the time for most institutions in doing what it is supposed to do.

We are talking about in the narrow case of financial stability—do we need a broader purpose and a carefully cabined approach using long trusted mechanisms? We think that we do.

Mr. FRANKS. Mr. Chairman, considering the history of the last year, we have seen some major intervention by government that is unprecedented in this country, and I would just suggest that if we had gotten back to just basics and told these financial institutions, "Listen, you better have enough equity to cover your risks and you better make sure that the taxpayer is the last one to have to intervene here, and if you don't you are not going to go bankrupt you are going to go to jail if you don't follow at least having the fundamental equity necessary to cover your risk." And if we did that and we said, "Okay, buyer beware, lender beware, guys, have a good time," I can tell you it would have worked a whole lot better than government trying to come in and tell everybody how to do it and guaranteeing everything to the extent that it threw the whole skew of a real market out of place in the minds of any rational participant.

And with that, Mr. Miller, I give you the last word here.

Mr. MILLER. Thank you, Mr. Franks.

I go back to what Mr. Johnson said earlier this morning in connection with Chairman Bernanke's statement about after the experiences with AIG and Lehman we need a third option. There is no place where Mr. Bernanke or anybody else has said, "What are the experiences in AIG and Lehman that requires this special superagency?"

I would submit to you that H.R. 3310 is a good start to where we should go incorporating those amendments into the bankruptcy code. We need to deal with the derivative problem. We have to take out those safe harbors that are in the bankruptcy code. And all of this without some cross-border solution is not going to work.

We are dealing with firms that are global and have huge operations overseas. In the Lehman case we now have 80 separate insolvency proceedings. We have to deal with corporate governance obligations and fiduciary duties in other countries that the FDIC can't deal with, or the Treasury, in terms of stability.

And until we have a cross-border solution the type of solution—this regime that is being proposed simply is not going to work. It all can be done in the bankruptcy—within the bankruptcy law and, as I said, with full transparency.

Mr. COHEN. [Presiding.] Thank you, sir. And this has been a very unusual manner of conducting a Committee hearing, but I think it has been very evocative of issues, and I think it has been very helpful to us. And I thank Mr. Miller for joining the panel and Mr. Barr and Mr. Krimminger for participating as we have gone long.

I would like this one last thing, Mr. Barr. I just think there probably needs to be some type of standard when you get out of the bankruptcy into this resolution, and the standard ought to be spelled out in some way, like a compelling state interest sometime that—your compelling financial economic doomsday, you know, and define some standards that could be met.

Mr. BARR. I would agree with that, Mr. Chairman, and we have a standard proposed in our legislation. We would be happy to make it available to you for your consideration.

Mr. COHEN. I look forward to that and I think—and I have to ask you, too, how are you related to Bob Barr? Are you all cousins?

Mr. BARR. We are not cousins. In fact, I am fairly confident we are not related in any way. My name comes from a long string of changes through the process of immigration and assimilation to the United States and I believe it used to be Kaplinski in Poland.

Mr. CONYERS. But so did Barr's, I think, came from the same place. [Laughter.]

Mr. BARR. The gulag. Maybe. Right now I am just your neighbor up the street in Ann Arbor.

Mr. COHEN. Thank each of you and I appreciate your testimony. And I would—you might want to find a different word that is a better word than regime. I am afraid that may reflect poorly. But I thank each of you.

Mr. BARR. Thank you for your advice.

Mr. COHEN. We will get the thesaurus together.

We would like to now welcome the second panel and thank our first panel for their—oh. I thought I beat the clock——

Mr. KING. Mr. Chairman, I——

Mr. COHEN. Mr. King is here.

Yes, Mr. King, you are recognized.

Mr. KING. Thank you, Mr. Chairman. I thought for a moment that you had suspended your peripheral vision and——

Mr. COHEN. I can go to my left.

Mr. KING [continuing]. And I seldom do.

And I want to thank the witnesses for your testimony, and as I look out across the list we have here perhaps I could start with Mr. Barr and ask you this question, and that would be, if we had simply allowed these financial institutions to go through a normal process of Chapter 11 or Chapter 7, what would you predict would be the results today? How would those large investment banks have fared? What would be left? Who would have picked up the pieces without regard to what the prediction might have been for the global financial structure?

Mr. BARR. I think that if we had—if the Federal Government at the time had not taken significant measures, both through the Federal Reserve and the Treasury and the FDIC, to provide liquidity in the system the financial consequences would have been much more severe and lasting. Already I think that the difficulties that have been experienced because of the financial crisis have been quite severe to American consumers and businesses and households and the taxpayer. I think——

Mr. KING. Mr. Barr, I think I am going to need to rephrase my question: What would the pieces look like if we had let that happen, though? I mean, I understand that you endorse the support that has been there for these institutions to maintain the entities that we had as much as possible to go through this.

Had we not, if we had decided that "too big to be allowed to fail" really didn't apply, that the free enterprise and free markets and the risk of failure as a deterrent for future imprudent investments or risks on lending institutions, what do you think would have happened in the function of the, say, bankruptcy court, for example, of those large investment institutions that were bailed out?

Mr. BARR. Sir, in my judgment let me just say, I don't really care at all about the firms themselves or what pieces would have been left of them or what——

Mr. KING. But I do, Mr. Barr. That is why I asked the question.

Mr. BARR [continuing]. What new pieces arrive. It is not about protecting the firm, so the key question is what is necessary, in terms of imposing the discipline on them in the future, making sure they have higher capital standards, higher liquidity requirements, bigger buffers in the system, tougher forms of prudential supervision. We have to make sure they are supervised on a consolidated basis so you don't have a firm like AIG that really is a loophole in the system with respect to bank holding companies.

And then the question is just, in the event of crisis if all that is crashing down and has failed, should the government have the ability to throw those firms into a resolution procedure? I think the answer is that in some cases maybe yes, and that is why there is this narrow authority that is provided in that special circumstance with respect to these largest interconnected firms.

Mr. KING. Thank you, Mr. Barr.

If I could direct that similar question to Mr. Miller, and also ask Mr. Miller if you have gamed this out and anticipated or tried to predict what would have happened if the government hadn't intervened. And as a person who takes care of my money—when I invest it in a business startup, for example, I do so with the prudence of the realization that if it doesn't work out I lose my money. When I borrow money or loan money it is done so with the prudence of the judgment of being allowed to fail.

And that deterrent was taken away, and I think it was taken away implicitly some years ago. In fact, some of the top financial people that I have heard from 2 years ago were, "What you do in this business is pretty much what everybody else does. That way, if they are making money you make money but if everything falls apart you get bailed out with the rest of them." What would you say about that subject matter?

Mr. MILLER. Mr. King, I would respond in this context: If the firms went into bankruptcy—Chapter 11 or Chapter 7—the survival of the firms would be minimal at all. The assets would have been offered for sale, they would have been broken up.

If the economy was in a stable condition there is a thing called—a capitalist term called constructive destruction, or something like that, that part of capitalism is failure, and when there is a failure other elements of the economy take over that deceased, let me call it, entity. I think the problem in September of 2008 was the systemic risk, where it wasn't a question of Lehman; it was the question, was Merrill Lynch next? Was Goldman Sachs next? Was Morgan Stanley next?

And if you had a successive set of bankruptcies for each one of those firms the consequences to the overall economy, I think, would have been disastrous.

Mr. KING. I thank you, Mr. Miller, Mr. Barr, all the witnesses. I appreciate it, Mr. Chairman, and I yield back the balance of my time.

Mr. COHEN. Thank you, Mr. King.

And now we will conclude the first panel, and we are going to quickly go because we are going to have to vote at 3'ish, or whatever.

Mr. BARR. Thank you, Mr. Chairman, Chairman Conyers.

Mr. COHEN. You are welcome, sirs. Thank you very much.

Second panel, come in. I am sorry I have been probably derelict in recognizing your expertise and just deferring to Mr. Miller but it made for a good panel discussion.

The first witness we are going to hear from is going to be Mr. David Moss. Professor Moss is the John McLean professor at the Harvard Business School, teaches business, government—senior economist at Abt Associates and he joined the business school faculty in 1993. And we will recognize Professor Moss now for his statement.

Professor Moss, if you would start in the interest of time?

TESTIMONY OF DAVID MOSS, HARVARD BUSINESS SCHOOL

Mr. MOSS. Thank you, Mr. Chairman.

Mr. Chairman and Members of the Subcommittee, I appreciate your inviting me here today, and I am very pleased to have the opportunity to speak about the proposal for a resolution mechanism for systemically significant financial institutions. I actually support—I do support the broad idea of a resolution mechanism, and the reason I support it is that I believe it could be helpful in navigating a rather narrow path and a treacherous path between——

Mr. COHEN. If I may interrupt, at the suggestion of the Chairman we will go through a continued unorthodox policy in this Committee, which I am happy to be the initiator of because I am very unorthodox in more ways than one. And what we would like to do is ask Mr. Moss, first, Professor Sagers, Professor Skeel, and Mr. Weissman to comment—you can incorporate some of what you had in your opening statements, all of which will be put into the record, but also to comment on what you have heard in the testimonies of Mr. Barr and others and give your opinion of their testimonies and how you—safeguards or non-safeguards you think we should look for in having a resolution group rather than bankruptcy.

Professor Moss, you start.

Mr. MOSS. It was quite an interesting discussion to begin with. I guess I would start that I am not sure that the choice, which has been framed here is, in fact, the choice we face. The choice that was framed in this discussion back and forth was one between a resolution mechanism and bankruptcy, and I realize that that may seem like the choice but I don't think it is.

I think the choice, sadly, is between resolution and bailout. I think that in the—what we have seen is that there is now a sufficiently widely held belief, perhaps correct, that bankruptcy of enough very large financial institutions could have catastrophic effects for the financial system. And given that, it is not clear that policymakers from any party at any time, in my view, would allow that to happen.

And I think as a result, although the law on the books would say to put the firm in bankruptcy, it is not clear to me that in fact that would be followed in a crisis. It was not followed in this crisis by either administration, Republican or Democrat. I don't think it would be followed in the future either.

And, as a result, I don't actually think the choice is, in fact, between resolution and bankruptcy. I think it is between resolution and bailout.

Between those two choices I will take resolution. I recognize its problems.

I will say that your predecessors, it seems to me—I had not prepared to talk about this, but—your predecessors have excluded financial firms quite regularly over the course of American history from bankruptcy law. The original 1898 act, as I recall—Mr. Miller, I am sure, would know better than I—but I believe excluded all corporations from voluntary bankruptcy, but banks in particular were excluded from involuntary bankruptcy, so they were already excluded. Banks, of course, were subsequently brought under FDIC.

And insurance companies are also excluded, if I am correct, from bankruptcy law. So I think the idea of excluding financial companies from bankruptcy law is not a new phenomenon.

Maybe I can just make one more comment—I know you want me to be brief. I have two significant concerns about the idea of a resolution mechanism. Broadly I think it is necessary, but I have two concerns.

One is that we should not fool ourselves to think that a resolution mechanism will solve all the problems. There is still the basic problem of systemic risk and the basic problem of moral hazard, and as we try to solve one we increase the other. A resolution mechanism is an attempt to provide a balancing act, but it is not a perfect one.

The more serious problem—and I think this is one you ought to consider if you go forward with the resolution mechanism—is that in a crisis, in a crisis it is not clear that we would, in fact, follow a resolution mechanism. The question is, is the resolution mechanism credible? Just in the way that we have to ask, is bankruptcy credible? Over the past year-and-a-half it has not been. At every opportunity we avoided it.

At every opportunity—it seems to me that if we are not careful we could create a beautiful resolution mechanism and it would be circumvented in a crisis. So we need to create a mechanism, and a system, that is credible.

I would be glad to talk about how to do that. I have some ideas. But I will just remind you that with FDIC—which, by the way, I think the resolution mechanism works quite well with FDIC—but it is attached to an insurance system that protects depositors. I suspect that if that insurance system did not exist we would be very reluctant to put a major bank into resolution for fear that it would spark runs on other banks by fearful depositors.

So there is a question of how we stabilize the broader financial system, whether we put a major financial institution into bankruptcy or resolution. Do we have a system for protecting the healthy institutions at the same time? I would be glad to talk about that in more detail if that would be helpful, but those are my broad comments.

[The prepared statement of Mr. Moss follows:]

PREPARED STATEMENT OF DAVID A. MOSS

Testimony of

David A. Moss

John G. McLean Professor
Harvard Business School

Before the United States House of Representatives
Committee on the Judiciary
Subcommittee on Commercial and Administrative Law
Oversight hearing on:

Too Big To Fail – The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform

October 22, 2009
Washington, DC

Mr. Chairman, and members of the Subcommittee, thank you for inviting me here today. I am very pleased to have the opportunity to speak with you about the need for a resolution authority for systemically significant financial institutions.

For the better part of a year, I have been focused on how best to manage the risk posed by systemically dangerous firms – and, by extension, how to structure our regulatory and legal systems so that no private financial firm is considered "too big to fail." When several of our country's largest and most interconnected financial institutions became vulnerable this year and last, our government was left with few options but to assist them, lest their failure and ensuing bankruptcy provoke a dangerous cascade of losses across the financial system. To avoid the need for bailouts in future crises, we must establish a strong resolution mechanism in advance, specially tailored for systemically significant financial firms, in a way that our existing bankruptcy system is not.

For a resolution mechanism to fulfill its promise and serve as a firewall against the need for bailouts, it must manage the twin dangers of systemic risk and moral hazard. First, it must be designed to limit – and certainly not exacerbate – the systemic threat posed by the failure of a very large and highly interconnected financial firm. It is now widely believed that the current bankruptcy system is not well suited for this purpose. At the same time, to prevent the creation of moral hazard (i.e., incentives for excessive risk taking), a resolution mechanism must be sufficiently tough so as not to resemble a bailout itself. It must also be sufficiently credible so that market participants are confident in advance that it will in fact be used (and not dropped in favor of a bailout), even in the midst of a financial crisis. Over the remainder of my testimony, I would like to discuss what a resolution authority that met these objectives might look like.

A strong resolution authority is needed to allow systemically significant firms to fail, without provoking an avalanche of losses in the process.

Although American bankruptcy law has served us extremely well in many different contexts over the past 100-plus years, it was never designed to handle the failure of a large, systemically significant financial institution, particularly at a moment of severe financial turmoil. For one, our bankruptcy procedure may be too slow to deal with the failure of a major financial institution in the midst of a fast moving crisis. Moreover, the preservation of certain claims, even at public expense, may in some special cases be necessary to prevent or limit a broader financial storm.

More concretely, at a moment of financial turmoil or distress, the bankruptcy of a systemically significant financial institution (SSFI) could potentially provoke cascading losses (far beyond the firm and its direct creditors and counterparties) and perhaps even trigger a severe financial panic. Concern about such a chain of events, stemming from the bankruptcy of a large financial firm, existed well before the failure of Lehman

Brothers, but was dramatically confirmed by Lehman's entry into bankruptcy in September 2008 and the financial havoc that followed. Given this, it is very likely that in some future moment of financial turmoil, federal officials would go to great lengths to prevent a systemically significant financial institution from falling into bankruptcy. In fact, with the notable exception of Lehman, this is precisely what happened in the recent crisis (with government-supported rescues of Bear Stearns, Fannie Mae, AIG, and Citigroup, among others).

As a result, the choice we now face may not be between the existing bankruptcy system and a new resolution process, but rather between an ad hoc bailout process (to avoid bankruptcy at a moment of systemic turmoil) on the one hand, and a strong resolution process on the other. Given this choice – and, I'm afraid, this is exactly the choice we face – I prefer the creation of a credible resolution process, specially designed for SSFIs.

The good news it that FDIC has had this authority for years with respect to commercial banks, and it has worked well. What is needed now is a comparable resolution process for all SSFIs, whether they are banks, bank holding companies, or other financial institutions. We need a resolution process that works, so regulators don't have to be afraid to let a systemically significant financial institution fail.

The resolution mechanism must be designed as one component of a comprehensive regulatory plan to eliminate the policy of "too big to fail."

While a resolution mechanism is necessary to help eliminate "too big to fail," it is by no means sufficient. If there is one thing I would like to convey today, it is this: in isolation, a resolution mechanism will not do the trick. Rather, it must exist as part of a larger program to manage systemic risk, or we will likely end up with the very same ad hoc bailout system that we are now trying to eliminate. FDIC's resolution mechanism for commercial banks exists as part of a broader system of regulation and insurance, and so must the new resolution mechanism for SSFIs that we hope to create.[1]

To effectively manage the problem of "too big to fail," we must take four linked steps, designed to reduce the risk of systemically dangerous firms failing in the first place, and to allow such firms to fail if necessary, without causing system-wide damage.[2]

- As a first step, I believe we must publicly identify systemically significant financial institutions (that is, those firms whose failure, whether in normal times or times of financial turmoil, could provoke a cascade of losses in the financial system); and we

[1] See note 4 below.
[2] For a fuller description, see David Moss, "An Ounce of Prevention: Financial Regulation, Moral Hazard, and the End of 'Too Big to Fail'," *Harvard Magazine*, September-October 2009 (http://harvardmagazine.com/2009/09/financial-risk-management-plan).

must develop and maintain this public list of SSFIs on an ongoing basis, before crisis strikes.

- Second, to reduce the risk that such institutions will fail, and to give them an incentive to slim down, we should impose heightened regulation on the systemically significant firms on the list. This heightened regulation should include, at a minimum, tough leverage and liquidity requirements, limits on the proportion of short-term debt on these firms' balance sheets, and restrictions on their off-balance sheet activity. A maximum leverage ratio for SSFIs might even be written directly into the statute.

- Third, to prepare in advance for the possibility of system-wide disturbance and to help make the resolution mechanism credible, we should create an explicit – but strictly limited – stabilization fund, which would trigger only in periods of severe systemic distress. The fund would require regular fees or premiums (ex ante) and would provide pre-specified (and temporary) capital infusions to all viable SSFIs to help stabilize the broader financial sector in the midst of a crisis. I'll return to this stabilization-fund proposal later in my testimony.

- Fourth and finally, we should develop an effective resolution mechanism – as I have mentioned – to ensure that no institution is seen as too big, or to systemic, to fail.

The resolution authority must be sufficiently tough and credible so as not to create moral hazard.

A resolution mechanism, placed within the broader regulatory program just described, would allow systemically dangerous financial firms to fail without the type of systemic damage a bankruptcy could create. However, as I mentioned in my introductory remarks, the resolution authority must not only prevent systemic damage, it must also avoid the danger of moral hazard. I see two potential scenarios in which a resolution mechanism could fail, leaving us with a de facto bailout policy – and the associated moral hazard.

First, in designing a resolution authority that would avoid the systemic damage engendered by bankruptcy, we must take care not to build in so much support for claims against the failing firm that the resolution is essentially a bailout itself. If the resolution process is not sufficiently tough – that is, if it is tantamount to a bailout – the market will still consider systemic firms government-guaranteed. Shareholders must be wiped out, and creditors must be converted into new shareholders (starting with the most junior creditors, and working up). Counterparties may require some protection, but even here there should be significant haircuts to avoid the perception of an implicit guarantee and the moral hazard that goes along with it.

Second, and most important, a resolution mechanism must be credible in order to eliminate implicit guarantees and reduce moral hazard. Market participants must believe that the mechanism will in fact be used to take down a failing financial firm, whether in normal times or in times of financial turmoil, and that public officials will not instead (and at the last minute) resort to an ad hoc bailout.

The problem is that in the event of a severe systemic disturbance that threatened to take down all (or at least many) of the nation's largest financial firms simultaneously, it would probably not be either feasible or desirable for the government to put every major financial institution into receivership at the same time. Nor could it credibly make this threat ex ante. Consequently, the danger exists that if we faced a broad financial crisis, in which numerous SSFIs were at risk of collapse, public officials might feel compelled to circumvent the resolution mechanism by providing direct (and open-ended) financial support to these firms, to prevent them from failing. If market participants perceived this bailout option to be inevitable in a crisis, the resolution mechanism would be far less effective than it should be in reducing (or, ideally, eliminating) implicit guarantees and the associated moral hazard.

As a result, while a resolution mechanism for SSFIs would play an important role in combating perceptions of "too big to fail," we should prepare in advance for a situation in which a systemic disturbance leaves many such firms vulnerable at the same time. To address this problem, we should create a stabilization mechanism that would provide a strictly limited infusion of funds to all *viable* SSFIs at a time of severe systemic turmoil.[3] Such an infusion (which would likely involve the purchase of preferred shares) would be available only to pre-designated systemically significant firms and would be designed to stabilize fundamentally healthy institutions. Weaker firms, whose failure was deemed imminent, would not receive the infusion and would face resolution immediately. Firms that received a capital infusion but neared failure in any case would also be forced into resolution.

In contrast to the current bailout approach, where open-ended government support is provided disproportionately to the weakest firms, the system described here would – in a crisis – separate SSFIs into two groups: strong firms, for which a limited (and temporary) capital infusion would be sufficient to ensure survival through the crisis; and weak firms where even the promise of a limited capital infusion would not be sufficient to ensure

[3] Specifically, I am recommending the creation of a stabilization fund for systemically significant financial institutions (SSFIs), which would require these firms to pay fees (or premiums) on an ongoing basis. At a moment of severe systemic turmoil – and only at such a moment – the fund would have the authority to borrow from the Treasury to undertake pre-specified (i.e., not open ended) capital infusions to all viable, pre-designated SSFIs. Once the crisis had passed, surviving recipient firms would be required to repurchase the government shares from the stabilization fund, and the fund would then repay the Treasury. Any losses to the fund would be covered by the previously collected fees (premiums). These fees might also be used to finance resolution operations, as necessary.

survival. Under the proposed system, strong firms would be stabilized until the turmoil dissipated, whereas weak firms on the verge of failure would be credibly forced into the resolution mechanism.

Importantly, the proposed stabilization fund would not create a new guarantee. Rather, it would transform an open-ended implicit guarantee, which already exists (and is by far the most dangerous kind of guarantee), into the possibility of explicit support that was well-defined, carefully limited in scope, effectively funded through premiums or fees, and reserved only for rare moments of systemic turmoil. In the period after the systemic disturbance, all surviving SSFIs would be required to repay the federal government (most likely by repurchasing the preferred shares that the government had acquired). Consequently, the only loss to the fund would be the amount provided to firms that ultimately failed, despite receiving stabilization assistance. This loss would be covered by fees (or premiums) paid into the fund by all SSFIs, ex ante.

Such a system would ensure that resolution remained a credible option for taking down systemically significant financial institutions, even in the midst of a severe financial crisis.[4]

Conclusion

Particularly given the string of bailouts that we just lived through, it is critically important that we develop a credible resolution mechanism for dealing with systemically significant financial firms in the future. No private entity should ever be "too big to fail." However, it is also essential not to deceive ourselves by creating a resolution mechanism that looks good on the surface but would in fact fail to reduce the implicit guarantee that these institutions now enjoy – either because the mechanism was so weak as to constitute a de facto bailout, or because it was not credible, with market participants doubtful that it would be used in a crisis. In either case, the unfortunate result would be a virtual continuation of the current policy of "too big to fail" and the severe moral hazard that goes along with it.

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[4] Proponents of a resolution mechanism for SSFIs commonly put forth as a model the FDIC's resolution process for commercial banks, which is widely regarded as effective. It is worth remembering, however, that the FDIC resolution process is part of a broader program of bank supervision that includes not only prudential regulation but also federal deposit insurance. Without the insurance component, officials at the FDIC might be reluctant to put a large bank into receivership, lest depositors at other banks become nervous and commence bank runs or even start a general panic. Just as FDIC's resolution process for commercial banks would be far less effective (and credible) without the existence of federal deposit insurance, so too a new resolution process for SSFIs would be unlikely to be very effective (or credible) without the existence of a stabilization fund.

For the resolution mechanism to be effective, the process of winding up a financial firm must be streamlined and the receiver must have some discretion to avoid triggering systemic losses; but the process must never coddle the creditors, counterparties, or management of failing financial firms simply because those firms are systemically significant. To be credible, the resolution mechanism must be accompanied by a stabilization fund to safeguard strong financial institutions in times of crisis and to allow the weak ones to be put into resolution. Together with heightened prudential regulation of systemically significant financial firms (to reduce the risk of failure), a stabilization fund and a resolution authority would enable the government to credibly take down weak institutions, preserve stronger ones, and dramatically reduce the problem of moral hazard by rendering obsolete the existing policy of "too big to fail."

Mr. COHEN. Thank you. And we will come back and hopefully have time for discussion.

We are going to go to Professor Sagers next because Mr. Miller has let us know his thoughts and participated in the colloquy that we previously had. Professor Sagers practiced law for 5 years in

D.C. at Arnold & Porter and Shea & Gardner, involved in large-scale litigation, public policy matters, and different issues of commercial affairs.

Professor Sagers, your thoughts and opinions?

TESTIMONY OF CHRISTOPHER SAGERS, CLEVELAND-MARSHALL COLLEGE OF LAW

Mr. SAGERS. Thank you very much, Mr. Chairman. It is my great privilege to be here.

I am more than happy to scrap my prepared statement because I think that I can be of use here in precisely one way, which is to answer Chairman Conyers' specific question, does the bill change existing antitrust law with respect to these entities? And I can give a yes or no answer. I have the disability of also being a lawyer, so I would like to expand on it a little bit if I could, but the simple answer is yes, it does change existing law.

In deference to Secretary Barr and Mr. Krimminger, I gather they are not antitrust lawyers primarily, and in drafting the bill and preparing their testimonies they were advised by antitrust counsel, and in their defense they gave answers which were not literally false. There is an existing—and I don't mean to cast any aspersion there—— [Laughter.]

Mr. COHEN. Criminal defense lawyer? [Laughter.]

Mr. SAGERS. The short answer—a short way of saying what is really a very complicated answer—is that it is true that bank merger review has always existed as something of a special case under our antitrust merger review system. And it is also true, as they testified, that that system contains a series of emergency safety valves that can make the process go really fast if the banking regulators decide that one of the banks is in danger of failure.

I think we need to beware—I do want to say, by the way, that there is one significant change. There is one technical legal change made to the law that really is potentially breathtaking. But even before getting to that, it is a bit misleading to say that we have addressed competition concerns because we just incorporate antitrust law that we have always had for bank failures.

The antitrust law that we have always had for bank failures is extremely problematic. It has never ever incorporated any concern for systemic risk; it has repeatedly approved the merger of immense banking institutions and conglomerate financial institutions even over strenuous objections about the increase in systemic risk that is being caused.

And I don't think that—even if that system weren't put into an incredibly rushed procedural framework under this bill, as it will be, it wouldn't—that existing system of bank merger law wouldn't be very well designed to handle the competitive risks, which are both systemic risks and also the more traditional competitive risks that we deal with in merger law. That system wouldn't be very well set up to deal with mergers of entities of this immense magnitude.

All right. That is all in answer to the question whether existing bank merger law is really adequate to deal with these problems even if it is not going to be changed by the bill. In one important respect existing bank merger law is changed by this bill, and that is that the bank holding companies that can be subject to the resolution authority under this bill include “financial holding companies”—that is, those businesses that are allowed to own both banks and other financial businesses.

It is clear under the bill that if one of these resolution actions is undertaken and an entire financial holding company or big pieces of it are given away—sold, rather; they wouldn’t be given away but sold to other large competitors—there will be merger review, and moreover, the non-banking piece of any financial holding company that is taken into receivership, that transfer of that piece will be reviewed not under bank merger law, but under the Hart-Scott-Rodino Act, or as the familiar, more normal review of antitrust merger review.

And that is how it would happen under existing law, except that this bill provides that that non-banking piece of the financial holding company that is to be transferred to a competitor, possibly a really big competitor with a lot of market share, that transfer will be judged under the Hart-Scott-Rodino Act, just exactly as it would under existing law, except that the antitrust agencies won’t be allowed to make the so-called second request for additional information, they won’t be allowed to request any extension of time for reviewing the merger.

So what we are basically going to have is transactions involving transfers of truly the largest non-banking financial institutions reviewed by DOJ or FTC under extremely tight time constraints and with very limited information, and those agencies are either going to be forced to rubber stamp these transactions or just challenge all of them so that they can get them stopped and the courts can review them. So the testimony that was given is, to some extent, incorrect and I think quite misleading.

[The prepared statement of Mr. Sagers follows:]

PREPARED STATEMENT OF CHRISTOPHER L. SAGERS

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STATEMENT OF CHRISTOPHER L. SAGERS
Associate Professor of Law, Cleveland State University

Before the
SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

of the
COMMITTEE ON THE JUDICIARY,
UNITED STATES HOUSE OF REPRESENTATIVES

Concerning
"TOO BIG TO FAIL: THE ROLE OF ANTITRUST AND BANKRUPTCY LAW IN CRAFTING A SOLUTION"

October 22, 2009

Chairman Cohen and members of the Subcommittee, my name is Chris Sagers and I am a professor of law at Cleveland State University in Cleveland, Ohio. With my gratitude I am pleased to offer these thoughts on antitrust aspects of the Administration's proposed financial regulatory reforms. I applaud the emphasis that Judiciary

Subcommittees have given this year to antitrust issues, because I believe that our competition policy is in need of attention.[1]

At the request of Subcommittee counsel, my testimony will concern Title XII of the Administration's financial regulatory reform package, entitled The Resolution Authority for Large, Interconnected Financial Companies Act of 2009 ("Act"). I have been asked to address the explicit ways in which the Act modifies the antitrust laws, and such other consequences it might have on antitrust through the "implicit repeal" doctrine or otherwise. I have studied the law of antitrust exemptions and immunities throughout my career. I was co-author, with Peter Carstensen of the University of Wisconsin, of the American Bar Association's book *Federal Statutory Exemptions from Antitrust Law* (2007), and Professor Carstensen and I were called for testimony on exemptions issues before the Antitrust Modernization Commission ("AMC") in 2006. I have also published articles concerning statutory exemptions in the ocean shipping, airline and railroad industries, as well as judicially created antitrust exemptions like the *Parker* and *Noerr-Pennington* doctrines.

Summary

If there is a criticism of the Act itself, from the perspective of competition policy, it is merely that it preserves our Byzantine, idiosyncratic and dubious system of bank merger law. The sense of general disappointment in this system was captured in the thoughts of an eminent banking scholar at a recent Symposium:

> What I have seen since [in the last fifteen years] is that the number one bank in the country will merge with the number five bank in the country

[1] I do not represent any party with any interest in this matter. I have received no compensation in connection with my testimony, I appear here at my own expense, and the views expressed are my own. I submit this testimony at the request of counsel for the Subcommittee.

> and create a multi-state institution, with billions of dollars in assets, and if it is found to violate the antitrust laws, the solution is to knock off half a dozen branches in the Peoria area or something like that, which makes me wonder: Do we really have an effective law of antitrust for banks?[2]

But indeed the Act not only preserves this system, it does so in a context in which concerns for competition seem more acutely needed than in other bank regulatory contexts. The transactions to take place under the Act that would raise antitrust concerns will almost by definition involve the largest entities, within markets that are already the most concentrated and interdependent (since, by definition, they will involve systemically significant entities), and they will at least sometimes result in making those entities even *bigger*. In fact, the Act manages in at least one case to make the system of bank merger review even more hasty and less careful.

Possibly it will seem unfair to criticize the Administration for failure in this narrowly tailored, special purpose bill to revise the general law of bank merger review. But the larger criticism is that neither the Act nor the rest of the Administration's financial regulatory reform package appears to conceive of competition itself as any part of the solution, or seeks meaningfully to constrain the breathtaking consolidation that has been the salient feature of financial institutions markets since the 1980s. This particular Act simply takes entities that are Too Big To Fail ("TBTF") as a given or a necessary evil.

Admittedly, in this particular context—the search for better regulatory solutions to financial sector problems—competition could not fix some persistent and difficult problems. On the one hand, as to some financial products price competition is already fierce and yet those markets are rife with problems needing regulatory attention. And on

[2] *Panel Discussion I: The Development of Bank Merger Law, Symposium: The Antitrust Aspects of Bank Mergers*, 13 FORDHAM J. CORP. & FIN. L. 511, 512 (2008) (comments of Professor Carl Felsenfeld, Fordham Law School).

the other hand, even where price competition is not healthy, merely improving it will not solve all the problems they present. And yet, as it will be my goal to show, competition in the financial sector, along with reinvigorated regulatory oversight, must be a component of policy. It is needed to generate efficiency, encourage innovation and product quality, and to reduce risk.

Competition and the encouragement of deconcentration could in reasonable, easy to imagine ways be made part of a solution to TBTF dilemmas. In fact, the Administration's reform package happens quietly to include one important step in that direction. Another Title of the package contemplates that regulators will from time to time designate systemically significant firms as "Tier 1 Financial Holding Company," a step that would subject those firms to enhanced (and more costly) prudential oversight. The drafters observe that in addition to the hoped-for risk reduction, this designation will have the effect of "compel[ling] these firms to internalize the costs they could impose on society in the event of failure."[3] But the more important benefit is that by creating and actually using this designation, the government will raise the costs of bigness itself. In this particular context opposition to bigness in and of itself is not just knee-jerking populism, and rather goes to the central problem of the current financial crisis.

Analysis

I. Specifics of the Pending Legislation and Their Relation to Existing Bank Merger Law

The Act contemplates that the Secretary of the Treasury will, when certain specified exigencies arise, determine that the default of a bank holding company ("BHC") would

[3] DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 20 (2009) [hereinafter "TREASURY REPORT"].

pose systemic consequences.[4] Upon that finding the Secretary may invoke either of two federal corrective measures, one of which is to place the BHC under the control of a federal conservator or receiver.[5] The conservator/receiver would then hold a number of powers to resolve the BHC's crisis, among them being to merge the BHC with another company or transfer any of its assets.[6] There lie the Act's antitrust consequences. Mergers of BHCs and transfers of their assets are subject to Clayton Act § 7, which prohibits mergers and acquisitions whose effect "may be substantially to lessen competition, or to tend to create a monopoly," 15 U.S.C. § 18,[7] and also to a complex series of special statutory rules that require a pre-transaction review process that roughly mirrors the Hart-Scott-Rodino ("HSR") process. BHC transactions are ordinarily exempt from HSR filing, though in some cases they are not.[8]

[4] BHCs are primarily governed by the Bank Holding Company Act, 12 U.S.C. §§ 1841-50. A BHC is a corporation, partnership, or other entity that holds control of one or more banks, and ordinarily is permitted to engage only in banking or activities that are closely related to banking, like some limited securities and insurance work. Only a company that complies with the terms of the Bank Holding Company Act may own control of a bank, and it must first seek approval of the Federal Reserve Board before it may do so. *See* 12 U.S.C. §§ 1841(a), 1842, 1843. *See generally* CARL FELSENFELD, BANKING REGULATION IN THE UNITED STATES (2004).

[5] In cases in which the BHC's largest subsidiary is a securities firm, the conservator/receiver will be the Securities and Exchange Commission ("SEC"). Act at § 1202(1). In other cases, it will be the Federal Deposit Insurance Corporation ("FDIC"). *See id.* at § 1204(b). The other corrective measure provided for under the Act is that, whether or not a conservator/receiver is appointed, FDIC may make loans or provide other assistance to the BHC. *Id.* at § 1204(a).

[6] First, the conservator/receiver may cause the seized company to be merged into another or may transfer any of its assets. *See id.* at § 1209(a)(1)(G)(i). Second, the conservator/receiver may create a "bridge bank holding company," which would be a temporary, federally chartered corporation fully controlled by the conservator/receiver, to which to transfer the assets of a seized entity. Following creation of the bridge BHC, either the entire company or its assets would be transferred to their ultimate owner. *See id.* at § 1209(h).

[7] There was actually uncertainty on this point during the first half of the twentieth century, but it was resolved by the seminal decision in United States v. Phila. Nat'l Bank, 374 U.S. 321 (1963). *Philadelphia National Bank,* which remains a fundamental decision in merger law generally, established that bank mergers are subject to Clayton Act § 7, even if they have been previously approved by a federal banking regulator. *See generally* Bernard Shull, *The Origins of Antitrust in Banking: An Historical Perspective*, 41 ANTITRUST BULL. 255, 260-75 (1996).

[8] *See generally* SECTION OF ANTITRUST LAW, AM. BAR ASS'N, BANK MERGERS AND ACQUISITIONS HANDBOOK1-12 (2006)[hereinafter "BANK MERGER HANDBOOK"]; Yvonne S. Quinn, *Practical Aspects of Defending Bank Mergers Before the Federal Reserve Board and the Department of Justice*, 62 ANTITRUST L. J. 91 (1994).

The Act deals with these antitrust issues in two explicit, identical provisions. Presumably, they were included simply to make clear that antitrust continues to apply to the conservator/receiver's remedial actions, even though they are ordered by the federal government. For the most part these provisions preserve the existing system of bank merger review, and indeed they are written in such a way as mainly just to reference that system obliquely. Existing bank merger law requires that BHC mergers and significant acquisitions cannot proceed until the parties seek permission to the appropriate federal banking regulator.[9] The responsible bank regulator must request and consider the views of both the Justice Department ("DOJ") and the other bank regulatory agencies as to competitive issues. They prepare their opinions under a process that largely tracks the analysis that the antitrust enforcement agencies perform in HSR review, though with one significant substantive difference: regulators can approve an otherwise illegally anticompetitive bank merger if they find its competitive costs to be "clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served."[10] In any case, this system of bank merger rules contains a series of saftey-valve provisions, which allow the responsible bank

[9] The identification of the appropriate regulator is itself a complex little statutory problem. It will most often be the Federal Reserve Board, as it is given authority over acquisitions by BHCs of any bank, 12 U.S.C. § 1842, as well as most acquisitions by state bank members of the federal reserve system, *id.* at § 1828(c)(2)(B). But if the acquiror is a national bank or a District of Columbia ban the regulator is the Office of the Comptroller of the Currency; if the acquiror is either a state bank that is federally insured by not a member of the federal reserve system, or is any federal insured bank that seeks to acquire a non-insured entity, the regulator is the Federal Deposit Insurance Corporation; and if the acquiror is a thrift the regulator is the Office of Thrift Supervision. *Id.* at § 1828(c)(2).

Technically, the particular rules that apply to any given bank merger or acquisition depend on exactly what is being transferred and to whom. Because conservator/receiver remedial actions might both cause the merger of an entire BHC or merely the transfer of some of its assets, a given case under the Act might involve a merger of two BHCs or the transfer of bank or banking related assets to anohter BHC or to a financial holding company. In each case the appointed regulator could be different, and the precise rules that apply could vary. But overall the same substantive standard would apply, and the overall process would be roughly the same.

[10] 12 U.S.C. § 1828(c)(5)(B).

regulator to speed up the approval process substantially, and even to exclude antitrust review entirely, where it finds there to be a risk of imminent failure of one of the banks.

The Act's approach to competition review is to provide that this whole process of merger review will occur as it ordinarily would, except that the Act automatically triggers all the emergency time period provisions, and it also makes one potentially significant modification. The Act's two, identical antitrust provisions provide that:

> (1) If a conservator/receiver transaction "requires approval by a Federal agency," then it cannot be consummated before the 5th calendar day after the approval is made.
>
> (2) Where such an approval requires a "report on competitive factors," then DOJ must be notified "promptly," and DOJ must then provide the report within 10 days of the request.
>
> (3) If a transaction requires an HSR filing, then the antitrust review agency must make its determination within 30 days after receipt of the filing, and it may not seek any extension of time or make any "second request" for additional information.
>
> (4) If the Treasury Secretary and Federal Reserve Chairman determine that a conservator/receiver transaction must proceed "immediately," in order "to prevent the [BHC's] probable failure," then no regulatory approvals or antitrust review are required at all and it may consummate with no delay.

See Act § 1209(a)(1)(G)(ii); § 1209(h)(10). The one apparent modification of existing law is in item number 4. At present, where some component of a bank merger transaction *is* subject to HSR review,[11] that review proceeds according the ordinary rules applied under HSR. Therefore, the reviewing agency would be free to make a "second request" for information in addition to information supplied with the HSR form, and thereby trigger an additional time period under which to continue review of the transaction.

[11] As can be the case when a financial holding company is involved that owns some non-banking asset, as well as banking assets.

An important aspect of existing bank merger law—which has consequences both for the process of review and for the substantive standards applied—is that there has been a substantial amount of interagency coordination to make bank merger review work. Much of this was necessary because bank merger law read literally, would allow approval of mergers under time frames that could be extremely burdensome for DOJ. There is also plenty of room in the law for what could have been disruptive substantive conflicts among the agencies, and indeed disagreements arose between DOJ and the banking regulators in the early 1960s, almost as soon as the present bank merger review framework was put in place.[12] The consequence has been certain formal agreements among DOJ and the banking regulators,[13] as well as informal norms, like the common practice of merging parties of providing DOJ with their application materials well before the banking regulator is legally required to do so.[14]

Why exactly this special system of bank merger review persists is a bit of a mystery. It has long been clear that, for reasons of its own, "Congress . . . has determined to deal with banking in a manner different from other forms of 'commerce . . . .' "[15] Banking thus remains one of only four industries in which the antitrust enforcement agencies must share merger review with an industry-specific regulator,[16] and is virtually unique in that anticompetitive mergers can be approved on a finding of "public interest." But the

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[12] *See* Shull, *supra* note 7, at 274.

[13] *See* U.S. DEP'T OF JUSTICE, BANK MERGER COMPETITIVE REVIEW—INTRODUCTION AND OVERVIEW(2000) [hereinafter "DOJ REVIEW POLICY"] (a document initially agreed to among DOJ and the banking regulators in 1995, which governs both the process and substantive standards applicable to the review).

[14] *See* Quinn, *supra* note 8, at 93-94.

[15] Adolph A. Berle, Jr., *Banking Under the Antitrust Laws*, 49 COLUM. L. REV. 589, 590 (1949).

[16] *See* ANTITRUST MODERNIZATION COMMISSION, REPORT AND RECOMMENDATIONS 363-64 (2007) [hereinafter "AMC REPORT"]. The others are certain aspects of electricity, in which merger review is shared with the Federal Energy Regulatory Commission, telecommunications, in which merger review is shared with the Federal Communications Commission, and the special case of the railroads, in which mergers are subject solely to review by the Surface Transportation Board. *See id.*

explanation exactly *why* that should be has changed over time and is not at the moment particularly persuasive. During the nineteenth century and the early part of the twentieth banking policy was dominated by explicit "destructive competition" arguments, of the sort that at one time supported broad antitrust exemptions and invasive economic regulation in sectors throughout the economy, including transportation, communications, utilities, insurance, and banking. (Those arguments are now largely dead, as applied to any industry other than one that can credibly claim natural monopoly effects, and for this reason much of the U.S. economy has been deregulated since the 1970s.) But by the time the bank merger review legislation was initially adopted, between 1956 and 1966, Congress's overriding concern was the alarming growth in (for the times) very large bank holding companies. At that time, there remained substantial doubt that bank mergers could be subject to Clayton Act § 7, even under the recent Celler-Kefauver amendment of 1950,[17] and banking law also imposed much more severe limits on the extent to which banks could compete with each other.[18] In other words, the law was originally set up to impose *more* competitive discipline on bank mergers than was thought to be available. Now, however, it imposes less invasive (or at least more rushed and less information-intense) review than might be available were banks and BHCs simply subject to the same rules as the rest of American industry. To the extent that this persistent difference in treatment has any theoretical foundation, it is different than the one that originally underlay bank merger law. It now appears to be justified by some sense that banks need special *protection* from competition policy, because their failures are damaging to communities and impose taxpayer costs through the deposit insurance system. In other

[17] *See infra* note 35.
[18] *See infra* note 21-22.

words, to the extent that bank merger review law has any current justification, it has reverted to the old fear of destructive competition.[19]

II. Competitive Consequences of the Legislation

A. Competition in the Financial Sector

Competitiveness in the financial sector is important, and in that special context it plays two distinct roles. First, these markets' lack of "competitiveness," in the sense that they lack numerous competitors, has been a key contributor to the increase in wolrd-wide systemic financial risk. The fewer financial institutions there are, given their growing interconnectedness, the more likely that failure of one of them will pull down many others.[20] Second, competition is the only discipline for price and output of the many products and services financial institutions provide so that our system of savings, investment and corporate finance works.

On any measure, U.S. financial markets have transformed completely since the early 1970s. There is little doubt that the transformation is irreversible.[21] Change began most prominently with deregulatory steps in the 1970s that were designed to remove regulatory barriers to competition in banking and securities, which caused them to lose access to traditional sources of legally protected, supra-competitive revenues. Insurance companies began to face similar pressures as well.[22] Then, throughout the 1980s and 1990s,

[19] *See* Shull, *supra* note 7; Lawrence J. White, *Banking, Mergers, and Antitrust: Historical Perspectives, and the Research Tasks Ahead*, 41 ANTITRUST BULL. 323 (1996).

[20] *See generally* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 316-17.

[21] *See, e.g.*, Shull, *supra* note 7, at 257 (so arguing).

[22] The major step in banking was to lift rules that set very low maximum interest rates for deposits. This was accomplished by repeal of the Federal Reserve Board's Regulation Q in the 1980s. In the securities industry the most important deregulatory step was in 1975, when congressionally mandated SEC action finally prohibited the centuries old practice of stock exchange members of fixing the brokerage commissions they charged their clients for executing securities trades. The Securities and Exchange Commission prohibited fixed commissions on May 1, 1975 by adopting its Rule 19b-3, 17 C.F.R. §

regulators gradually loosened restraints on the lines of business in which traditional financial institutions could engage. Geographical restraints on banking were loosened as well, and interstate branching was generally authorized by Congress in 1994.[23] The crowning event so far has been the adoption of the Gramm-Leach-Bliley Act ("GLB")[24] in 1999, which finally permitted banking businesses to branch into unrestricted securities and insurance businesses. Though we may tend to forget it now, arguments supporting all of these regulatory changes were framed relentlessly in the language of *competition*, and indeed one early version of the GLB bill actually bore as its formal short name the Financial Services *Competition* Act.[25]

However, while the increased competition that resulted from these reforms should have been and for a time was fairly unequivocally pro-consumer, it also caused certain unforeseen consequences. The loss of legally protected sources of excess profits caused the traditional institutions to invade one another's geographic and line-of-business territories in search of new revenues. But this new competitiveness also set off a mad scramble of consolidation, which has generally been seen as an effort to stave off competitive inroads.[26] Thus we have seen waves of consolidation in banking and other

240.19b-3. In insurance the problem was that changing interest rates and the growing availability of competing consumer investment products caused consumers to lose interest in traditional life insurance. As to all these changes, see generally Wilmarth, *supra* note 18.

[23] Interstate branching was authorized in the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (Sept. 29, 1994) (codified in scattered sections of 12 U.S.C.). The Riegle-Neal Act permitted states to "opt out" of the Act in several respects, but most did not do so. For the most part, BHCs are free to hold banks in multiple states and individual banks are free to engage in interstate branching.

[24] Pub. L. 106-102, 113 Stat. 1338 (Nov. 12, 1999), now codified at scattered provisions of U.S. Code.

[25] Financial Services Competition Act of 1997, H.R. 10, 105th Cong., 1st Sess. (Jan. 7, 1997) (emphasis added).

As for the competition rhetoric that always surrounded the bill, see for example H.R. REP. NO. 106-434 (1999) (conference report); S. REP. NO. 106-44 (1999) (committee report accompanying bill that would be enacted as Gramm-Leach-Bliley Act); H.R. REP. NO. 105-164 (1997) (committee report accompanying H.R. 10, 105th Cong., 1st Sess. (1997)).

[26] *See* sources cited at n. 38, *infra*.

financial markets since the early 1980s that, from the aggregate national perspective, has increased concentration substantially. Indeed, a large wave of mergers during the 1990s involved a whole series of bank and financial institution combinations each of which was the single largest merger of its kind to date.[27]

One salient trait of this merger wave has been that the larger mergers, and especially the very large mergers of financial conglomerates, have had disappointing economic results.[28] In part this reflects what appear simply to be significant scale and scope diseconomies in bank operation beyond a certain size.[29] Much of this failure among the larger conglomerate mergers also has resulted from the mistaken prediction of consumer enthusiasm for "one-stop shopping" in financial products.[30] There is no serious doubt that—since the claimed efficiencies probably aren't the real goal of these mergers—some part of the motivation has been the self-interest of managers, who among other things seek the implicit federal subsidy of TBTF status.[31]

As a result of this period of consolidation, the financial sector has come to have an essentially two-tiered structure. Banking for consumers and small to mid-size businesses remains a predominantly local affair, engaged in by smaller and regional banks, and to a lesser extent by branches of larger banks. But large scale banking—major commercial loans, loan syndications, mass-marketed commodity products like credit cards and mortgages—is mainly now the domain of very large banks. Moreover, there remains a two-tiered aspect to bank concentration. While aggregate concentration in banking—the

[27] *See* Robert Kramer, Speech Before the Section of Antitrust Law, American Bar Association, *"Mega Mergers" in the Banking Industry* (April 14, 1999); Stephen A. Rhoades, *Competition and Bank Mergers: Directions for Analysis From Available Evidence*, 41 ANTITRUST BULL. 339 (1996).

[28] Wilmarth, *supra* note 18, at 272-79.

[29] Wilmarth, *supra* note 18, at 279-81.

[30] *See* Wilmarth, *supra* note 18, at 432.

[31] *See* Rhoades, *supra* note 25, at 340-41; Wilmarth, *supra* note 18.

number of entities representing banking business nationally—has increased dramatically during the period of transformation, concentration in local banking markets has remained relatively constant throughout that period.[32] That, though, is not necessarily cause for much optimism, as it also seems widely acknowledged that local banking has always been subject to some concentration and is prone to some market power.[33] Concentration is also prevalent in other sectors, as among investment banks and securities dealers,[34] and the immense global duopoly that now dominates the credit rating business.[35]

On top of this evidence concerning concentration, there also remains persistent evidence of serious, collusive anticompetitive conduct among financial institutions. Prior to 1944, when it was made clear that banks could be subject to U.S. antitrust law,[36] banks engaged in open and extensive price-fixing as to deposit rates, and even thereafter they apparently did not work hard to conceal price-fixing until well into the 1960s.[37] Other financial markets have been rife with collusion as well. Indeed, the New York Stock Exchange ("NYSE") is generally said to find its origin in a naked horizontal price-fixing conspiracy, and throughout its history it was governed by a series of explicit (and for the most part legally protected) price and output restraints, which were enforced by

[32] *See* Shull, *supra* note 7, at 257.

[33] *See* Shull, *supra* note 7. As to market power in local banking markets, see Wilmarth, *supra* note 18, at 293-300. Interestingly, the one isolated context in which short-term stock price improves for both an acquiring and a target bank in large bank mergers, and that is where the two banks previously competed in the same geographic markets. *Id.* at 293

[34] *See generally* FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS (2002).

[35] *See* Thomas J. Fitzpatrick, IV & Chris Sagers, *Faith-Based Financial Regulation: A Primer on Oversight of Credit Rating Organizations*, 61 ADMIN. L. REV. 557 (2009).

[36] During the 19th century the Supreme Court had held that the business of insurance was not within "interstate commerce" for purposes of the Commerce Clause jurisdiction of Congress, Paul v. Virginia, 75 U.S. 168 (1868), and it widely was presumed that other financial businesses were not, either. The Court reversed this rule as to insurance in United States v. S.E. Underwriters Ass'n, 322 U.S. 533 (1944), and, again, it was presumed that the reversal would be effective as to other financial businesses as well. *See* Shull, *supra* note 7, at 260-63.

[37] *See* Shull, *supra* note 7, at 263.

horizontal boycotts. In more recent times anticompetitive conspiracies have been more secretive, of course, but major conspiracies plainly persist in the financial sector, like the spectacular rings of fraud and collusion among Wall Street firms broken up by the New York Attorney General during the past 15 years.[38]

Still, having said all that, assessing the price competitiveness of financial product markets is complex. Traditional banking products—taking deposits and making loans—is fairly prone to market power wherever concentration increases. Entry is thought to be difficult not only because it requires regulatory approval, but because traditional banking involves a "relational" aspect under which consumers smaller business clients value long-term relationships and personal attention.[39] However, some financial products have come to be effectively commodity-like, in that they can be mass-marketed directly to consumers. Examples include mortgages, consumer loans, and credit cards. It is thought that because the products can be sold at low cost and entry is easy, price competition as to these products tends to be fierce. Thus, the core business of smaller banks is thought by many—including DOJ and the bank regulators—to be much less competitive than the core businesses of very large banks and financial conglomerates. But, as will be explained below, this narrow focus on specific products—which happens to guide current bank merger law—may be importantly incomplete.

B. Consequences of Conservator/Receiver Transactions Under the Act

However infrequently the government might use its new powers under the Act, any government remedy that causes yet further concentration in these already highly

[38] *See generally* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (2d ed. 1995); HANS R. STOLL, REGULATION OF SECURITIES MARKETS: AN EXAMINATION OF THE EFFECTS OF INCREASED COMPETITION (1979); Wilmarth, *supra* note 18.

[39] *See* Wilmarth, *supra* note 18.

concentrated markets should be taken as a grave matter. Indeed, conservator/receiver transactions under the Act will normally involve transactions in which, at least at the national aggregate level, concentration issues are particularly acute. Virtually by definition they will involve the largest entities in already concentrated, interconnected markets, because by definition those entities will be systemically significant.

Because the Act deals with competitive issues by simply incorporating existing bank merger law, assessment begins with the existing system. Criticism of that system has been extensive.[40] It has focused in large part on the substantive standard the regulators follow, first formulated during the sharp narrowing of antitrust enforcement of the 1980s and ultimately codified by agreement among DOJ and the bank regulatory agencies in 1995.[41] While nominally that standard is more or less the same ordinarily applied under Clayton Act § 7 and HSR, DOJ and the bank regulators have decided that the only serious competitive issues in bank mergers concern the credit needs of small and mid-sized businesses. In the regulators' view both consumers and large business have sufficient alternatives for their needs that consolidation in those areas simply will not restrict competition.

Accordingly—while in and of itself this fact is not a criticism—DOJ's actual enforcement of antitrust against bank mergers is vanishingly slight. DOJ has not formally challenged a bank merger since 1993, and on average it requests divestiture

[40] [Peter C. Carstensen, *A Time to Return to Competition Goals in Banking Policy and Antitrust Enforcement: A Memorandum to the Antitrust Division,* 41 ANTITRUST BULL. 489 (1996); Peter C. Carstensen, *Restricting the Power to Promote Competition in Banking: A Foolish Consistency Among the Circuits,* 1983 DUKE L. J. 580; Felsenfeld, *supra* note 2; Margaret E. Guerin-Calvert, *Current Merger Policy: Banking and ATM Network Mergers,* 41 ANTITRUST BULL. 289 (1996); *See generally* AMC REPORT, *supra* note 16, , at 363-64 (criticizing all statutory limits on merger review in regulated industries, calling for full application of Clayton Act § 7 and the HSR to all such mergers, and calling for full competition review authority as to such mergers to be returned to the antitrust enforcement agencies).

[41] That policy is contained in DOJ REVIEW POLICY, *supra* note 13.

concessions in only about one out of the 1000 or more bank mergers it reviews each year.[42] Somewhat more directly in critique of the agencies' approach is the poor economic performance of most of the large bank mergers and especially the super-sized conglomerate mergers that they approve. That performance is important because a guiding premise of bank merger law has been the conviction that larger banks, other things equal, are more economically efficient and desirable than small ones. That is, the currently very permissive approach effectively begins with a strong presumption that mergers will be efficiency enhancing. In quite a lot of these mergers that premise is evidently false, and there being no pro-competitive motive for these transactions the question remains what their other motives might be and whether they should have relevance to an antitrust policy.

Indeed, while large bank and financial institution mergers tend not to produce anything *good* for the economy, they do appear to give merging parties some market power.[43] This may be true not only as a consequence of immediate increase in concentration in those local markets to which the current merger review policy is calibrated. As my collaborator Peter Carstensen has frequently pointed out, there may be significant constraints associated with the fact that local branches in a given market are acquired by a national firm, even if the acquisition does not cause any substantial, immediate change in concentration there.[44] Moreover, it is now widely accepted in the industrial organization literature that firms that experience multiple contacts—firms that compete in many markets, and face each other in more than one—are more prone to

[42] Gregory J. Werden, *Perceptions of the Future of Bank Merger Antitrust: Local Areas Will Remain Relevant Markets,* 13 FORDHAM J. CORP. & FIN. L. 581, 582 (2008) (reviewing records of DOJ bank merger reviews).

[43] *See supra* note 31.

[44] *See* Carstensen, *supra* note 38.

oligopolistic interdependence than might otherwise be thought to be the case on the basis of concentration levels alone.

But, as mentioned, a wholly separate concern, that is in some sense a competitive one, is increasing systemic risk and the related problem of increasing numbers of TBTF firms. Even though American law really contains only one, isolated rule that could hope to constrain this problem in banking and financial markets—Clayton Act § 7, as applied through our regime of bank merger law—the government has refused to use it to reduce risk. Indeed, strenuous TBTF objections were made to DOJ in its review of the Citicorp/Travelers merger of 1998—the largest financial merger in history at the time, the first major merger of banking and non-banking businesses since the Great Depression, and one of the largest mergers in world history—but DOJ's view as that "this [w]as primarily a regulatory issue to be considered by the [Federal Reserve Board.]"[45] The merger was approved in all respects.

Incidentally, while the Act does not explicitly exempt or affect the antitrust treatment of collaborative conduct, it is relevant to that conduct. Elementary theory suggests that collusion is easier the fewer competitors there are in any given market.[46] If the bill facilitates more consolidation then it will aggravate the risk of collusion.

All of this criticism, it should be added, is wholly aside from the fact that our antitrust law currently refuses to consider concentrations of *power* as of any relevance. It focuses instead purely on costs and elasticities in narrowly defined relevant markets (as if allocational efficiency were a concept even yet dreamed of by the Congress of 1890).

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[45] Kramer, *supra* note 25, at 6.

[46] *See* U.S. DEP'T OF JUSTICE & F.T.C., HORIZONTAL MERGER GUIDELINES § 2.1 (1997); DENNIS W. CARLTON & JEFFREY M. PERLOFF, MODERN INDUSTRIAL ORGANIZATION 132-45 (3d ed. 2000); George Stigler, *A Theory of Oligopoly*, 72 J. POL. ECON. 44 (1964).

That is a bit of a shame in this context, as many of the major bank and financial holding company mergers since the boom began in the 1980s have been among *the largest consolidations of wealth and power in U.S. history*. Of course, though it was not always so,[47] addressing that concern through antitrust is a ship that for the time being has definitely sailed. But why we have convinced ourselves that the Congress of the Unites States should be prohibited from caring about concerns of this magnitude, and making them part of some coherent federal policy, is beyond me.

One final and completely separate issue deserves mention, as it relates to competition policy. The Act contains a special provision that requires the conservator/receiver to consider certain policy goals to guide the use of its powers, and among these goals is the protection of competition. This provision will be irrelevant on any practical level. The Act requires the conservator/receiver to exercise all of its § 1209 powers in accordance with a list of six policy aspirations, *see* § 1209(a)(10)(E), and one of them is to "ensure[] timely and adequate competition and fair and consistent treatment of [potential buyers of the failing BHC]," *id.* at § 1209(a)(10)(E)(v). For two reasons this provision will lack meaning. First, the other five values the conservator/receiver may consider are different, equally vague, and sometimes inconsistent with the competition duty. Most importantly, the conservator/receiver is directed, "to the greatest extent practicable," to "maximize[] the net present value return from the sale or disposition of . . . assets." *Id.* at § 1209(a)(10)(E)(i). At least some times the acquiror who would be most willing to pay for assets held by the conservator/receiver will be the one who can use them most

[47] *See, e.g.*, Robert Pitofsky, *The Political Content of Antitrust*, 127 U. PA. L. REV. 1051 (1979) (article by longtime FTC Chairman and leading antitrust academic, arguing that one of the purposes of antitrust should be to constrain unwelcome concentrations of private *power*, in addition to improving allocational efficiency in specific markets).

anticompetitively, because their use in that acquiror's hands will lead to supra-competitive profits. Second, the duty is effectively unenforceable by any party that would have any concern for competition. Even assuming there could be a plaintiff with standing, and even assuming judicial review is available,[48] it seems extremely unlikely any decision of the conservator/receiver would ever be reversed for failure to give effect to these six factors.[49]

C. Drafting Ambiguities and Unintended Consequences

Finally, some consideration should be given to a handful of drafting ambiguities that have relevance to competition matters.

First, the Act provides that where any portion of a transfer of assets made by a conservator/receiver would be subject to HSR, the antitrust enforcement agencies are barred from making a "second request" for information. *See* Act at §§ 1209(a)(1)(G), 1209(h)(10)(A). This is slightly ambiguous because even where bank merger reviews are not subject to HSR (as is almost always the case), the agencies have access to civil investigative demands ("CID") under the Antitrust Civil Process Act,[50] and indeed DOJ has issued CIDs in bank mergers in the recent past, both to the merging entities and third

[48] The conservator/receiver would constitute an "agency" under the Administrative Procedures Act ("APA"), and its final actions would therefore ordinarily be subject to judicial review under 5 U.S.C. § 702. However, given the ambiguity and range of discretion implied in these six factors, the conservator/receiver's asset sales under the Act might conceivably be exempt from review as being "committed to agency discretion by law," 5 U.S.C. § 701(a)(2). That exception applies to decisions made under "statutes are drawn in such broad terms that in a given case there is no law to apply." Citizens to Preserve Overton Park v. Volpe, 401 U.S. 402, 410 (1971).

[49] The decision would be subject only to the very deferential standard of review under APA § 706(2)(A), that the decision be upheld unless it was "arbitrary [or] capricious." A decision by a federal agency is "arbitrary or capricious" where (1) the agency failed to consider those factors in making its decision that are made relevant by the underlying legislation, or (2) the agency failed to show that its decision drew some rational connection between facts contained in the record at the time of the decision and the policy actually adopted. *See Overton Park*, 401 U.S. at 416.

[50] 15 U.S.C. §§ 1311-14.

parties that might hold relevant information.[51] Those powers are available to the agencies even where the responsible banking regulator triggers emergency time periods. Presumably the limitation on HSR second requests was not meant to affect the CID power, and is meant only to avoid the time delays that can occur under HSR. This point should be clarified.

Second, under § 1204(a) of the Act, whether or not the Treasury Secretary chooses to appoint a conservator/receiver, the Act empowers FDIC to provide loans and make other assistance available to BHCs whenever the Secretary makes the determination required under § 1203(b). Among FDIC's assistance powers, it may "purchas[e] assets" of the BHC or "acquir[e] any type of equity interest" in it. Act § 1204(a)(2), (4). It may then "sell[] or transfer[] all, or any part thereof . . . ." *Id.* at § 1204(a)(6). What seems ambiguous is that on its terms of this section, FDIC could apparently acquire a controlling interest in the failing BHC or any of its subsidiaries, and then transferring it to another bank, BHC or financial holding company. If this section has the effect of exempting such a transaction from antitrust altogether, that would seem unambiguously bad. But if not, then it would seem to subject to such a transaction to fairly different treatment (namely, more thorough, unrushed review) than conservator/receiver transactions receive under §§ 1209(a)(1)(G) and 1209(h)(10) of the Act.

One more minor peculiarity is that one of the Act's two antitrust provisions, § 1209(a)(1)(G), says that merger or transfer of assets may be undertaken "without obtaining any approval, assignment, or consent with respect to such transfer." Presumably this language is meant to waive requirements for shareholder or board approval that might have been required as a matter of corporate law, or state regulatory

[51] *See* Quinn, *supra* note 8, at 94.

approval. It is made fairly clear that this language is not meant to waive regulatory approval under bank merger law, because the power to make mergers or transfers is made explicitly "[s]ubject to clause (ii)" of the subsection. Clause (ii) implies that regulatory approvals are not waived. I might note, though, that clause (ii) does not explicitly *require* approvals to be gotten, and so this remains a non-trivial ambiguity that might lead to uncertain consequences in the event of litigation.

Conclusion

From the perspective of competition norms, the narrow problem with the Act is just its incorporation of an idiosyncratic and dubious system of merger review that itself calls for serious reconsideration. But this reflects a much larger consideration: the Administration's financial regulatory reform package largely ignores competition as any part of any solution. This is a shame, because consolidation and concentration are part of some of the financial sector's worst problems.

Mr. COHEN. Professor Sagers, thank you for your addendum to their testimony.

Mr. David Skeel, professor of corporate law at Penn, author of “Icarus in the Boardroom”—the history of bankruptcy laws—publications, received several distinguished recognitions and honors, corporate law, bankruptcy, and sovereign debt, law and religion, and poetry in the law.

Thank you, Professor Skeel.

TESTIMONY OF DAVID A. SKEEL, JR., UNIVERSITY OF PENNSYLVANIA LAW SCHOOL

Mr. SKEEL. Well, thank you for that plug. I wish I had brought a few of my books to have outside to try to sell to people before we are done today.

I think I have three quick points in response to the commentary I have heard so far. The first is, although Harvey Miller and I do not agree about everything—there are a few things in bankruptcy we are not completely on the same page on—I pretty much agree completely with everything Harvey has said thus far. To elaborate on that just a tad, Professor Moss made the comment that our real choice is resolution versus bailout. In my view that is not quite right. I think our real choice is bankruptcy versus bailout.

In my view, the proposed resolution authority would just institutionalize the bailouts we have seen in the last year. If we had that resolution authority in place, what would happen if we had another Lehman or AIG is they would be bailed out before they got to the resolution authority decision. And I think it is not either accidental or unimportant that the trigger decision—the decision whether to invoke the resolution authority—is a purely political decision being made by bank regulators. So that is my first point.

My second point is, with respect to Mr. Krimminger and Mr. Barr—and I am sorry they are not here now; Michael Barr is a friend of mine; I have not previously met Mr. Krimminger—they repeatedly referred to 75 years of beautiful FDIC history resolving bank failures. In my view, the reality is the FDIC was not tested from the 1930’s until the 1980’s. We didn’t have bank failures, for the most part, and that is one of the beauties of post-war America.

The first time the FDIC was truly tested was in the banking and S&L crisis of the 1980’s. By most accounts their performance was quite poor. And as a result of that poor performance we put new banking laws in place in 1989 and 1991 that really forced the FDIC’s hands.

We have prompt corrective action rules, we have least cost resolution rules. Those work pretty well for small banks and maybe for medium-sized banks as well. But they effectively don’t apply to the very institutions we are talking about today.

They do not apply to large banks. When they run into trouble the FDIC is able to do whatever it wants, exaggerating just a little bit. And the FDIC’s history with the big banks is not a good history. I think the Indymac example from last year is a good example.

So to the extent the FDIC is effective, it is only effective with small and medium-sized banks. It is not effective with large banks and there is not good reason to extend its authority beyond banks to other financial institutions.

Finally, in my view the key question—what I would hope you all will be thinking about and talking about in the coming months—is how we can make a bankruptcy system that works really well even better. And the answer to that, it seems to me, has to do with derivatives.

Over the past 20 years, as part of the their campaign against regulation derivatives lobbyists together with the Fed and the Treasury persuaded Congress—that is you all—to exempt derivatives from several key core bankruptcy provisions, the most important of which is the automatic stay. What I hope you all will be talking about is how and how much to reverse that deregulation of the last 20 years and reimpose the stay.

One approach to that would be a blanket reversal, a stay of all derivatives. Another would be the approach that has been suggesting in H.R. 3310. Either of those, I think, are very good approaches and I hope that is where you all end up before the dust settles.

Mr. COHEN. Do you have a poem to close with?

Mr. SKEEL. I will work on one before—give me a couple more hours. I can——

Mr. COHEN. A limerick will do——

Mr. SKEEL. Let us go now, you and I, while the evening is spread against the sky. [Laughter.]

Mr. COHEN. It is not for us to do or die.

Mr. SKEEL. We are reading from the same script. That is for sure.

[The prepared statement of Mr. Skeel follows:]

PREPARED STATEMENT OF DAVID A. SKEEL, JR.

Written Testimony of David A. Skeel, Jr.

Before the Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
United States House of Representatives
October 22, 2009

Thank you for the opportunity to testify about the role of bankruptcy in effective financial regulation reform. It is a great honor to appear before you today.

Last summer, the Obama administration rolled out an extensive package of proposed financial reforms.[1] The principal resolution proposals in the proposed reforms would give bank regulators sweeping resolution authority with respect to financial institutions that are designated as systemically important, and which are in financial distress. In my view, some of the administration's proposals are desirable, and would improve our financial regulation. But the resolution proposal would make the regulatory framework far worse, rather than better. H.R. 3310, which would rely on bankruptcy rather than the bailout approach used in the recent crisis, is a much more promising approach, as are the existing bankruptcy laws.

Under the resolution proposal in its current form, a financial institution could be designated as systemically important at any time, including right before intervention. If the Treasury concluded that such an institution was in financial distress, it could invoke the special resolution regime "after consulting with the President" and "upon the written recommendation of two-thirds of the members of the FDIC Board (or, if the largest subsidiary is a brokerage, two thirds approval of the SEC commissioners). At this point, the Treasury would appoint a regulator, usually the FDIC, to step in and take steps to resolve the financial distress.

[1] The administration released a lengthy white paper outlining its financial reform proposals in June 2009. U.S. Department of the Treasury, Financial Regulatory Reform: A New Foundation (June 17, 2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

This proposal is designed to expand the rescue process that was used in 2008 with Bear Stearns and AIG.[2] It would institutionalize the ad hoc bailouts of the last year. There are at least three problems with this approach. First, it, together with the designation of systemically important institutions, would increase the number of institutions that are "too big to fail," and would lead to even more concentration in the financial services industry than we already have. Second, the resolution proposal is backward looking: it assumes that the financial regulatory landscape will be the same in the future, and pose the same problems, as it did last year -- such as the opacity of the derivatives markets. Finally, it would abandon a far superior approach: bankruptcy

In the remarks that follow, I will focus primarily on the benefits of a bankruptcy-based approach, and the significant costs of institutionalizing the bailouts of the past year. My discussion will consider four issues:

1) I first critique a key piece of the conventional wisdom about the crisis: the view that the default of Lehman Brothers was the sole reason for the financial panic last fall, and that Lehman casts doubt on the efficacy of bankruptcy. These claims are not borne out by the evidence.
2) I outline several of bankruptcy's key benefits.
3) I describe the serious costs of relying on bailouts.
4) I conclude that the best use of Congress's time would be to consider possible ways to improve the bankruptcy laws, in particular by imposing a stay on at least some derivatives, and thus reversing Wall Street's effective campaign in the 1990s to protect the derivatives markets from regulation.

Much of the discussion that follows draws on current scholarship of mine that develops these arguments in more detail, particularly an article with Northwestern Law professor Kenneth Ayotte.[3]

[2] The White Paper introduces the proposal with the statement that the "government's responses to the impending bankruptcy of Bear Stearns, Lehman Brothers, and AIG were complicated by the lack of a statutory framework for avoiding the disorderly failure of nonbank financial firms." *Id.* at 74.

[3] Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, Journal of Corporation Law (forthcoming 2010), *available at* www.ssrn.com.

1—The Lehman Myth—Rethinking the Crisis

According to the conventional wisdom, Federal bank regulators were right to bail out Bear Stearns in March 2008, and to bail out AIG in September 2008. Their only mistake was failing to bail out Lehman Brothers, also in September 2008. The Lehman Brothers bankruptcy and the turmoil in the financial markets in September and October 2008 show, it is claimed, that bailouts are a better solution to the financial distress of a large investment bank or other nonbank financial institution than bankruptcy. This understanding, which is central to the case for expanding bank regulators' authority, is deeply misleading.

To put the events of 2008 into their proper context, it is necessary to start by considering the bailout of Bear Stearns six months before Lehman's collapse, and the effects that the bailout had. After the markets lost confidence in Bear and its $18 billion of cash reserves began to disappear in March, Bear Stearns chief executive Alan Schwartz called Timothy Geithner, who was then head of the New York Federal Reserve Bank. Geithner, then-Treasury Secretary Hank Paulson and Ben Bernanke pushed Bear into the arms of J.P. Morgan, a much healthier bank. The deal was structured so that the creditors of Bear Stearns would be fully protected, while its shareholders would lose much of the value of their shares. The government provided a $29 billion guarantee of Bear's most dubious assets.

If regulators had decided not to bail Bear out, the short-term effects might have been jarring. The creditors of Bear Stearns would have suffered losses, and the shareholders would have been wiped out. But this hard medicine would have sent a very clear message to the managers, creditors and shareholders: better watch what the company is doing, or you could get burned. In more technical terms, a Bear Stearns bankruptcy would have eliminated moral hazard—the tendency not to take precautions if you'll be spared the consequences of bad outcomes.

The government did take steps to limit the moral hazard of the company's shareholders. Indeed, it pushed J.P. Morgan, the buyer of Bear Stearns' assets, to offer less for Bear Stearns' stock than J.P. Morgan originally planned, in order to make sure that shareholders were not completely bailed out. But it ensured that all of Bear's creditors were fully protected. The creditors—mostly Wall Street banks and other financial institutions—who lent money to or entered into derivatives transactions with Bear Stearns were paid in full, despite having dealt with a highly leveraged institution that had been engaging in extraordinarily risky activities.

When Bear Stearns fell, Lehman Brothers was widely viewed as similarly vulnerable, since it too was highly leveraged and heavily exposed to subprime mortgages. Yet Richard Fuld, Lehman's chief executive, rejected a proposed investment by Warren Buffett and made only desultory efforts to sell the company in the months after the Bear Stearns bailout.

Nor, once bankruptcy became a serious possibility, did Lehman make a serious effort to prepare for bankruptcy. When Lehman filed for bankruptcy, no one even knew who Lehman owed money to and who the counterparties on its derivatives contracts were. AIG behaved in very similar fashion. These responses are perfectly understandable given both companies' assumption—an assumption shared by nearly everyone as a result of the Bear Stearns bailout—that regulators would rescue any big, troubled financial institution. Not only was there no need to plan for bankruptcy. But the bailout strategy gave Lehman and AIG an incentive not to prepare for the worst. The more unprepared they were, the worse the bankruptcy option would look, and the more likely a bailout would be forthcoming.

This, not the bankruptcy system, is why Lehman's collapse was such a shock to market participants. Lehman, its suitor Barclays, and everyone else assumed that a bailout would be forthcoming. But regulators decided at the last minute not to provide bailout funds after all. Lehman's failure to prepare, and the way it was dumped into bankruptcy, were the problems. The bankruptcy itself has gone remarkably smoothly. Lehman's investment banking operations were sold to Barclays four days after the bankruptcy filing, and Lehman has been selling its less time sensitive assets in a more leisurely fashion in the months that have followed.

If Bear had filed for bankruptcy back in March, the managers and investors of Lehman and AIG surely would have acted differently in the weeks before their failures. The prospect of bankruptcy would have given them a very different perspective on the implications of their financial difficulties. At the least, they would have gotten their books in order and started looking for buyers for their businesses much earlier.

Not only have the effects of Lehman's default been mistakenly attributed to bankruptcy, but the evidence calls into question the widespread view that Lehman's collapse triggered the economic panic last fall. In a recent paper, Ken Ayotte and I find that Lehman's default did not cause any more disruption in the financial markets than the government's decision to bail out AIG two days later. The fall in the stock market, as measured by the S&P 500 index, was nearly identical. The rise in the VIX, an index used to measure volatility (and informally known as the "fear index") saw a slightly higher percentage increase following Lehman. The TED spread, an indicator of credit market risk, saw a larger percentage point increase following AIG.[4] Similarly, yields on short-term U.S. Treasury bills (a measure of investor flight to safe assets) saw a larger fall following the AIG news.

Stanford economist John Taylor has provided additional evidence that the Panic of 2008 was not triggered by Lehman's default. Based on, among other things, an analysis of the Libor-OIS spread—which is the difference between the interest rate for longterm loans and the overnight interest rate—he concludes the major triggering event was the requests by Treasury for what eventually became the legislation providing for $700 billion in TARP funds.

In short, the significance of Lehman's bankruptcy filing has been seriously misinterpreted by the conventional wisdom. The effect of Lehman's default was due primarily to its failure to prepare for a bankruptcy filing, and to market participants' surprise when the government refused to bail Lehman out. In addition, Lehman's role in the market disruptions of fall 2008 has been exaggerated. Finally, and of particular importance for this hearing, the actual bankruptcy case has proceeded remarkably smoothly under the circumstances.

2—<u>The Benefits of Bankruptcy</u>

Bankruptcy has a number of provisions that make it well suited for resolving the financial distress of nonbank financial institutions. It may be useful to briefly outline

[4] The TED spread is the difference between 3-month LIBOR (an interest rate at which banks lend to each other) and the 3 month U.S. Treasury Bill rate.

these provisions before I describe the perverse effects of bailouts, and how bankruptcy avoids these problems.

The first key bankruptcy provision is the one that made possible the sale of Lehman's assets shortly after its bankruptcy filing: section 363 of the Bankruptcy Code. Under this provision, the debtor can sell its assets free and clear of any existing liabilities at any time after filing for bankruptcy, subject to approval by the bankruptcy court and an opportunity for the company's creditors to object to the proposed sale. Because sales under section 363 are free and clear of liabilities, financially troubled companies often prefer to effect a sale of their assets in bankruptcy, rather than trying to sell them outside of bankruptcy.

Second, the Bankruptcy Code provides a very generous financing provision (section 364) that often makes it possible for a company to borrow the money necessary to fund its operations during the bankruptcy case. While senior, secured loans are sometime available outside of bankruptcy, in many cases they will not be possible. Most bond indentures, for example, contain negative pledge clauses that limit or prevent the incurrence of new, senior debt. In bankruptcy, by contrast, these clauses are rendered ineffective.

Third, the automatic stay (section 362) requires that creditors cease any efforts to grab assets from the debtor or to try to collect what they are owed. This can provide the firm with the breathing space it needs to conduct its business in an orderly fashion, preventing a desperate scramble to satisfy the claims of withdrawing creditors. The breathing space can be valuable not only if the firm plans to remain as a going concern, but also if it plans to liquidate its assets but needs time to do so. The one major exception to the automatic stay is derivatives: as discussed in more detail below, the derivatives industry, the Federal Reserve and the U.S. Treasury persuaded Congress to exempt derivatives from the automatic stay, through a series of amendments to the Bankruptcy Code over the past several decades.

Fourth, bankruptcy is extremely transparent. Creditors are entitled to examine the debtor and its managers, and a company is required to disclosure a large amount of information about its operations while in bankruptcy. The kinds of hidden activities that have raised considerable concern in contexts such as Bank of America's purchase of

Merrill Lynch would be very unlikely in bankruptcy. As bankruptcy lawyers sometimes say, a company is required to open all its closets and drawers when it files for bankruptcy.

Finally, the bankruptcy trustee—or if there is no trustee, the company itself—has extensive power to retrieve any preference payments or fraudulent transfers made prior to its bankruptcy filing. If a company pays exorbitant bonuses to its executives prior to bankruptcy, and these bonuses squander valuable assets, the executives can be forced to disgorge them.

In short, the bankruptcy laws offer a full menu of provisions for addressing the financial distress of a large nonbank financial institution. With each of the two large investment banks that have filed for bankruptcy—Drexel Burnham two decades ago and Lehman Brothers last year—it has proven very effective.[5]

3—<u>The Problems with Bailouts and the Proposed Resolution Authority</u>

The Adminstration's proposed new resolution authority would expand the authority that the FDIC has over bank failure to every financial institution that is deemed systemically important. The intuition behind the proposal is that the FDIC has done an effective job of resolving bank failures, and that this authority would prove equally effective for systemically important financial institutions. These assumptions are problematic for several reasons.

The first problem with the assumption that Congress should extend FDIC-style authority to other financial institutions is that commercial banks are special. Although the so-called shadow banking system plays an increasingly important role in financial life, commercial banks still are unique because of the importance of protecting ordinary Americans' deposits, and of assuring that business always have access to the lines of credit they secure from a bank. For these reasons, deposits are federally insured. Because the deposit insurance guarantee gives taxpayers a huge financial stake in commercial banks, the FDIC is given dictatorial powers when a bank becomes financially distressed. The FDIC can take over the bank, force its sale, and determine how the creditors of the bank will be treated. Further, its actions are almost completely protected

[5] The Drexel and Lehman cases are discussed in detail in Ayotte & Skeel, *supra* note 3.

from judicial review. These powers, and the complete lack of transparency, are not justified for other financial institutions.

Second, the FDIC's performance is very different with small banks than with large ones. When a small or medium-sized bank becomes distressed, the FDIC often closes it relatively promptly.[6] Indeed, the prompt corrective action rules instruct the FDIC to step in before the institution becomes insolvent. With large institutions, on the other hand, these rules do not apply. In these cases, the FDIC often ends up bailing the institution out. If FDIC authority were extended to systemically important firms as proposed by the administration, we can be sure that these institutions would inevitably be bailed out. As already noted, the proposal would expand and institutionalize the recent use of bailouts.

Bailouts have four very serious downsides. The first problem is that they cause moral hazard, as discussed earlier. If the managers of a financial institution know they will be bailed out in the event the institution fails, they will have an incentive to take extraordinary risks. Investors will have little incentive to monitor the institution if they too will be protected by a bailout. The government significantly reduced the problem of shareholder moral hazard by ensuring the Bear Stearns and AIG shareholders were not fully protected when their companies were bailed out, but it magnified the moral hazard of debt. The creditors of both companies were fully protected. The bondholders of bank holding companies such as Citigroup and Bank of America are also expecting to be protected if either bank fails, which has aggravated the serious moral hazard in the financial services industry.

The second problem is that bailouts cause significant distortions in corporate governance. When the government insists that a CEO be replaced—as with AIG—or that the company complete a problematic merger—as with the acquisition of Merrill Lynch by Bank of America—the decision is likely to influenced by factors other than optimal corporate governance. The distortions may be still greater if the government oversees the investment decisions made by the company even after the initial rescue loan. Both

[6] The FDIC's resolution of the banks during the recent crisis has been criticized by some, and the FDIC has recently announced that it will need to impose additional charges on banks because its guaranty fund is dangerously low. But, in my view, the FDIC have been relatively effective with small and medium sized banks, and its current authority is justified in that context. But there is no justification for extending this power to encompass other financial institutions.

because of the limits of their expertise and because of the conflicting pressures they face, the government's track record when it shifts from regulator to decision maker is not a good one.

Third, bailouts often simply postpone a needed restructuring. The decision to bail out AIG, for instance, seems to have significantly delayed the process of restructuring its operations. The temptation for regulators with a bailout is to "kick the can down the road," delaying the hard decisions of how best to resolve the firm's problem.

Finally, the bailouts of the past year have protected the Wall Street institutions who were creditors of the institutions that were bailed out. Wall Street banks and other financial institutions have often been the principal beneficiaries of bailouts.

None of these problems arise in bankruptcy. The prospect of bankruptcy dramatically reduces moral hazard; is much less likely to distort corporate governance; forces a restructuring; and requires all parties to bear the consequences of the default, not just some.

4—Possible Bankruptcy Improvements—A Stay on Derivatives

My conclusion that bankruptcy is the best mechanism for resolving the distress of nonbank financial institutions does not mean that the current bankruptcy laws are perfect. The current laws are preferable to bailouts, but it is worth considering how the existing bankruptcy framework might be improved. The most important issue in this regard, in my view, is the special treatment given to derivatives and other financial contracts.[7]

Due to the ongoing efforts of the derivatives lobby, as well as the Federal Reserve and the U.S. Department of the Treasury, Congress enacted a series of special protections for repurchase transactions, credit default swaps and other financial contracts in the 1980s, 1990s, and 2000s.[8] Counterparties to these contracts were exempted from several core protections of the Bankruptcy Code. They are not subject to the automatic stay, or to the preference and fraudulent conveyance provisions. Much as they insisted that derivatives should be immune from regulatory oversight, proponents of these provisions

[7] I also believe it would be useful to limit the government's ability to finance a financially troubled financial institution in bankruptcy. H.R. 3310 would impose a strict prohibition.
[8] The legislative history, and the arguments for reversing the special treatment of derivatives that are outlined below, are discussed in more detail in David A. Skeel, Jr., *Bankruptcy Boundary Games*, Brooklyn Journal of Corporate, Financial & Commercial Law (forthcoming, 2010), available at www.ssrn.com.

argued that bankruptcy should not be allowed to interfere with the derivatives markets. If derivatives were subject to the automatic stay, they argued, the bankruptcy of one institution could lead to "ripple effect" failures of other institutions that had entered into contracts with the debtor. The recent crisis has shown, however, that the inability to stop counterparties from exiting these contracts may exacerbate the consequences of a default, not reduce them.

Congress could fix this problem in several different ways. One approach would be to simply reverse the exemption from the automatic stay, based on a view that the arguments for exempting the derivatives markets from bankruptcy no longer seem compelling. Exempting derivatives counterparties from the stay reduces their incentive to monitor the debtor and does not seem to provide a bulwark against systemic risk.

H.R. 3310 offers an alternative approach. Under this proposed legislation, the stay would be applied under certain circumstances in cases in which the debtor is a nonbank financial institution. The special treatment would remain in place for other kinds of debtors.

In my view, either of these approaches would improve on the treatment of derivatives and other financial contracts in bankruptcy.

Conclusion

Bankruptcy is a much better method of resolving the financial distress of nonbank financial institutions than bailouts. If Congress adopts more effective regulation of the derivatives markets and other needed financial reforms, the bankruptcy approach is likely to be even more attractive.

Mr. COHEN. Mr. Weissman has written extensively. He is our next witness—Robert Weissman, Public Citizen president. That is a pretty heady title. Expert on economic, health care, trade, and globalization, electoral property, and regulatory policy, and issues related to corporate responsibility and commercialism.

Written extensively over the years. Prior to joining Public Citizen he was director of corporate accountability organization Essential Action, editor of Multinational Monitor, that tracks corporate actors worldwide, and an attorney with the Center for the Study of Responsive Law.

Mr. Weissman, you are on.

TESTIMONY OF ROBERT WEISSMAN, PUBLIC CITIZEN

Mr. WEISSMAN. Thank you very much, Mr. Chairman. I am sorry that I am afraid I won't be able to offer any poems or a—perhaps concepts achieve pristine insight of poetry.

I want to thank you for holding the hearing and emphasize, I think, the importance of an antitrust approach to considering the "too big to fail" problems in the structure of the financial sector. I think antitrust offers us a lot of tools and principles to think about how to handle the sector.

With Chairman Greenspan I am happy to say that we agree that an appropriate application of antitrust principles is to actually directly break up the largest institutions. They are too big to fail. I agree with all of the proposals that Mr. Barr put forward on the front end to deal with systemic risk, but they are not enough. The largest institutions will always find a way to get around narrow, traditional agency regulation—prudential regulation.

But if they are smaller they are more able to be grappled with. We can avoid a lot of the problems that we are spending this hearing talking about if we go ahead with an aggressive breakup strategy.

It is feasible, can be done in an aggressive, top-down way, or it can be done in a more gentle way by the institutions themselves. Citigroup, for example, is itself now stripping itself down effectively on the model that I might be suggesting.

Second, I think antitrust teaches us about the importance of structure and also looking to revising Glass-Steagall itself or Glass-Steagall-like principles and separating out the super-risky activities of the investment banking operations from the commercial banks. And again, we are here very happy to side with Chairman Volcker on this point.

There are more modest ways to achieve these kinds of objectives—for example, unwinding the recent set of mergers which have made the "too big to fail" problem much worse, or at least saying there should be a standstill on future mergers that are going to exacerbate the problem going forward.

We should also be enforcing existing concentration limits which have been breeched in the last round of mergers, and there should be examination, I think, by Congress over new forms of concentration limits, both in terms of the depository institutions but also thinking about asset categories other than depository institutions, where it is not obvious what kind of standards you would impose.

Finally, in terms of trying to avoid problems before they emerge, I think antitrust teaches us not just to look at traditional regulation but a set of conduct remedies that are different in approach from what traditional regulators do. And to just quickly highlight some of the things we—I think it is worthwhile for Congress to consider both avoid systemic risk problems, enhance the ability of regulators to understand what is going on in the super large institutions, and to offer increased consumer protection.

For this category of institutions that still are super large, there should be a prohibition on the use of offshore tax havens and off-the-books accounting, both of which make it too hard for our regulators to understand what is going on. There should be affirmative obligations that bonuses are tied—executive pay and bonus compensation is tied to long-term performance to avoid the wrongful incentives that exist with the short-term bonus structure that we have now.

There should be, as Mr. Barr said, increased capital reserve standards, and I think also increased consumer protection obligations on the largest institutions. To the extent they are permitted they can continue to exist.

On the specific issue of resolution authority, we do think that there is a good case to be made for resolution authority to avoid the bailout problem, but with some caveats and with some suggestions. One is that there should be a presumption that the institutions are not provided with new financing unless there is some very affirmative showing made that there needs to be external financing made available. So you really are talking about winding down the institution and you are avoiding the problem of the subsidies that were given to AIG counterparties.

The AIG bailout, by the way, was really not a bailout of AIG so much as it was a bailout of AIG counterparties, which is, I think, an important consideration to keep in mind.

There should be also, I think, a directive—this speaks to Professor Sagers' point—there should be a directive to any resolution authority that as it is doing the resolution a central and maybe overriding objective must be to avoid a worsening of "too big to fail" problems, that as they are breaking up banks or merging them, whatever they are doing, it should not be to create new even bigger institutions, the bigger great white sharks of Mr. Johnson's metaphor—maybe I do have some poetry in my after all. We ought to be avoiding worsening that problem.

And finally, there should be conditions attached on the resolved enterprises, either in whole or when parties are broken up, replicating, I think, some of the things that I mentioned in the area of conduct remedies. Those things including, as you pointed out properly, compensation limits and competition standards ought to be attached. If taxpayers are going to be involved and intervening in these institutions it is reasonable that we have some reciprocal demands on what goes on with them after they are put back into the private sector.

[The prepared statement of Mr. Weissman follows:]

PREPARED STATEMENT OF ROBERT WEISSMAN

Testimony of Robert Weissman
President, Public Citizen
Hearing on "Too Big To Fail –
The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform"
Before the House Judiciary Committee
Subcommittee on Commercial and Administrative Law
October 22, 2009

Mr. Chairman and members of the Committee, thank you very much for inviting me to testify today. I am president of Public Citizen, a nonprofit research, lobbying and litigation public interest organization with 150,000 members and supporters. Based in Washington, D.C., and founded in 1971, Public Citizen accepts no government or corporate funds.

Public Citizen is a member of Americans for Financial Reform, a coalition of more than 200 consumer, community, labor, civil rights, housing, faith-based and other public interest organizations. I have appended to this statement the Americans for Financial Reform position paper on resolution authority issues.

I want to thank you for holding today's hearing. Financial re-regulation is the subject of intense debate and discussion in Congress -- and around the country -- right now. It is important that the issue of financial re-regulation be considered from multiple vantage points. The Judiciary Committee has a crucial role to play in the re-regulation debate, considering matters in light of its expertise in bankruptcy and, especially, antitrust.

Antitrust offers a different approach to addressing Wall Street abuses than traditional regulation. Antitrust looks to industry structure rather than just setting rules for all market participants. When it turns its attention to troubling conduct of institutions with market power, it commonly employs remedies which provide (somewhat) self-enforcing specific rules of conduct. This is in contrast to the agency rule-making and enforcement approach, which usually requires effective regulatory surveillance and enforcement. The traditional regulatory approach is vital; but policymakers need also to draw on the distinct and complementary wisdom embodied in antitrust.

There is widespread agreement that creation of too-big-to-fail financial institutions was a key contributing factor to the financial crisis -- and that addressing the too-big-to-fail problem is a central challenge for regulation going forward. The traditional regulatory approach directs policy inquiry into how regulatory agencies can monitor the too-big-to-fail financial institutions to ensure they do not engage in excessively risky operations. The antitrust approach suggests a more fundamental inquiry: Should the too-big-to-fail financial institutions be permitted to exist? What social value do they offer as against harms and risks to financial stability and a functioning democracy? Are the dangers of too-big-to-fail financial corporations great enough to overcome the presumption in favor of leaving private corporations to grow as they please? If too-big-to-fail Wall Street firms are permitted to continue to exist at current scale, should they be subject to specific conduct rules, including rules designed to limit their speculative undertakings? And, should government policy exhibit a bias against size, at least to the extent that government-facilitated combinations of financial institutions do not exacerbate the too-big-to-fail problem?

In this testimony, I will touch on these issues, in the context both of the current profile of the financial services industry, and proposals to create a resolution authority for too-big-to-fail non-bank financial institutions.

The first section of my testimony briefly reviews consolidation trends in the financial sector over the last quarter century, and highlights the serious and unique problems with excessively sized corporations in the financial sector. These include consumer and competition problems, but especially the familiar "too big to fail" issue and concerns with how large financial institutions impair a functioning democracy. The second section draws on antitrust principles to suggest a series of proposals to shrink excessively sized financial firms -- including but not limited to a call to break up the biggest banks -- and to control large firms that continue to exist. The final section turns attention to the issue of what to do with failing non-bank financial companies that pose a threat to the overall financial system. It concludes that the case for establishing new resolution authority is strong, but that this authority should be guided by legislative directives to prevent continuation of a misguided bailout policy.

The Rise of Too-Big-to-Fail – and the Fall of the Financial System

Merger mania in the financial industry has been all the rage for more than 25 years. "Bigger is indeed better," proclaimed the CEO of Bank of America in announcing its merger with NationsBank in 1998.[1] In the United States, about 11,500 bank mergers took place from 1980 through 2005, an average of about 440 mergers per year.[2]

The size of the mergers has increased to phenomenal levels in the pre-crisis period: In 2003, Bank of America became a $1.4 trillion financial behemoth after it bought FleetBoston, making it the second-largest U.S. bank holding company in terms of assets. In 2004, JPMorgan Chase agreed to buy Bank One, creating a $1.1 trillion bank holding company.[3]

[1] Dean Foust, "BofA: A Megabank in the Making," BusinessWeek, September 13, 1999, available at: <http://www.businessweek.com/archives/1999/b3646163.arc.htm>.
[2] Loretta J. Mester, Senior Vice President and Director of Research at the Federal Reserve Bank of Philadelphia, "Some Thoughts on the Evolution of the Banking System and the Process of Financial Intermediation," Economic Review, First & Second Quarters, 2007, available at: <http://www.frbatlanta.org/filelegacydocs/erq107_Mester.pdf>.
[3] Loretta J. Mester, Senior Vice President and Director of Research at the Federal Reserve Bank of Philadelphia, "Some Thoughts on the Evolution of the Banking System and the Process of Financial Intermediation," Economic Review, First & Second Quarters, 2007, available at: <http://www.frbatlanta.org/filelegacydocs/erq107_Mester.pdf>.

From 1975 to 1985, the number of commercial banks was relatively stable at about 14,000. By 2005 that number stood at 7,500, a nearly 50 percent decline.[4] A staggering series of mergers led to ever larger banks at the top.[5]

By mid-2008, the top five banks held more than half the assets controlled by the top 150.[6]

Regulators and antitrust enforcers rarely challenged the rash of bank mergers and acquisitions.

(A similar story can be told about the securities side of the financial sector. Summarizes analyst Jane D'Arista: "Mergers have also consistently reduced the number of firms in the securities industry. At year-end 1984, the top 10 firms — 0.12 percent of the 7,800 firms registered — accounted for 41 percent of the sector's capital, 47 percent of total revenue and 55 percent of underwriting profits. Of the top 10, all but three (Merrill Lynch, Lehman Brothers and Goldman Sachs) had been acquired by or merged with other institutions by the beginning of 2008."[7])

Strikingly, the bursting of the housing bubble and subsequent financial crash has led to a sharp *intensification* of the quarter century trend. The top two mortgage companies, Wells Fargo and Bank of America, originated 44 percent of all mortgages in the second quarter of 2009, up from 28.6 percent the previous year. The jump reflects Bank of

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[4] Loretta J. Mester, Senior Vice President and Director of Research at the Federal Reserve Bank of Philadelphia, "Some Thoughts on the Evolution of the Banking System and the Process of Financial Intermediation," Economic Review, First & Second Quarters, 2007, available at: <http://www.frbatlanta.org/filelegacydocs/erq107_Mester.pdf>.

[5] James Brock, "Merger Mania and Its Discontents: The Price of Corporate Consolidation," Multinational Monitor, July/August 2005, available at: <http://www.multinationalmonitor.org/mm2005/072005/brock.html>. (In a brief review of mergers through 2005, Brock writes, "Through two decades of ever-larger acquisitions, NationsBank became one of the country's largest commercial banking concerns, absorbing C&S/Sovran (itself a merged entity), Boatmen's Bancshares ($9.7 billion deal), BankSouth and Barnett Bank ($14.8 billion acquisition). Then, in 1998, NationsBank struck a spectacular $60 billion merger with the huge Bank of America, which itself had been busily acquiring other major banks. The merger between NationsBank and B of A created a financial colossus controlling nearly $600 billion in assets, with 5,000 branch offices and nearly 15,000 ATMs. Bank of America then proceeded to acquire Fleet Boston — which had just completed its own multi-billion dollar acquisitions of Bank Boston, Bay Bank, Fleet Financial, Shawmut, Summit Bancorp and NatWest. Giants Banc One and First Chicago NBD — their size the product of numerous serial acquisitions — merged, and the combined entity was subsequently absorbed by J.P. Morgan which, in turn, had just acquired Chase, after the latter had merged with Manufacturers Hanover and Chemical Bank in the financial business of underwriting stocks and bonds. Other mega-mergers include the $73 billion combination of Citicorp and Travelers Group in 1998, as well as the acquisition of leading brokerage firms by big banks, including Morgan Stanley's ill-fated acquisition of Dean Witter.")

[6] Loretta J. Mester, Senior Vice President and Director of Research at the Federal Reserve Bank of Philadelphia, "Some Thoughts on the Evolution of the Banking System and the Process of Financial Intermediation," Economic Review, First & Second Quarters, 2007, available at: <http://www.frbatlanta.org/filelegacydocs/erq107_Mester.pdf>.

[7] Jane D'Arista, "Financial Concentration." Wall Street Watch, August 2009, available at: http://wallstreetwatch.org/blog/?p=73.

America's acquisition of Countrywide, and Wells Fargo's takeover of Wachovia.[8] Other metrics also reveal a starkly more concentrated market: The market share percentage of deposits held by JP Morgan Chase, Wells Fargo, and Bank of America has risen from 21 percent in 2007 to 33.9 percent in 2009, according to SNL Financial data reported by The Washington Post.[9] The top four banks held 49 percent of total banking assets as of June 2009;[10] a roughly 50 percent jump from June 2003, when the top four held 33 percent of total assets.[11]

The financial industry has also witnessed another kind of consolidation over the last decade, following the repeal of the Glass Steagall and related acts, and adoption of the Gramm-Leach-Bliley Financial Modernization Act of 1999. Gramm-Leach-Bliley paved the way for commercial banks to merge with insurance companies and investment banks. It helped introduce the speculative risk-taking culture into commercial banking -- providing the toxic mix of government insurance and speculative betting that helped generate the financial crisis.[12]

The financial crisis has intensified the combination of commercial banks and other financial enterprises, with JP Morgan's acquisition of Bear Stearns and Bank of America's takeover of Merrill Lynch.

Bigger banks are bad for society. Although there are contradictory studies in the area, there is compelling evidence that large banks take on more risk than smaller banks, while providing inferior service and higher charges to consumers. Studies have shown that compared to smaller banks, large banks take on greater leverage,[13] more investments in derivatives,[14] and higher percentages of uninsured deposits.[15] Derivative risk, in fact, is overwhelmingly concentrated in the top banks: The top five banks own 96 percent of all

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[8] Kate Berry, "Mortgages' Big Two Are Too Big to Avoid," National Mortgage News, September 30, 2009, available at: <http://www.nationalmortgagenews.com/lead_story/?story_id=96>.
[9] David Cho, "Banks 'Too Big to Fail' Have Grown Even Bigger (The Big Get Bigger)," The Washington Post, August 28, 2009, available at: <http://www.washingtonpost.com/wp-dyn/content/graphic/2009/08/28/GR2009082800426.html?sid=ST2009082800437>.
[10] <http://www.federalreserve.gov/releases/lbr/current/default.htm>.
[11] <http://www.federalreserve.gov/releases/lbr/20030630/lrg_bnk_lst.txt>.
[12] "When repeal of Glass-Steagall brought investment and commercial banks together, the investment-bank culture came out on top. There was a demand for the kind of high returns that could be obtained only through high leverage and big risk taking." Joseph Stiglitz, "Capitalist Fools," Vanity Fair, January 2009, available at: <http://www.vanityfair.com/magazine/2009/01/stiglitz200901>.
[13] Rebecca S. Demsetz and Philip E. Strahan, Federal Reserve Bank of New York, Research Paper 9506, April 1995, available at: <http://www.newyorkfed.org/research/staff_ reports/research_papers/9506.pdf>. See also Arnold Danielson, "Getting Ready for the 21st Century: A Look at Recent Banking Trends," Banking Pol'y Rep., March 15, 1999. (Banks larger than $50 billion had an average capital ratio of seven percent while banks between $100 million to $2 billion in size had an average capital ratio of just over nine percent).
[14] Rebecca S. Demsetz and Philip E. Strahan, Federal Reserve Bank of New York, Research Paper 9506, April 1995, available at: <http://www.newyorkfed.org/research/staff_ reports/research_papers/9506.pdf>.
[15] Office of the Comptroller of the Currency, "OCC's Quarterly Report on Bank Trading and Derivatives Activities, First Quarter 2009" available at: <http://www.occ.treas.gov/ftp/release/2009-72a.pdf>.

U.S. bank-owned financial derivatives (by notional value).[16] The top five banks own 80 percent of the entire U.S. derivatives risk.[17]

These risky policies combine to exacerbate institutional and systemic risk. Jane D'Arista offers one example: "Much of that increase [in borrowing by the banking sector] reflects leverage -- that is, borrowing (under repurchase agreements) using assets reported on their books as collateral to obtain cash to buy additional assets that could be held off-balance-sheet. Institutional size mattered because the margin of return over the cost of borrowing was so small that profitability depended on the size of the position and thus on the ability to attract the amount of funds needed to finance a huge pool of investments. The result of burgeoning leverage was even larger balance sheet and (especially) off-balance-sheet liabilities that increased the market dominance of these institutions at the same time that it exacerbated their fragility and interdependence."

The too-big-to-fail enterprises also benefit from an implicit subsidy, as they are able to raise funds on the capital markets at a lower interest rate, reflecting their perceived invulnerability to failure. Economist Dean Baker and researcher Travis McArthur find the cost of funds for institutions with assets in excess of $100 billion to be .78 percentage points less than the average cost of funds for smaller banks. The difference in cost of funds has leapt dramatically since the financial crash, which Baker and McArthur attribute to the adoption of a nearly formalized too-big-to-fail policy. This difference -- which Baker and McArthur emphasize is sure to change over time, and may shrink -- implies an annual subsidy to large financial institutions of roughly $34 billion.[18]

On the consumer side, there is evidence that larger banks charge higher overdraft fees, checking account fees and ATM fees.[19]

There is no public policy rationale for maintaining mega-financial institutions (beyond the not unimportant presumption that firms should be left alone). Proponents inevitably cite synergies and efficiencies for every merger, but retrospective analyses (as well as common sense) show that these do not emerge.[20] Even the savings from closing branches

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[16] Office of the Comptroller of the Currency, "Quarterly Report on Bank Trading and Derivatives Activities, First Quarter 2009," available at: <http://www.occ.treas.gov/ftp/release/2009-72a.pdf>.
[17] David Katz, "Five Firms Hold 80 percent of Derivatives Risk, Fitch Report Finds," CFO, July 24, 2009, available at: <http://www.cfo.coma/article.cfm/14113089>.
[18] Dean Baker and Travis McArthur, "The Value of the 'Too Big to Fail' Big Bank Subsidy," Center for Economic and Policy Research, September 2009, available at: <http://www.cepr.net/index.php/publications/reports/too-big-to-fail-subsidy>.
[19] Timothy H. Hannan, "Retail Deposit Fees and Multimarket Banking," Federal Reserve Board, December 2005, available at: <http://www.federalreserve.gov/pubs/feds/2005/200565/200565pap.pdf>.
[20] See Allen N. Berger and David B. Humphrey, "The Dominance of Inefficiencies Over Scale and Product Mix Economies in Banking," J. Monetary Econ., 117-48, August 28, 1991; Allen N. Berger and David B. Humphrey, "Megamergers in Banking and the Use of Cost Efficiency as an Antitrust Defense," 37 Antitrust Bull. 541, 554-65 (1992); Simon Kwan and Robert A. Eisenbeis, "Mergers of Publicly Traded Banking Organizations Revisited," Fed. Res. Bank of Atlanta, Econ. Rev., 4th Qtr. 1999; Jane C. Linder & Dwight B. Crane, "Bank Mergers: Integration and Profitability," 7 J. Fin. Servs. Res. 35, 40-52 (1992); Stavros Peristiani, "Do Mergers Improve the X-Efficiency and Scale Efficiency of U.S. Banks? Evidence from the 1980s," 29 J. Money, Credit & Banking 326, 329-33, 336-37 (1997); Steven J. Pilloff,

and layoffs are offset by increased costs.[21] The behemoth financial institutions have long passed the point of absorbing all available economies of scale. Reasons the financial companies continue to grow in size, despite a paucity of evidence that such growth contributes to efficiency, include empire building and executive compensation, which often rises in conjunction with greater institutional size.[22]

Defenders of the goliath financial institutions sometimes claim they are necessary to service giant non-financial corporations, and that the United States needs goliaths to compete globally. But these claims are meritless. Large corporations may need large banks, but there is no reason to believe they need banks on the scale of today's giants versus the size of the top banks a year ago, or five years ago. The global competition argument collapses once it is recognized that larger banks are not more efficient -- on exactly what terms arc the colossus banks supposed to be better competitors?[23]

But even if there were a narrow economic case to be made for preserving the giant financial corporations, it would be overwhelmed by two countervailing concerns: the creation of too-big-to-fail institutions, and the excessive political power of the Wall Street giants. These concerns signal the need for a policy bias against giant financial institutions, and a willingness to employ appropriate tools to prevent and unwind undue concentration among financial firms.

The too-big-to-fail problem has hovered over policymaking in the U.S. financial sector for at least a quarter century, since the bailout of Continental Illinois. The current crisis has now shown how too-big-to-fail endangers the national (and global) economy. Too-big-to-fail was a cause as well as cost of the crisis. On the one hand, the backstop of a de

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"Performance Changes and Shareholder Wealth Creation Associated with Mergers of Publicly Traded Banking Institutions," 28 J. Money, Credit & Banking 294, 297-98, 301, 308-09 (1996).

[21] Arthur E. Wilmarth, Jr., "The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation and Increased Risks," 2002 U. Ill. L. Rev. 2 215 (2002), available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=315345>.

[22] Allen N. Berger and David B. Humphrey, "The Dominance of Inefficiencies Over Scale and Product Mix Economies in Banking," J. Monetary Econ., 117-48, August 28, 1991; Arthur E. Wilmarth, Jr., "The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation and Increased Risks," 2002 U. Ill. L. Rev. 2 215 (2002), available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=315345>.

[23] On these matters generally, see multiple posts by Simon Johnson and James Kwak at www.baselinescenario.com. In an October 12, 2009 posting, "Who Needs Big Banks?," Kwak writes: "Let's take a big, global transaction — say, a debt offering. Here, arguably, it might be good to have a single bank with global scale, since you want to sell bonds in as many markets as possible in order to get the broadest possible pool of investors. In 2008, J&J issued $1.6 billion (face value) of bonds. Who got the deal? Goldman, JPMorgan, Citi, Deutsche Bank, Bank of America, Morgan Stanley, Williams Capital Group, BNP Paribas, HSBC, Mitsubishi UFJ, and RBS Greenwich Capital. Eleven investment banks based in five countries, including five U.S.-based banks. (In 2007, J&J issued 500 million pounds of debt, using thirteen underwriters — six of whom were not involved in the 2008 offering; two out of three book-running managers were European banks.) So when push comes to shove, our beloved mega-banks are nowhere near up to the task. What this tells me is that it's the big companies that call the shots, and they like parceling out business to lots of banks. This is another basic principle of business: it's better to have multiple suppliers than one supplier, so you can keep them in competition." Available at: http://baselinescenario.com/2009/10/12/who-needs-big-banks/#more-5216.

facto federal guarantee helped drive the financial sector to an ever-greater speculative frenzy. The giants threw caution to the wind, in part because of the assumed federal backstop. On the other hand, the imminent threat of institutional failure has drained hundreds of billions of dollars from federal coffers, and required trillions of dollars of public supports for Wall Street.

Not unrelatedly, the Wall Street goliaths accumulate extraordinary and dangerous political power. This distorts appropriate policymaking in all kinds of ways, involving matters from trade to climate policy.[24] Most acutely, this accumulated power enables Wall Street to lobby effectively for deregulation that makes speculation, financial bubbles and subsequent collapse more likely;[25] for unconditional bailouts in the face of crisis; and against modest restraints even in the aftermath of financial crash and bailout (as is currently the case).

It is inconceivable that the advantages of maintaining giant financial firms, if any were demonstrated, could outweigh -- or even come close to offsetting -- the enormous costs attached to entrenchment of too-big-to-fail financial corporations and the associated subversion of effective democracy.

Antitrust Tools to Address Too-Big-to-Fail

In considering the too-big-to-fail problem, the issue, of course, is not whether the too-big-to-fail institutions are monopolies; although market concentration is fast worsening, the commercial banks and most too-big-to-fail financial institutions probably do not possess monopoly power nationally (although they may in local retail markets). Because the too-big-to-fail problem is nonetheless a problem of size (as well as the more complicated issue of interconnectedness), Congress, and relevant federal agencies, should employ appropriate antitrust principles and utilize appropriate antitrust tools to address the too-big-to-fail problem. The idea is to apply these concepts and instruments in a context closely akin to, but slightly different from, traditional antitrust analysis. What are the implications of this approach?

First, the most powerful implement in the antitrust toolkit is to break up existing enterprises. We believe using this tool is the simplest and most efficient way to deal with the too-big-to-fail problem. With Alan Greenspan, we agree that "If they're too big to fail, they're too big."[26]

Pursuing a break-up-the-banks policy would be no simple matter, of course, particularly given that a substantial (if uncertain) number of institutions that have achieved too-big-to-fail status. A deconcentration process would necessarily have to take place over time.

[24] On this matter generally, see Robert Kuttner, *The Squandering of America: How the Failure of Our Politics Undermines Our Prosperity*, New York: Knopf, 2007.
[25] See Robert Weissman and James Donahue, "Sold Out: How Wall Street and Washington Betrayed America," March 2008, available at: <http://www.wallstreetwatch.org/soldoutreport.php>.
[26] Quoted in Scott Lanman and Michael McKee, "Greenspan Says He's Not Concerned About Dollar's Drop," Bloomberg, October 15, 2009, available at: <http://www.bloomberg.com/apps/news?pid=20601103&sid=ai02YskF0RqI>.

It could be managed in a top-down fashion, with government regulators managing the break-up process. Alternatively, the government could instruct the mega institutions to sell off operations or spin off subsidiaries in line with government established targets. Graduated over time, it is very feasible. To address its own financial difficulties, Citigroup is undertaking this sort of process on its own initiative right now.

A more modest approach would be to unwind some or all of the recent megamergers. Undertaken in times of crisis, it is now evident, as noted above, that they have worsened both the size problem, and the problem of combining commercial banks and other, riskier financial institutions.

Second, Glass-Steagall, or an updated version of the venerable law repealed in 1999, should be reinstated. The core idea of Glass-Steagall remains highly relevant: Insured depository institutions should be kept separate from insurance companies, investment banks or other enterprises undertaking risky investments. The combination of commercial banks with risk-seeking subsidiaries in a single corporate entity is an invitation to disaster -- for the corporate entity, and, in the case of larger institutions, for the financial system overall.

Beyond Glass-Steagall's structural restraints, there should be put in place additional rules to control excessively risky practices by commercial banks. Paul Volcker has identified this set of activities as including ownership of hedge funds and private equity funds, and undertaking of heavy proprietary trading.[27]

Third, while we believe that breaking up the mega-financial institutions, and imposing a new Glass Steagall regime, are both desirable policies on the merits, we would also support less robust measures toward the same end. One less ambitious approach would be to impose a standstill or do-no-harm rule, so that the too-big-to-fail and related problems do not grow worse. This would suggest the need for a prohibition on acquisitions by existing too-big-to-fail institutions, a prohibition on mergers among large financial enterprises whose combination would create too-big-to-fail or nearly too-big-to-fail companies, and a prohibition on new mergers and acquisitions combining commercial banks with non-commercial bank enterprises.

Relatedly, the same rules should at least presumptively guide the actions of a resolution authority, an issue I discuss below.

Fourth, the existing 10 percent concentration limit for depository institutions should be enforced.[28] Under the Riegle-Neal *Interstate Banking and Branching Efficiency Act of*

[27] Paul Volcker, Testimony before the House Financial Services Committee, September 24, 2009, available at: <http://www.house.gov/apps/list/hearing/financialsvcs_dem/fchr_092409.shtml>. ("As a general matter, I would exclude from commercial banking institutions, which are potential beneficiaries of official (i.e., taxpayer) financial support, certain risky activities entirely suitable for our capital markets. Ownership or sponsorship of hedge funds and private equity funds should be among those prohibited activities. So should in my view a heavy volume of proprietary trading with its inherent risks.")

[28] 12 USC 1842(d)(2)(A) ("The [Federal Reserve] Board may not approve an application pursuant to paragraph (1)(A) if the applicant (including all insured depository institutions which are affiliates of the

1994, a bank may not acquire another bank if the acquisition will give it more than 10 percent of deposits held nationwide.

Congress should also consider lowering the limit to a point well below the too-big-to-fail threshold.

Fifth, Congress -- through hearings and/or commissioned studies -- should assess what constitutes appropriate size or interconnected limits for non-depository assets. These limits should be designated with an eye to both pro-competition objectives and preventing too-big-to-fail and systemic risk problems. The proliferation of financial assets makes an assessment of appropriate limits a complicated task. How great a holding of derivative instruments is required before an institution poses a systemic risk? Should this question be considered as a percentage of outstanding derivatives? An absolute total? This line of inquiry should also explore what set of assets should be subjected to limits: Does it matter from a pro-competitive or systemic risk perspective if individual institutions gain more than 10 percent each of all mortgages? All credit card business?

Sixth, if there is discomfort with acting immediately on break-up and Glass-Steagall proposals, Congress should create an independent commission to assess the structure and risks posed by the financial services industry.[29] This line of inquiry would be wholly distinct from the important efforts to investigate the causes of the financial crash. Instead, it would focus on how the evolving structure of the industry impacts competition and systemic risk.

Seventh, Congress should impose a fee on the too-big-to-fail institutions to capture for the public the subsidy these corporations are receiving in credit markets. This fee should be separate from other fees aiming to deter creation of too-big-to-fail corporations, fund a resolution authority for such institutions, or serve other purposes.

Finally, special conduct rules should be applied to the largest financial institutions. Because of the systemic threats they pose, the largest institutions should be subject to special rules aiming to deter risky behavior and enable effective monitoring by

applicant) controls, or upon consummation of the acquisition for which such application is filed would control, more than 10 percent of the total amount of deposits of insured depository institutions in the United States."

[29] Bert Foer of the American Antitrust Institute, who supports such a study commission, emphasizes the importance of the Depression era Temporary National Economic Commission (TNEC). "The TNEC model is a way to bring together a variety of viewpoints and develop a consensus over a sustained period of time and to come up with recommendations based on evidence, diverse ideas and directed debate. The actual contribution of the TNEC in terms of legislation was not great, but the TNEC led to acceptance of the idea that high levels of concentration could be dangerous and deserved to be the focus of national attention. And that realization eventually led to modifications of the Clayton Act, intended to stop monopolies, or near monopolies, from being formed through mergers." "The Centralization of Financial Power: Unintended Consequences of Government-Assisted Bank Mergers," An Interview with Bert Foer, Multinational Monitor, November/December 2008, available at:
<http://www.multinationalmonitor.org/mm2008/112008/interview-foer.html>.

government regulators. And because these institutions are positioned to leverage their marketing and market power to gouge consumers, they should be subject to special consumer protection obligations. Appropriate conduct rules would include:

- Prohibitions on use of offshore tax havens, which facilitate complicated and non-transparent maneuvering.[30]

- Prohibitions, or at least stringent limits, on off-the-books accounting, which even if permissible obscure risk from regulators.

- Mandating that bonus pay for highly compensated executives and employees be linked to long-term performance, so that key employees are not incentivized to take speculative gambles with short-term payouts but long-term risks.

- Prohibitions on excessively risky undertakings, particularly derivative exposure where neither party has an underlying interest (e.g., naked credit default swaps).

- Enhanced reporting standards (not subject to exceptions otherwise in place) for derivative holdings and other risky investments, so that regulators and the public are better able to assess institutional and systemic risks.

- Enhanced capital reserve standards. Ideally, these would be set high enough to offset the real risks posed by too-big-to-fail institutions, and thus to meaningfully deter creation of such excessively sized corporations. MIT Professor Simon Johnson argues that the appropriate capital standard for too-big-to-fail institutions should be 15 percent.

- Enhanced consumer protection standards, including application of a "reasonableness" standard to dealings with consumers and the requirement of offering plain vanilla financial products.

- Enhanced affirmative obligations to serve consumers in underserved communities, including (for commercial banks) by offering lifeline accounts and accounts with low or no minimum balance requirements.

- Obligations to distribute invitations via regular and electronic mailings to consumers to join independent, federally chartered consumer organizations.

[30] In December 2008 the Government Accounting Office reported that Citigroup had 427 subsidiaries in jurisdictions listed as tax havens or financial privacy jurisdictions (including 90 in the Cayman Islands alone) -- the largest number of any Fortune 100 company. Government Accounting Office, "International Taxation: Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions," GAO-09-157, December 18, 2008, available at: <http://www.gao.gov/products/GAO-09-157>.

Resolution Authority and Resolving to Avoid Unconditional Bailouts

It is hard not to be somewhat sympathetic to the regulators who acted to rescue or merge (and in one notable case permit to go bankrupt) failing financial institutions in 2008 and 2009. They faced a crisis of a scale unmatched over the last 70 years, they were forced into seat-of-the-pants decision-making, there were no guidelines to direct their efforts, and they were forced to operate with unclear, at best, legal authority.

Nonetheless, it is hard to look at what was done over the past year-and-a-half and conclude it was anything less than disastrous. This is not to argue that the government should have done nothing. It had to intervene. But it did not have to, and should not have, offered an unrequited bailout.

It is worth very briefly reviewing the ad hoc fashion in which regulators treated failing institutions over the past 18 months, in order to highlight the flaws in the inconsistent strategies used.

In the case of the Bear Stearns, the Federal Reserve gifted JP Morgan with an agreement to absorb $30 billion in Bear Stearns risk, while orchestrating a low price amidst non-transparent negotiations for JP Morgan's acquisition of Bear.

In the case of Lehman Brothers, regulators decided to permit the firm to go bankrupt. This decision appears more reckless and misguided in retrospect than it did contemporaneously. It is also the case that a financial crisis was likely inevitable irrespective of what happened at Lehman. Nonetheless, the decision to permit the bankruptcy was clearly a mistake; it functioned as the trigger for an all-out panic in financial markets.

With AIG, regulators decided they could not permit another failure. Enormous sums of taxpayer money have been pumped into AIG in order to satisfy obligations to derivative counterparties. In this sense, the "AIG bailout" is a misnomer; the bailout of AIG has really served as a backdoor bailout of the giant firms on Wall Street, led by Goldman Sachs, and overseas (where AIG sent half of its credit default payments, after being bailed out). These firms, unjustifiably, escaped even a hair cut; instead, they were paid 100 cents on the dollar, even as AIG faced insolvency. New management is in place at AIG, but even though the government now owns nearly 80 percent of the company, it is not directing operations, though it does appear to be pressuring management to sell off units and take other steps to raise revenues.

With Merrill Lynch, regulators again arranged a shotgun marriage. The murky conditions of the deal are now the subject of major controversy, as Congressional investigators peel back layers of secrecy to determine who knew what about Merrill's pending bonus payments, and who promised what to whom.

In the case of Citigroup, the government has provided supports going far beyond TARP and the one-third share acquired in the company. Among other measures, the government has offered a guarantee on $290 billion of Citi's toxic assets. The FDIC is reportedly pressuring Citi both to shed assets and shake up internal management.

The government did not and has not required reciprocity from any of the bailed-out firms (the GSEs are a separate case, and unique in that the government is using these enterprises -- now 80 percent publicly owned -- as tools of public policy). Apart from insignificant standards in the important area of executive compensation, the government has not demanded changed behavior from the firms it has saved from ruin. Not an end to risky speculation, not mortgage modifications, not even an end to credit card ripoffs.

This recent history makes clear that things should be done differently next time, and offers a strong affirmative case for establishing resolution authority for non-bank financial institutions.

The government needs tools to move quickly and with some policy flexibility in cases of insolvency or pending insolvency of large financial corporations whose failure poses systemic risk.

On the one hand, bankruptcy is unlikely to serve as a satisfactory means to address the failure of too-big-to-fail institutions. The process is too slow, leaving too much uncertain for too long. For institutions with large derivative exposure, bankruptcy may trigger additional liability -- worsening the condition of the failing enterprise, and worsening the systemic risk problem. And, after the Lehman experience, it is implausible that government regulators will permit too-big-to-fail institutions to file bankruptcy; they will find some way to bail them out. As Paul Volcker told the House Financial Services Committee, "Experience, not only here but in every country with highly developed, inter-connected financial systems and institutions bears out one point. Governments are not willing to withhold financial and other support for failing institutions when there is a clear threat to the intertwined fabric of the financial system."[31]

On the other hand, the bailout strategy is unacceptable. It may alleviate some of the short-term risks of systemic collapse posed by the bankruptcy approach, but it unjustifiably plunders the public treasury to support failed, reckless enterprises, while reinforcing the cycles that lead to periodic failure and ever larger bailouts. The recent round of bailouts: 1) through trillions of dollars of public supports, maintained large financial institutions that likely are insolvent, encouraging further recklessness going forward; 2) resulted through mergers in larger and more interconnected too-big-to-fail institutions; and 3) provided counterparties of the otherwise-failing AIG with 100 cents on the dollar, shifting all costs from AIG's reckless behavior from the counterparties to the public.

The resolution authority, by contrast, rejects the let-the-chips-fall-where-they-may approach of bankruptcy as too dangerous in the case of systemically important institutions. Yet, in contrast to bailout approach, it offers a strategy of intentional and structured government intervention, rather than makeshift and haphazard action. A

[31] Paul Volcker, Testimony before the House Financial Services Committee, September 24, 2009, available at: <http://www.house.gov/apps/list/hearing/financialsvcs_dem/fchr_092409.shtml>.

resolution authority gives the government the tools it needs to address systemic risk, and the means to act through mechanisms other than throwing taxpayer money at financial behemoths that have grown so large that their failure threatens the functioning of the financial system.

A carefully vectored resolution authority will hopefully help deter financial institutions from mutating into too-big-to-fail enterprises; exercise of the authority would represent a failure both to curtail the existence of excessively sized institutions and of prudential regulation. But resolution authority can only do so much. It is no substitute for a competition policy breaking up the big financial institutions (as well as asymmetric standards -- including capital reserve standards and fee assessments -- tilted against excessively big institutions), nor for sound regulation.

Nor is resolution authority an automatic guard against the hazards of a bankruptcy process or the bailout approach. Unless carefully implemented, and with properly equipped regulators, resolution could potentially result in the same dangers as bankruptcy (for example, in triggering posting of collateral to derivative counterparties). A resolution authority is also vulnerable to becoming a bailout vehicle, or replicating bailout outcomes. This latter risk is particularly acute, and suggests the need for legislative directives and presumptions.

First, consideration should be given to establishing that institutional resolutions will presumptively draw exclusively on the available assets of the institution undergoing resolution. This approach would eliminate the risk of bailout. The presumption might be established by stipulating that the resolution authority not have access to external financing (besides some modest amount to administer institutions under conservatorship or receivership) unless there is a written finding of emergency need by a top official (for example, the Treasury Secretary, or the chair of the Federal Deposit Insurance Corporation) or perhaps by the systemic risk regulator, if one is created. A stronger presumption would prevent access to external financing except by act of Congress, although this approach would seem to build in unacceptable delays for what is by definition an urgent circumstance.

Second, and relatedly, there should be a strong presumption that -- excluding insured depositors, consumers in regulated industries such as insurance, secured creditors and perhaps other designated categories where there is a demonstrable public policy interest in providing de facto government insurance -- creditors of an institution in resolution will take a haircut. There should never be a repeat of the AIG fiasco, with credit default swap counterparties siphoning public funds in order to receive one hundred cents on the dollar.

Third, to the extent that the resolution authority will have access to substantial financing, these resources should be drawn from the category of too-big-to-fail institutions (if they are quasi-formally designated as Tier One institutions) or simply from the biggest financial firms. These resources should be raised from fees assessed *before* the next financial crisis. Based on recent experience, the needed resources may be very substantial in scale. There will understandably be reluctance to collect such fees in the aftermath of a crisis, while the financial sector is struggling; and delay is likely to mean the fees are never collected. Legislation adopted now should set a date in the near-to-medium future -- perhaps two years from now -- when fee collection will begin.

Fourth, direction should be given to the resolution authority not to deepen the too-big-to-fail problem. In merging a failing corporation into another firm, or selling off a failing corporation's pieces, there should be a strong presumption against combinations into an already too-big-to-fail institution, or one close to that status. It is important that this heavy presumption be legislated, and implemented in advance of the next crisis. Financial crises necessarily demand exigent decision-making, and in such circumstances the easiest solution will often be to merge a failing company into another financial giant, since only other behemoths will have the financial capacity to absorb the failed firm. Specific guidance directing the authority to work to avoid exacerbating the too-big-to-fail problem is also necessary, because an exclusive focus on recovery of taxpayer assets may prod the authority to turn to too-big-to-fail acquirers. While recovery of taxpayer assets must be a high-level concern, it would be a mistake to prioritize short-term repayment over the long-term public interest in preventing future crises.

Fifth, and following the principle of the preceding point, direction should be given to the resolution authority not to increase risk-taking by commercial banks. In merging a failing non-bank financial institution into another financial institution, or selling off a failing corporation's pieces, there should be a strong presumption against combinations into a commercial bank (or a bank holding company). The core of the too-big-to-fail problem is that de facto insured corporations will be incentivized to take excessive risk. This is a particularly acute problem when the too-big-to-fail institution is backed up by an explicit depository insurance program.

A presumption against combining investment banks and other risk-taking institutions into commercial banks may in some cases be in tension with a presumption against combinations that increase market concentration. This tension can be resolved by a sixth principle: The resolution authority should have the power to maintain ownership of a resolved firm, if doing so serves public policy objectives; and it should also have authority to break up a failing firm and sell it off in pieces.[32] In either instance, the resolution authority's power should not be unduly constrained by the objective of maximizing recovery to the public purse. Indeed, even where the resolution authority sees no purpose or advantage in holding a firm over time, there may be a strong pro-competitive or systemic risk rationale to selling the resolved firm in pieces (or spinning off components as standalone enterprises), a process certain to take more time than a one-off sale.

Last, in disposing of resolved firms, the resolution authority should strongly consider conduct rules to advance established policy objectives. It is possible that attaching such rules will diminish the sale value of the resolved enterprise; but any such diminution in price should be considered evidence that costs would otherwise be externalized on

[32] This issue is explored in a forthcoming paper from Corporate Ethics International, co-authored by Charlie Cray and me.

consumers or the financial system overall. Appropriate conduct remedies for consideration would track many of those elaborated above: ensuring incentive pay is linked to long-term performance; prohibiting practices that gouge consumers and requiring consumer-friendly practices such as plain vanilla offerings; prohibitions on off-the-books and deceptive accounting maneuvers; limits or prohibitions on use of offshore tax havens; and prohibitions on excessively risky undertakings (for example, naked credit default swaps).

Conclusion

Mr. Chairman, thank you again for the opportunity to testify today. I hope that the Committee follows up on today's hearing. The antitrust perspective suggests a range of needed policy approaches that are not instinctual for policymakers operating in other regulatory traditions.

Wall Street is now populated by a handful of dominant mega-corporations -- a smaller group of larger firms than existed even before the current financial crisis. Many -- including many who believe the too-big-to-fail problem is a looming, ongoing, long-term and recurring threat to financial stability -- believe this state of affairs is a fait accompli. The antitrust tradition teaches us that it need not be so.

Americans for Financial Reform
Accountability, Fairness, Security

Resolution Authority

Dana Chasin

Bob Kuttner
Demos

Bankruptcy Law Is Inadequate for Systemically Significant Nonbank Institutions

The current bankruptcy regime does not work well for bank holding companies and systemically significant nonbanks institutions. The federal government has long had the power to take over and close banks and other deposit-taking institutions whose deposits are insured by the government and subject to detailed regulation. But it has no such "resolution authority" with respect to bank holding companies and non-bank financial institutions such as insurance companies, investment banks, hedge funds, private equity firms and other financial institutions.

The bankruptcy of a systemically significant non-bank can aggravate liquidity problems and destabilize financial markets, but the Bankruptcy Code's provisions for the distribution of the assets of a bankrupt financial institution take no account of the systemic considerations that regulators can and should consider. Because the bankruptcy system was not designed for these circumstances, financial regulators may feel the need to prop up the ailing institution in order to avoid a messy and potentially destructive bankruptcy process.

The government needs new power to seize non-bank financial entities whose collapse might jeopardize the national and global financial systems. In particular, resolution authority is needed so that the Federal Deposit Insurance Corporation (FDIC) can take into conservatorship or receivership bank holding companies such as Citigroup. Current law gives FDIC no authority over bank holding companies, which is where the main mischief—and damage—occurred.

Given the potential risk from triggering acceleration clauses in credit default swap (CDS), there may be value in affording the regulator the authority to perform—as FDIC regulators do— "least cost resolution" analysis. In the case of CDS exposures, resolution authority could include a non-receivership approach. The FDIC could, for example, require the company to sell certain non-core businesses (with regulatory oversight) and disgorge troubled assets at the same time.

The Proposal

The Congressional Oversight Panel, the Treasury Department, and others have proposed establishing a receivership and liquidation process for systemically significant as well as other nonbank financial institutions that is similar to the resolution system for banks. Under most of these proposals, the FDIC would be empowered to appoint itself as conservator or receiver for failed or failing non-bank financial institution holding companies and their subsidiaries.

The FDIC would be charged not just with wielding resolution power but also setting standards that should limit the need to use the resolution authority. It would have responsibility over systemically important and other nonbank financial institutions and would share with Congress the responsibility for establishing resolution implementation standards. The FDIC would further have the authority to:

- Make loans to the covered financial company or any subsidiary;
- Purchase assets of the covered financial company or any subsidiary;
- Assume or guarantee obligations of the covered financial company or any subsidiary;
- Acquire any type of equity interest or security of the covered financial company or any subsidiary;
- Take a lien on any or all assets of the covered financial company or any subsidiary; and
- Appoint itself as conservator or receiver of the covered financial company.

Bailouts Versus Resolution Authority

Resolution authority would be a major improvement on the current bailout strategy, which uses taxpayer funds and loans and guarantees from the Federal Reserve to prop up banks that are, by any reasonable measure, insolvent. The cost of the current strategy is that it prolongs a day of reckoning. It leaves in place seriously wounded banks incapable of serving the nation's credit needs, which prolongs the recession and creates the risk of a Japan-type "lost decade."

The public-private partnership model announced in late March also creates huge opportunities for conflicts of interest, with the government assuming most of the risk and private speculators appropriating most of the gain. It is unlikely to achieve its goal of increasing the market value of depressed securities because the underlying mortgages are only worth a fraction of their nominal value. The bailout process is also almost totally non-transparent.

It would be far better to enact and then use resolution authority so that banks which are effectively insolvent are taken into public receivership by a government agency with the competence and capacity to do true audits rather than hypothetical stress tests. As with resolution of smaller institutions by the FDIC, this agency would assess how large is the hole in the institution's balance sheet, and decide what combination of public capital and bondholder losses should make up the loss. Incumbent management would be replaced, and the institution would be returned to new private ownership as soon as practical. Experience on other nations that have suffered banking collapses (Japan, Sweden) suggest that this approach of acknowledging losses and recapitalizing institutions is preferable to a policy of piecemeal bailout.

A large set of organizations are working together to advance our common interest in an accountable, transparent and secure financial system, and to accomplish our shared policy goals. Because the organizations involved and the issues addressed are diverse, not every organization works on or has a policy position on every specific issue. We are unanimous in our call for change to repair our nation's broken financial system, establish integrity in the financial markets, and facilitate productive economic activity that benefits all segments of our communities.

Mr. COHEN. Thank you, Mr. Weissman. I appreciate it.

Mr. Miller, who has been on our panel—he is our Black's Law of bankruptcy; he is also associated with NYU and Columbia Schools of Law and the firm of Weil, Gotshal & Manges.

Last thoughts?

Mr. COHEN. Microphone.

Mr. MILLER. Thank you.

Professor Skeel stated my position much more eloquently than I can, and I will rely upon his statement.

Mr. SKEEL. He has a sense of humor, too. [Laughter.]

Mr. COHEN. Mr. Conyers, do you have questions of the panel?

Mr. CONYERS. Well, I think we have covered it all except that I would think that in the next 2 to 3 weeks, if not sooner—Mr. King, I would like you to hear this, as well, because I would want to get the concurrence of this Committee—first of all, I think the selection of these professors, lawyers, experts is very, very much needed. I think that we may have to reassemble to monitor what the Congress does and what further—we have got to go over this transcript. There is an incredible amount of material that we have got to digest and evaluate.

We have had experts all over the place here, and I want to try to elicit an agreement that our panel would be able to come back and that we would be able to have them back as we proceed in a somewhat informal way that the Chairman has conducted this meeting, but it has been important.

Why do you need a 5-minute rule? We are talking about the economic future of the Nation, and we are asking somebody to summarize in 5 minutes where this should go. And I appreciate the way that this has been conducted, and I commend all of you for what you have contributed to that.

And I think Mr. Miller might want to comment in here, and I would like to yield to him if I can, Mr. Chairman.

Mr. COHEN. Mr. Miller, briefly. We have got 10 minutes and Mr. King. But Mr. Miller, you are on.

Mr. MILLER. I think I have said all I want to say about my position and I would be happy to answer any questions.

Mr. COHEN. Thank you, sir.

And thank you, Mr. Chairman.

Mr. King, briefly please?

Mr. KING. Thank you, Mr. Chairman. I am happy to expedite this, and I would second Chairman Conyers' recommendation and suggestion. There is far too much knowledge and expertise here to dispense with it in 5 minutes of testimony each and a printed testimony. I hope we can find a time to do this in an environment where we can dig into this in depth.

I had the whim to request a beer summit with all of you. I think that would be a constructive thing to do.

But the testimony that I have heard and the testimony that I have read is engaging, and a lot of it concurs and overlaps, but the contradictions especially—those disagreements—I think we need to take some time to explore it in an intelligent fashion. And so rather than have me drill into one component of this I would really look at it at the broad perspective and second the recommendation of Chairman Conyers and ask that we do come back together and do justice to the quality of the witnesses we have today.

I thank you and I would yield back.

Mr. COHEN. Thank you, Mr. King.

I appreciate all of the witnesses. I apologize for the timing. We are going to be out for another hour. We may, if you are kind enough to return, ask you to return at a future time for another hearing. Your prepared remarks will be part of the record.

We had, I think, a very good discussion and I appreciate Mr. Miller coming up. He is the only one of the panelists who I was familiar with, and I am sure that each of you could have contributed as well, but it would have not been maybe as—it might have been unwieldy. So I thank you for allowing me to have that type of discussion, which I think was helpful to us.

It is an issue—bankruptcy versus resolution—and maybe it is another issue because people talked about the bailout. And when do you—the compelling interests of the—but you lose some—some of the people lose out if you go to resolution that don't lose out in bankruptcy. They have to be thought about.

And there is a concern in this Nation that we have done too much, as I think Barney Frank talks about the collateral benefit that to help the whole country we have had to help some people who aren't deserving of help because they are not appreciative and they are such gluttons that they poison the water to where nobody wants to swim there again. And we might have to go there again, but it will be difficult because of the great white sharks that are out there swimming in that water.

Mr. CONYERS. Would the Chairman yield for——

Mr. COHEN. Yield to the Chairman of the Chairman——

Mr. CONYERS. I just wanted all of you to know that we have been in consultation with Chairman Barney Frank, and that both the Judiciary Committee and the Finance Committee are moving together—we are not at odds or in competition. We met before this hearing, and we will certainly be meeting before we all reassemble again. So the thoughts and recommendations that you accumulate in preparation for this next Committee hearing, we will be looking forward to.

And again, I want to extend my thanks to each of you for what you have done and contributed here today.

Mr. COHEN. Thank you, Mr. Conyers.

And I would like to thank all the witnesses for their testimony and their—today.

Without objection, Members have 5 legislative days to submit any additional written questions which we forward to the witnesses, and we would ask you to answer promptly as you can to be made part of the record. Without objection the record remains open for 5 days for submission of other materials. And I thank each Member for their time, their patience, their forbearance for the way I ran the Committee and the time that we took.

This hearing of the Subcommittee on Commercial and Administrative Law is adjourned.

[Whereupon, at 3:11 p.m., the Subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

MATERIAL SUBMITTED BY THE HONORABLE LAMAR SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS, AND RANKING MEMBER, COMMITTEE ON THE JUDICIARY

THE WALL STREET JOURNAL.
WSJ.com

OPINION | FEBRUARY 9, 2009

How Government Created the Financial Crisis

Research shows the failure to rescue Lehman did not trigger the fall panic.

By JOHN B. TAYLOR

Many are calling for a 9/11-type commission to investigate the financial crisis. Any such investigation should not rule out government itself as a major culprit. My research shows that government actions and interventions -- not any inherent failure or instability of the private economy -- caused, prolonged and dramatically worsened the crisis.

The classic explanation of financial crises is that they are caused by excesses -- frequently monetary excesses -- which lead to a boom and an inevitable bust. This crisis was no different: A housing boom followed by a bust led to defaults, the implosion of mortgages and mortgage-related securities at financial institutions, and resulting financial turmoil.

Monetary excesses were the main cause of the boom. The Fed held its target interest rate, especially in 2003-2005, well below known monetary guidelines that say what good policy should be based on historical experience. Keeping interest rates on the track that worked well in the past two decades, rather than keeping rates so low, would have prevented the boom and the bust. Researchers at the Organization for Economic Cooperation and Development have provided corroborating evidence from other countries: The greater the degree of monetary excess in a country, the larger was the housing boom.

The effects of the boom and bust were amplified by several complicating factors including the use of subprime and adjustable-rate mortgages, which led to excessive risk taking. There is also evidence the excessive risk taking was encouraged by the excessively low interest rates. Delinquency rates and foreclosure rates are inversely related to housing price inflation. These rates declined rapidly during the years housing prices rose rapidly, likely throwing mortgage underwriting programs off track and misleading many people.

Adjustable-rate, subprime and other mortgages were packed into mortgage-backed securities of great complexity. Rating agencies underestimated the risk of these securities, either because of a lack of competition, poor accountability, or most likely the inherent difficulty in assessing risk due to the complexity.

Other government actions were at play: The government-sponsored enterprises Fannie Mae and Freddie Mac were encouraged to expand and buy mortgage-backed securities, including those formed with the risky subprime mortgages.

Government action also helped prolong the crisis. Consider that the financial crisis became acute on Aug. 9 and 10, 2007, when money-market interest rates rose dramatically. Interest rate spreads, such as the difference between three-month and overnight interbank loans, jumped to unprecedented levels.

Diagnosing the reason for this sudden increase was essential for determining what type of policy response was appropriate. If liquidity was the problem, then providing more liquidity by making borrowing easier at the Federal Reserve discount window, or opening new windows or facilities, would be appropriate. But if counterparty risk was behind the sudden rise in money-market interest rates, then a direct focus on the quality and transparency of the bank's balance sheets would be appropriate.

Early on, policy makers misdiagnosed the crisis as one of liquidity, and prescribed the wrong treatment.

To provide more liquidity, the Fed created the Term Auction Facility (TAF) in December 2007. Its main aim was to reduce interest rate spreads in the money markets and increase the flow of credit. But the TAF did not seem to make much difference. If the reason for the spread was counterparty risk as distinct from liquidity, this is not surprising.

Another early policy response was the Economic Stimulus Act of 2008, passed in February. The major part of this package was to send cash totaling over $100 billion to individuals and families so they would have more to spend and thus jump-start consumption and the economy. But people spent little if anything of the temporary rebate (as predicted by Milton Friedman's permanent income theory, which holds that temporary as distinct from permanent increases in income do not lead to significant increases in consumption). Consumption was not jump-started.

A third policy response was the very sharp reduction in the target federal-funds rate to 2% in April 2008 from 5.25% in August 2007. This was sharper than monetary guidelines such as my own Taylor Rule would prescribe. The most noticeable effect of this rate cut was a sharp depreciation of the dollar and a large increase in oil prices. After the start of the crisis, oil prices doubled to over $140 in July 2008, before plummeting back down as expectations of world economic growth declined. But by then the damage of the high oil prices had been done.

After a year of such mistaken prescriptions, the crisis suddenly worsened in September and October 2008. We experienced a serious credit crunch, seriously weakening an economy already suffering from the lingering impact of the oil price hike and housing bust.

Many have argued that the reason for this bad turn was the government's decision not to prevent the bankruptcy of Lehman Brothers over the weekend of Sept. 13 and 14. A study of this event suggests that the answer is more complicated and lay elsewhere.

While interest rate spreads increased slightly on Monday, Sept. 15, they stayed in the range observed during the previous year, and remained in that range through the rest of the week. On Friday, Sept. 19, the Treasury announced a rescue package, though not its size or the details. Over the weekend the package was put together, and on Tuesday, Sept. 23, Fed Chairman Ben Bernanke and Treasury Secretary Henry Paulson testified before the Senate Banking Committee. They introduced the Troubled Asset Relief Program (TARP), saying that it would be $700 billion in size. A short draft of legislation was provided, with no mention of oversight and few restrictions on the use of the funds.

The two men were questioned intensely and the reaction was quite negative, judging by the large volume of critical mail received by many members of Congress. It was following this testimony that one really begins to see the crisis deepening and interest rate spreads widening.

The realization by the public that the government's intervention plan had not been fully thought through, and the official story that the economy was tanking, likely led to the panic seen in the next few weeks. And this was likely amplified by the ad hoc decisions to support some financial institutions and not others and unclear, seemingly fear-based explanations of programs to address the crisis. What was the rationale for intervening with Bear Stearns, then not with Lehman, and then again with AIG? What would guide the operations of the TARP?

It did not have to be this way. To prevent misguided actions in the future, it is urgent that we return to sound principles of monetary policy, basing government interventions on clearly stated diagnoses and predictable frameworks for government actions.

Massive responses with little explanation will probably make things worse. That is the lesson from this crisis so far.

Mr. Taylor, a professor of economics at Stanford and a senior fellow at the Hoover Institution, is the author of "Getting Off Track: How Government Actions and Interventions Caused, Prolonged and Worsened the Financial Crisis," published later this month by Hoover Press.

Please add your comments to the Opinion Journal forum.

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THE WALL STREET JOURNAL.
WSJ.com

OPINION | MARCH 27, 2009

Geithner Is Overreaching on Regulatory Power

We don't need more politics in our economics.

By FRANCIS X. DIEBOLD and DAVID A. SKEEL JR.

One of the main proposals in the regulatory reforms outlined by Treasury Secretary Timothy Geithner yesterday would give the Treasury, FDIC and the Fed authority to take control when investment banks or other financial institutions (hedge funds, etc.) appear troubled, just as the FDIC presently does with deposit-taking banks.

The proposal is being offered as a clever political solution to the turf war that might have erupted if the Treasury or FDIC alone were given this quasi-nationalization authority, with no input from the Fed. But the real issue is whether this expansion of regulators' powers is wise. It isn't.

Start with the FDIC's performance in practice. One would suspect that the government might not be a shrewd player in the banking business, and recent events confirm that suspicion. IndyMac, for example, was not taken over by the FDIC until long after it was obvious that it should be closed, and current estimates of the cost to taxpayers approach $10 billion. Shortly after the IndyMac failure, moreover, the FDIC brokered a deal to sell Wachovia to Citigroup at a lowball price and wound up with egg on its face when Wells Fargo emerged with a vastly superior offer. We could continue.

There's also significant room for principled skepticism based on economics and law. Indeed, the case for broadening regulators' oversight to include investment banks and other financial institutions is based on three flawed assumptions.

The first is that the same factors that justify expansive powers to close banks and take control of their assets are equally applicable to investment banks and other financial institutions. But the FDIC's interest in commercial banks is unique -- because it guarantees deposits up to $250,000, the FDIC is a bank's most important creditor and has a stake in its health as the representative of American taxpayers. The government's stake and the need to assure that depositors do not lose access to their deposits, even temporarily, arguably justify the FDIC's extraordinary powers. Those factors are not present with investment banks or other financial institutions.

The second flawed assumption is that our bankruptcy laws are not adequate for handling defaults by investment banks or other financial institutions. The Lehman Brothers bankruptcy, which created turmoil in credit markets, is often offered as irrefutable evidence. But the conventional wisdom is based on a serious misreading of the Lehman collapse.

The Lehman bankruptcy was so destructive because the Fed and Treasury had strongly suggested they would bail out any large troubled investment bank, as they did with Bear Stearns. Regulators' sudden shift in policy took Lehman and its potential buyers completely by surprise. If the government had instead made clear that it did not intend to rescue troubled investment banks, Lehman surely would have taken steps to prepare for the possibility of bankruptcy. Lehman and its buyers would not have played chicken with the Fed and Treasury as they did, holding out for a government guarantee of the sales of Lehman's assets.

Nevertheless, the Lehman bankruptcy ultimately proceeded quite smoothly. Contrary to the widespread myth that bankruptcy is time-consuming and ineffectual, Lehman sold its major brokerage assets to Barclays less than a week after filing for bankruptcy. It is now in the process of selling its tens of billions of dollars of less time-sensitive assets at a more deliberate pace. Lawmakers should take a second look at Lehman as they decide what to do with AIG.

The third flawed assumption is that financial firms flirting with distress are somehow worse decision makers than federal regulators. But the opposite is likely true. If the Treasury, FDIC and Fed had authority over investment bank failures, troubled banks would have a strong incentive to negotiate for rescue loans, and their pleas would be heard by regulators influenced as much by political as financial factors. The involvement of three different regulators (and mandatory consultation with the president) would magnify this risk. With bankruptcy, in contrast, the decision of whether and when to file is made by an institution's managers and creditors, who have the best information and their own money on the line.

Extending the FDIC's authority, in conjunction with Treasury and the Fed, to include investment banks and other financial institutions is being sold as a small and pragmatic step. In reality it is a big step, and that big step would be a big mistake.

Mr. Diebold is a professor of economics, finance and statistics, and co-director of the Wharton Financial Institutions Center, at the University of Pennsylvania. Mr. Skeel is a professor of law at the University of Pennsylvania.

Please add your comments to the Opinion Journal forum.

Printed in The Wall Street Journal, page A11

The Washington Times

Close Print

Wednesday, September 16, 2009

Foiling future financial meltdowns

Rep. Spencer Bachus and Rep. Lamar Smith

The anniversary of Lehman Brothers Holdings Inc.'s collapse presents a good opportunity to reflect on the past year's financial crisis and look for ways to prevent future failures. The financial tumult that began in 2007 destroyed trillions of dollars in household wealth and prompted government interventions that cost American taxpayers billions of dollars. While a policy of "deregulation" is often identified as a central cause of the financial crisis, it was in truth misguided government regulations over a period of decades that did more to destabilize our financial system than any other single factor.

In the remaining months before adjournment, Congress will consider ways to fix and modernize our financial infrastructure. Although the administration's health care overhaul has monopolized the public's -- and Congress' -- attention, we cannot neglect the proposed changes to the financial regulatory regime because they will directly affect our nation's future prosperity.

During the last 18 months, the federal government has rescued large and interconnected financial institutions like Fannie Mae, Freddie Mac and American International Group Inc. from collapse. Meanwhile, the American people have grown increasingly alarmed that their government is rewarding corporate failure with taxpayer dollars. Common-sense reforms will ensure that taxpayers never again pay the bill when financial firms fail.

However, the administration's plan adds new layers of bureaucracy to a system that is already too complex. It entrusts the Federal Reserve Board with the responsibility for identifying and containing systemic risk. But expanding the Federal Reserve's regulatory purview can only distract it from its primary mission of conducting our nation's monetary policy, while at the same time promoting a false sense of security among market participants that risk has somehow been magically removed from the financial system.

The administration's plan establishes a new consumer-protection overseer, separate from the risk regulator. This separate agency would result in consumer protection occurring in a vacuum, with potentially inadequate consideration given to the costs, efficacy or impact of the consumer-protection agency's edicts on the safety and soundness of regulated financial institutions.

Proving that memories in Washington are short, this division of regulatory responsibilities is an identical supervisory structure to Fannie Mae's and Freddie Mac's before they collapsed as a result of inadequate oversight. The failure of these companies cost American taxpayers tens of billions of dollars and counting.

Most significantly, the administration's plan would perpetuate the notion that some institutions are "too big to fail," guaranteeing future billion-dollar taxpayer bailouts of ailing financial behemoths.

By contrast, the Republicans' proposal focuses on the causes of the financial meltdown and addresses them with common-sense solutions. Our plan reduces systemic risk by ensuring that the costs of failure are borne by business, clients and creditors, not American taxpayers. By explicitly prohibiting government bailouts, our plan signals to market participants that they must protect their own interests rather than look to the government to save them. Without this bailout ban, big institutions will continue to take big risks, expecting American taxpayers to foot the bill when those risks don't pay off.

Unlike the administration's plan, the Republican proposal brings regulators within a unified structure, plugging gaps in institutional oversight and marrying oversight with consumer-protection functions. The new consolidated agency promotes innovation and consumer choice, but also ensures consistent enforcement of the rules, while allowing the Federal Reserve to focus on its monetary policy mission.

And rather than grant the federal government the authority to spend unlimited amounts of taxpayer and borrowed cash to prop up large firms -- as the administration proposes -- the Republican plan enhances the bankruptcy code to allow the courts, in concert with the financial regulators, to resolve insolvent institutions. It makes clear that creditors and counterparties of failed financial firms will have their claims transparently adjudicated by impartial arbiters according to well-settled legal precedents, not by government employees and politicians meeting behind closed doors. We can only strengthen the financial system if companies are again allowed to reap the rewards of their successes and required to bear the responsibilities of their failures.

Congress, too, must not ignore the failures of the past. Sound financial regulation can prevent future crises. Any serious proposal for reforming the financial regulatory structure must seek to restore market discipline, punish rather than reward failures, and protect taxpayers from having to pay the price for bad business decisions on Wall Street and misguided policies from Washington. The administration's plan simply repeats the mistakes of the past. The Republican proposal provides common-sense reforms by prohibiting bailouts, encouraging innovation, and protecting consumers from dangerous financial products and unscrupulous business practices.

Spencer Bachus of Alabama and Lamar Smith of Texas are Republican members of the U.S. House of Representatives.

THE AMERICAN
The Journal of the American Enterprise Institute

The Peril of Anointing a Favored Financial Few

By Vincent R. Reinhart
Wednesday, October 14, 2009

Filed under: Economic Policy, Boardroom, Government & Politics

The Obama administration's financial reform package hits the trifecta of bad policy making.

We, the people of the United States, uphold equal protection of the law. Equality was first claimed to be a God-given right in the Declaration of Independence. Its practical manifestation took several amendments to the Constitution, significant legislation, and two centuries of struggle. Even today, this equality is not always satisfied in practice, but it should always and everywhere be a national aspiration.

Except, apparently, in the finance industry.

The Obama administration's proposed financial industry reform would institutionalize a two-tier system of banking. Big, well-connected, and complicated firms would receive the special protection of being designated too big to fail. They would operate under their own rules, enforced by their own financial stability cop. In return, they would be held to higher capital and leverage standards, evidently the purchase price of this special status.

In fact, the package hits the trifecta of bad policy making. The White House proposal misdiagnoses the problem, fails to recognize the inherent adverse dynamics of regulation, and treats the bulk of the industry unfairly.

Our fundamental problem is not that institutions deemed too big to fail do not get sufficient scrutiny. Our problem is that some institutions are deemed too big to fail. This designation confers advantages to those institutions: lower funding costs and better access to credit.

The lesson taken away by managers of financial institutions is to get big and complicated so that regulators will fear financial interconnections too much to trust market forces at a time of stress. This complexity makes it impossible to understand the risk profile of a large institution from the outside. Thus, effective supervision is a nonstarter and market discipline is blunted.

The complexity also makes it unlikely that there can ever be a reliable resolution mechanism that regulators would be willing to employ when the going gets tough. Even worse, the resultant complexity lessens managers' ability to understand risk-taking within their own firms. Weak internal oversight opens up the opportunity for abuses that create crises when employees look to their own short-term interest and not the longer-term needs of their firms and their customers.

The administration has the touching faith that additional regulation can correct these inherent flaws. But that neglects that we are here precisely because regulation and supervision failed to govern complicated structures properly.

Moreover, we have no reason to expect that regulators will get better over time. Regulation is decidedly pro-cyclical—it gets tough when markets are volatile and intolerant toward risk and easy during booms. Legislation might get the right treatment of capital and leverage at the outset. Over time, as markets tolerate more risk and the past year recedes into memory, the small cadre of the favored big guys will almost certainly lean on the financial stability regulator for more lenient treatment. This inner circle will also concoct new balance-sheet structures to stay one step ahead of bureaucrats.

Also note that officials have been extremely reluctant to define the perimeter of too-big-to-fail protection. One thing we know is that the perimeter will never shrink, and at times it will grow. After all, Bear Stearns was a moderate-sized investment bank that would be under the radar of too-big-to-fail protection in normal times. When markets were volatile, the Federal Reserve was willing to break a 60-year-old precedent and lend to the nonbank institution to facilitate its takeover.

Lastly, in anointing a favored few, the administration would hardwire unequal treatment for the rest of the industry. The next time markets get skittish, creditors and investors will flee to big firms, recognizing that the U.S. government stands behind them. Thus, small- and medium-sized firms, the engine of innovation, will face an uphill struggle. And the patent unfairness of the system will ultimately undercut the support of the public, already made suspicious by the revolving door connecting the executive suites of our government and the too-big-to-fail firms.

Vincent Reinhart is a resident scholar at the American Enterprise Institute.

FURTHER READING: **Reinhart wrote "The High Cost of Getting the Story Wrong," describing how the narrative first written about the Great Depression was mistaken in many important respects, as is the initial narrative on today's crisis. His other pieces for The American include "Simple Rules for a Complex Financial World" and "When They Were Young," a look back to the last time that Larry Summers, director of the National Economic Council, and Timothy Geithner, secretary of the Treasury, "saved the world."**

image by Darren Wamboldt/Bergman Group.

Opinion

Government made the mess. Now clean it up

Examiner Editorial
October 21, 2009

When Rep. Barney Frank, D-Mass., declared last year that "the private sector got us into this mess," he offered a solution: "The government has to get us out of it." Neither claim was true, of course, but that's the point. In order to maintain the illusion that the Obama administration can deliver an economic recovery, the role of government in causing the crisis in the first place must be obscured.

Thank goodness for people like Peter Wallison of the American Enterprise Institute who skillfully analyze government data. He noted recently in the Wall Street Journal that two-thirds of the bad mortgages -- those "toxic assets" we heard so much about last year -- were bought by government agencies or required to be bought by private companies under government pressure. How could this have happened? The answers are found in Peter Schweizer's superb new book, "Architects of Ruin." Schweizer describes in detail the radicalization of government housing regulations, beginning in the 1970s under the Carter administration.

Then in the Clinton decade, the federal government elevated a political goal -- increasing homeownership among minorities -- over the traditional sound lending principles that prevent the creation of toxic assets. At the same time, Fed Chairman Alan Greenspan's cheap money policies unleashed a flood of lending that encouraged the real estate bubble. The bubble inspired the Washington politicians to engage in more social engineering through housing policy, even as it temporarily insulated them from the inevitable consequences.

We are still dealing with those consequences. In September, delinquencies among U.S. commercial mortgage-backed securities surged to 3.64 percent, up from .54 percent last year. The Mortgage Bankers Association projects that foreclosure rates will keep climbing through until late next year, particularly among Federal Housing Administration loans, 8 percent of which were in foreclosure or delinquent at the end of June, compared with 5.5 percent in early 2006.In 2008, it insured 21.5 percent of all new mortgages, up from fewer than 6 percent in 2007. Yet despite all those failing loans, FHA so far this year has backed nearly 2 million mortgages worth at least $328 billion. What is it they say about the definition of insanity?

You wouldn't know it, however, according to a study from the Pew Research Center's Project for Excellence in Journalism. Pew found that only three storylines have dominated coverage of the financial crisis:Efforts to help revive the banking sector, the battle over the stimulus package and the struggles of the U.S. auto industry. In other words, nothing about the government's -- and Barney Frank's -- dirty little secret.

Forbes.com

On My Mind

Fuel for the Financial Fire

John Taylor, 11.02.09, 12:00 AM ET

Conventional question: did the government's quick intervention on Wall Street last year save us from another Great Depression? Alternative question, one that I prefer: Did government intervention make matters worse? As facts about the crisis roll in, more people are beginning to answer the second question in the affirmative.

First, consider the once controversial view that the crisis was largely caused by the Fed's holding interest rates too low for too long after the 2001 recession. This view is now so widely held that the editorial pages of both the *New York Times* and the *Wall Street Journal* agree on its validity. The low interest rates fueled the housing boom, encouraging adjustable-rate mortgages and other risk-taking searches for yield, which ultimately ended with the bust, defaults and toxic assets on banks' balance sheets. This government intervention, in which the Fed deviated from a policy that had worked well for most of the 1980s and 1990s, turned out to be very harmful.

Next, consider the view that the crisis was prolonged by a misdiagnosis that led to more interventions. When the crisis first flared up, government officials argued that high interest rates in the money markets were due to a shortage of liquidity rather than to risk on the banks' balance sheets. That this was a misdiagnosis is now obvious; the weakness of banks' balance sheets is apparent to everyone. Yet the misdiagnosis led to several harmful interventions, including a sharp increase in Fed liquidity and a sudden cut in interest rates, which depreciated the dollar and led to sky-high gasoline prices and a drop in purchases of automobiles and other durables in the summer of 2008.

Now, with the recent one-year anniversary of the Lehman bankruptcy, people are discussing why the financial crisis worsened so much in the panic last fall. Many still say that the big government mistake was not stopping the failure of Lehman. I do not think the evidence supports that view. Of course the losses for Lehman's creditors and the run on certain money market funds were a jolt to the market. But far worse was the chaotic intervention by the government in the following weeks, including the Treasury Department's not very credible description of how it would remove toxic assets from banks' balance sheets, the huge amount of money it asked for with only two and a half pages of legislation and the scare stories it let loose about another Great Depression if the legislation was not passed. That the financial Armageddon stories were told to members of Congress behind closed doors and then leaked out gradually added to the fears, uncertainty and panic.

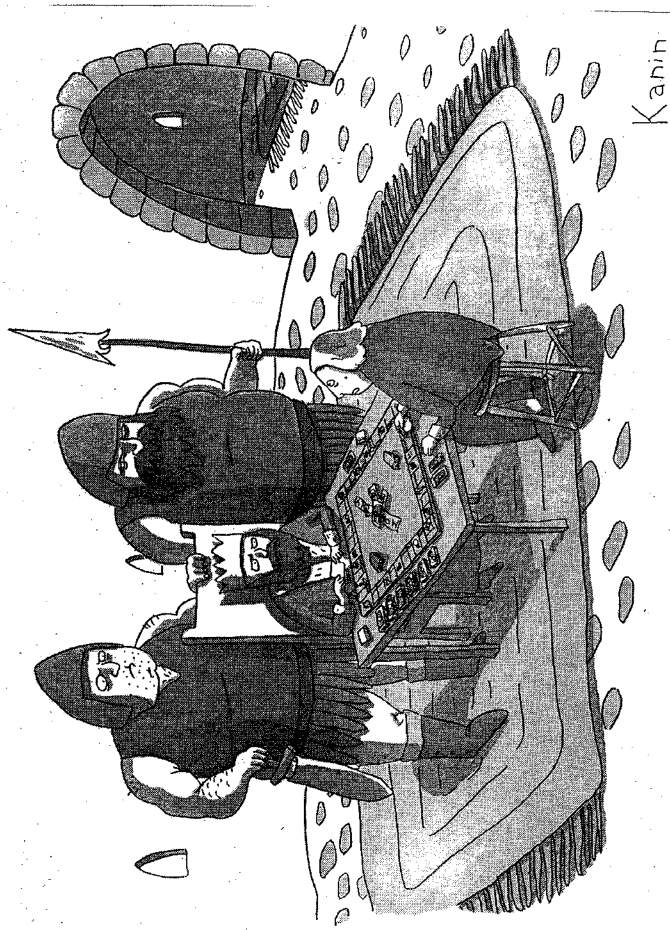
The S&P 500 was at 1252 on Sept. 12, the Friday before the Lehman bankruptcy. It initially fell with the bankruptcy news, but at the Sept. 19 close it had recovered to 1255. It was not until the following week and the frightening rollout of the toxic assets rescue plan that stock prices began to tank. They continued to sink until Oct. 10, when the S&P 500 hit 899 and the government finally clarified what the bailout money would be used for (equity injections). The same patterns are found in stock markets in Europe, Asia and Latin America.

The government interventions during this time of panic were part of a pattern of ad hoc responses starting with the Bear Stearns bailout. No guidance was given following Bear Stearns about the circumstances under which another firm, such as Lehman, would be rescued. Indeed, Timothy Geithner, who led the initial bailout as president of the New York Fed, suggested that more bailouts should be expected. So when the decision was made--without a good legal or economic reason--not to save Lehman, no one was prepared. But the problem was not the lack of intervention so much as the unpredictable, unprincipled pattern of intervention that had been followed for months, a pattern the toxic asset rescue plan revealed for the whole world to see.

This view of how government intervention led to the panic of 2008 is still controversial. Time will tell whether it will be as widely held as the previously controversial view that government interventions caused and prolonged the crisis. But as I see the facts, they are leading in that direction.

John B. Taylor, a senior fellow at the Hoover Institution and professor of economics at Stanford University, is the author of

Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis (Hoover Press, 2009).



"Um, O.K., yes, Boardwalk for Connecticut Avenue."

Testimony

Before the House Financial Services Committee

July 21, 2009

Peter J. Wallison

Arthur F. Burns Fellow in Financial Policy Studies

American Enterprise Institute

Mr. Chairman, Ranking Member Bachus, and members of the Committee:

The Committee has asked the witness today to address a single question: Are some institutions too big to fail and if so what should we do about it? In this testimony I will address those two questions.

Are some institutions too big to fail?

The answer to that question is yes, but as discussed below those institutions are only large commercial banks.

When we say that a company is too big to fail (TBTF), we mean that if it fails it will cause damage to the financial system as a whole—in other words, that its failure will cause many other companies to be seriously weakened or forced into bankruptcy. One of the problems associated with attempting to prevent a systemic breakdown is that it is difficult to determine, in advance, whether the failure of a particular company will cause a systemic breakdown or merely a temporary disruption. For the same reason, it is very difficult to determine, in advance, when a company is TBTF.

Nevertheless, it is important to distinguish between failures that will cause disruption and those that will cause a systemic breakdown of some kind. We should not want to rescue firms from failure if their bankruptcy would only create a temporary disruption in the economy. Those companies should not be regarded as TBTF. If we embarked on a path that would rescue all large firms, because their failure would cause economic disruption, we would create moral hazard. Market discipline would be impaired as creditors thought that they would be rescued by the government. Bad managements and bad business models would be preserved—when, in reality, they should disappear to make room for new and better managements and business models. That's how innovation, efficiency and change occur in our economy.

In theory, however, it is possible to visualize how the failure of a large bank might have more than simply a disruptive effect. Companies deposit their payrolls in banks pending use; individuals deposit funds in banks in order to pay their bills and their mortgages; and small banks deposit funds in large banks as part of the payment system. So when a large bank fails there could be a cascade of immediate losses through the economy. If this happens, companies will not be able to meet their payrolls, individuals will not be able to pay their mortgages, and smaller banks will not be able to meet their obligations to pay out the funds that are withdrawable on demand. In other words, the failure of a large bank can cause a cascade of losses and failures through the economy that might qualify as a systemic breakdown—that is, something more than a mere temporary disruption.

Can a nonbank financial institution create systemic risk and thus be TBTF? On the other hand, it is very difficult to see how a *nonbank* financial institution like a bank holding company, insurance company, securities firm, finance company or hedge fund—no matter what its size—can cause a systemic breakdown or become TBTF. Using a bank holding company (BHC) as an example, it's useful to consider what would happen if a large nonbank financial institution like that were to fail. Importantly, its liabilities are not deposits, and are not withdrawable on demand. As a result, if it fails, very few of its creditors suffer any immediate cash losses. No business, for example, deposits its payroll with a BHC. The BHC may have short term creditors, but unless it's a very financially strong company these short term obligations are likely to be collateralized, and thus short term creditors can make themselves whole by selling their collateral. Most of a BHC's creditors are long term, however, and they will suffer a loss over time. Of course, if the company defaults on any of its debts, all its obligations will usually come due because of cross-default provisions in its outstanding borrowings, and it will thus be forced into bankruptcy. This does not change the condition of long-term creditors; they simply now get in line to receive their share of the bankrupt company's assets, or they approve a plan of reorganization that returns the company to viability if they believe the company will eventually be able to pay them back.

But, still, how does a BHC's bankruptcy create a systemic breakdown? If most of its short-term creditors are made whole through the collateral they hold, and its long-term creditors will eventually take losses as the company goes through bankruptcy, it's not obvious that a systemic breakdown can occur. Even if the long-term creditors take losses, these losses occur over time; they will not be the immediate cash losses that occur when a bank fails. Moreover, the BHC's creditors are very likely to be institutions whose lending is widely diversified. They will lick their wounds, but will not be forced into bankruptcy because of the failure of the bank holding company. They will continue functioning. There would be no systemic breakdown.

Moreover, there is no evidence—none—that credit default swaps (CDS) or other derivatives had anything to do with what happened after Lehman, or that if AIG had been allowed to fail there would have been a catastrophic effect on the financial markets. Lehman's CDS were all cleaned up after its bankruptcy for a total of $5.2 billion exchanged among the various counterparties. Goldman Sachs was the largest CDS counterparty of AIG, with contracts valued at $12.9 billion. But when a spokesman for Goldman was asked what would have been the effect on Goldman if AIG had failed, the answer was that the effect would have been "negligible." As required in most CDS contracts, Goldman had received collateral from AIG before its rescue and had also hedged its AIG exposure. If Goldman, AIG's largest counterparty, would not have suffered significant losses, there is no reason to believe that anyone else would have suffered systemically significant losses either. After all, AIG's CDS—like all CDS—were simply like insurance or reimbursement contracts, with AIG in the position of the insurer. If AIG had failed, its counterparties—like the homeowner whose insurance company fails before he has a loss on his home—would have been required to find another insurer, but they would not have suffered any major loss.

Finally, we read all the time that financial companies are "interconnected," and that's the reason they must be treated specially. It's certainly true that financial firms are interconnected in some sense—that's the nature of financial firms, which are in the business of moving money from a place where it's not well-used to a place where it is better employed. To accomplish that, interconnections are necessary. But the question is not whether these firms are interconnected; it is whether these interconnections create cross-obligations that are so large as to make it probable that if one nonbank financial firm fails it will bring others down with it. There is no evidence for this, and it is highly unlikely for the reasons stated above. After Lehman failed, for example, there was only one case of another company encountering trouble. In that case, a money market mutual fund (the Reserve Fund) was unable to maintain the value of its shares at one dollar, and suffered a run. But beyond that, there is no indication that any other firm suffered serious losses as a result of Lehman's failure. Even the CDSs on Lehman, as noted above, were quickly settled with no known adverse effects.

I should add here, as an aside, that our banking laws have been structured so that the failure of a bank holding company should have no effect on the underlying bank or banks. It's simply the failure of a bank's shareholder. Banks are restricted by banking law and regulations from making loans of significant size to their parent company or affiliates, so that the bank is insulated from the failure of the holding company. The reason is that the holding company is or could be engaged in activities that are riskier than the activities of a bank, and is more likely to fail for that reason. Many on the committee will remember that this restriction was put in place to prevent the extension of the so-called "federal safety net" beyond banks themselves. It is ironic that the administration is now proposing to extend a safety net to the same companies that were not supposed to cost the government anything.

The important point, however, is that if a BHC fails there are very few immediate cash losses that render its creditors unable to meet their own obligations, and thus no cascade of losses through the economy. So if we define a systemic event as a kind of contagion in which the losses of one company spread to others and affect the whole economy, it seems that only the failure of a large bank can have this effect. In other words, in my view, only a large bank can be too big to fail.

The Lehman case. Having said this, there is one category of events that is frequently called a systemic breakdown but is not. Here I am referring to the kind of turmoil that occurred after the failure of Lehman Brothers in September 2008. In that case, there was an immediate freeze-up of lending by banks and other financial intermediaries around the world. Because no direct losses are known to have occurred as a result of Lehman's failure (except the Reserve Fund as described above), this was not a classic case of a systemic breakdown in which losses were transmitted through an economy or financial system. What happened after Lehman Brothers' failure is what is known as a "common shock"—an event that causes a market to stop functioning because the participants have encountered new information that nullifies their previous expectations about the future. In this case, in a classic example of moral hazard, market participants were shocked to learn that—despite the rescue of Bear Stearns the preceding March—the government did not intend to rescue every firm that was larger than Bear. This new and highly adverse information required all market participants to reassess whether their counterparties and borrowers were solvent and safe, since a government rescue could no longer be considered a near certainty. The result was a freeze-up in lending as every major institution hoarded cash while it reassessed the financial condition of its counterparties.

A market freeze-up that results from a common shock is not the same thing as a systemic event and can't be prevented by the regulation of individual institutions. It is the result of a loss of confidence in the future by market participants as a group, not the failure of a particular institution. In reality, there were two common shocks that led to the current crisis. The first was the recognition by market participants in the summer of 2007 that defaults on U.S. mortgages were much higher than expected and mortgage-backed securities backed by these mortgages and rated AAA were not nearly as safe as previously thought. This led to the downgrading of mortgage securities portfolios, the shutdown of the asset-backed securities market, and large financial losses at banks because of the influence of mark-to-market accounting. The second shock was the failure of Lehman. It is highly unlikely that the second shock would not have had the adverse effect that it did without (i) the prior rescue of Bear Stearns, which made Lehman's failure a shock, and (ii) the weakening of bank capital positions because of the shutdown of the asset backed market in mid-2007 and the resulting sharp loss in the value of asset-backed securities.

Bank regulation failed to prevent the losses at individual banks because neither the banks nor their supervisors recognized that the assets they were acquiring in the form of mortgage-backed securities (MBS) and other asset-backed securities (ABS) were not of AAA quality, and that the market for these securities would completely dry up when the poor quality of these securities became known. Even more important, there was no general recognition anywhere in the system that virtually all the world's major banks were buying and holding the same weak assets. This made them all subject to the same effect when the first shock—the loss of value for MBS and ABS—occurred in mid-2007. Once all these institutions were weakened at the same time, they became vulnerable to any shock that caused a sharp loss of confidence about the future. Lehman was that shock.

The crises of the past did not result in similar global financial collapses because most financial institutions were considered adequately capitalized and financially strong enough to survive a substantial change in circumstances. Accordingly, the failure of the large securities firm Drexel Burnham Lambert in 1990, the collapse of the Thai Baht and the Russian default later in that decade, and the failure of Penn Central and the relatively small Herstatt bank in the 1970s, all caused major disruptions in the financial markets when they occurred, but none caused a global financial meltdown. However, once all or almost all major banks are perceived as weak and unstable—as they were in 2008—anything that shook market confidence and disrupted expectations would have had the same effect as Lehman's failure. This would include a major earthquake in the United States, the collapse of the government of a major oil exporting nation, or some other natural or unexpected catastrophe that causes market participants to recalibrate who is safe to deal with and who is not.

This leads to the conclusion that if we are to prevent a financial crisis in the future we should take steps to prevent virtually all major banks from taking on the same risks and becoming weak at the same time. To carry out this policy, it will be necessary to recognize in advance that the elements for a severe common shock are coming together. Thus, in order to prevent a recurrence of the financial crisis, the regulation of commercial banks should focus not only the safety and soundness of the individual bank, but also on safety and soundness of the banking system as a whole. In this way, we can minimize the chances that the failure of a large bank will create a systemic event, and the chances that the banking system as a whole will become so weak that any Lehman-like common shock will cause a financial meltdown. As outlined below, then, we should adopt a form of what might be called macro-prudential regulation.

This strategy also avoids the negative effects on economic growth that would flow from regulating nonbank financial institutions the way we regulate banks. These nonbank institutions are not backed by the federal government, and are still controlled by market discipline. Placing them under government regulation, as the administration proposes, would create moral hazard and give them substantial funding advantages over their smaller competitors. It would be like creating Fannie Maes and Freddie Macs in every sector of the financial economy where these institutions are designated for special regulatory treatment. Even more important, as distinguished from banks, these institutions are supposed to be risk-takers; they are supposed to fail at higher rates than commercial banks. There is no reason to keep them from failing. If we were to regulate all these institutions the way we regulate commercial banks we would suppress the risk-taking that drives growth and innovation in our economy.

If large commercial banks are too big to fail, what should we do about it?

Once we focus on large banks as the most likely sources of systemic risk—and as a bulwark against devastating common shocks—there are a number of steps we can take. These are generally of two kinds: first, to create a means for discovering conditions in the financial markets that might make the financial system vulnerable to a common shock; and, second, to place supervisory limits on banks that will (i) restrict their risk-taking, (ii) limit the their procyclical tendency to lend freely when asset prices are rising, and (ii) ensure that they have the capital to remain strong when the inevitable asset bubbles deflate.

1. *A systemic risk council*. As outlined above, one of the reasons for the current crisis is that virtually all large banks held the same weak assets—weak because they were not of high quality themselves and were subject to rapid devaluation if the market for them disappeared.. One way to address this problem would be to authorize some regulatory body to monitor the worldwide financial system and report to Congress and the public on the possible growth of systemic risk or the factors that might produce a serious common shock. A suitable body for this purpose would be the President's Working Group, reconstituted as a Systemic Risk Council. The Council, which would have a small staff of its own, would be able to use the combined knowledge of the bank regulators, as well as the SEC and the CFTC, to broaden its perspective on the markets.

2. *Metrics of risk-taking*. The bank supervisors, working with banks and bank analysts, should develop metrics and indicators of risk-taking that all banks would be required to publish regularly. One of the continuing functions of supervisors would be to assure that these metrics were kept up to date and consistently calculated and reported by the banks under their supervision. If properly designed, metrics of risk-taking would signal when a bank is holding assets that are subject to sharp declines in values, assets that are highly correlated with assets held by other banks, or that a bank is relying excessively on short term liabilities to fund long term assets. Regular publication of these metrics would enhance market discipline by alerting creditors more effectively to bank risk-taking.

3. *Subordinated debt*. The largest banks should be required to issue subordinated debt that by law could not be bailed out by the government. If the interest rate on these instruments

were to rise substantially above the rate on Treasury securities, it would signal to regulators that the market perceives excessive risk-taking in the issuer bank.

4. *Higher capital requirements for banks*. We could require very large banks to reconsider the benefits of size by imposing higher capital requirements as banks grow above a certain level. In this way, the largest banks would be protecting themselves and the financial system against the possibility of their own failure, and would also have a strong financial incentive not to grow larger.

5. *Countercyclical capital increases and other measures*. We could put in place regulatory requirements that would operate countercyclically, tending to restrain bank growth when asset prices are rising and cushion bank losses when asset prices are falling. For example, requiring higher reserves or capital levels as asset values rise would accomplish this. Eventually, those values will deflate, and at that time we want banks to have enough capital cushions so that market confidence in their health is not eroded. Capital requirements could also be increased if a bank's ratio of short term liabilities to long term assets rises above a predetermined level. This would tend to discourage banks from borrowing short term in the money markets in order to profit from the spread between short term money costs and the returns on long term assets. This would reduce the tendency of banks to act procyclically in fostering asset bubbles.

6. *Countercyclical macro-prudential measures*. The Systemic Risk Council could be authorized to establish an acceptable level of bank growth and impose appropriate limits on growth that are not consistent with these limits. For example, the council could impose a higher leverage ratio on banks when it appears that asset prices have risen too quickly. The leverage ratio for U.S. banks is defined as total common equity divided by total assets. Well capitalized banks must maintain a leverage ratio of 5%; the minimum is 3%. Raising the bank leverage ratio would require banks to sell assets or restrict lending, which would tend to mitigate the growth of asset bubbles. This would be a more direct way of limiting bank contributions to asset bubbles than expecting the Fed to raise interest rates.

If these measures were put in place, and coupled solely with a focus on large commercial banks, we would minimize the likelihood of another financial crisis while maintaining the dynamism and risk-taking that economic growth requires.

PEW

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The argument against a government resolution authority

Peter J. Wallison[1]

The administration's plan for regulatory reform of the financial system includes a proposal that existing government agencies have the authority to resolve failed or failing "systemically important" nonbank financial institutions.[2] In support of this idea, the administration argues that authorizing the government to resolve failing nonbank financial firms is necessary to assure that these firms are resolved in an "orderly" way. The administration's concern seems to be that allowing a systemically important nonbank financial institutions to enter an ordinary bankruptcy proceeding may be "disorderly," and thus contribute to a systemic breakdown.

Nonbank financial institutions that might be systemically important include bank holding companies, insurance companies, securities firms, finance companies, hedge funds, private equity firms, and any other financial-related firm that might—because of its size, role in the financial system or interconnectedness-- cause a systemic breakdown if it fails.

This note argues that while the terms "systemic risk," or "systemic breakdown" can be defined in words, they cannot be used as an effective guide for policy action. We have no way of knowing when or under what circumstances the failure of a particular company will cause something as serious as a systemic breakdown—as distinguished from a simple disruption in the economy. Government officials' inability to forecast or predict the effect of a particular company's failure will mean that the government will take over or rescue from bankruptcy many companies that should be allowed to fail in the normal way. The effect will be to introduce moral hazard into the financial system, as creditors come to believe that large financial companies will be rescued; the financial system will be weakened as inferior managements and business models are saved from extinction by inappropriate government action; and the taxpayers will be required to bear needless costs.

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[2] United States Treasury Department, "Financial Regulatory reform: A New Foundation," June 2009

In addition, a resolution system for nonbank financial institutions is unnecessary to prevent a systemic breakdown because these institutions cannot create a systemic breakdown. A systemic breakdown occurs when the failure of one financial institution causes immediate cash losses to others, rendering them unable to meet their own obligations, and causing losses to cascade through the entire economy. This condition can only be caused by the failure of a large commercial bank, which deprives other banks of the funds they were expecting to be paid, deprives businesses of access to their payroll funds, and deprives individuals of the funds they use for their daily needs. The losses that occur as a result of the failure of a nonbank financial institution are not of this character; they occur over time as obligations that come due are not paid, and affect creditors who are generally diversified, and able to withstand an occasional loss. No business deposits its payroll with a securities firm.

Accordingly, as argued in this note, there is no sound policy basis for providing the government with authority to resolve to nonbank financial institutions, and granting such authority would be harmful to the financial system and the economy generally. Instead, failing nonbank financial institutions, both large and small, should be allowed to go into bankruptcy.

The administration's plan compared to bankruptcy

The administration's plan includes two possible scenarios—a conservatorship, in which the institution is managed back to viability, and a receivership, in which the institution is probably sold or liquidated.

- A conservatorship resembles a chapter 11 bankruptcy proceeding, in which the debtor remains in possession of its assets and continues to operate the business. In both cases, the objective is to return the firm to viability rather than to unwind it. However, in a conservatorship the firm is managed by a government agency, while in chapter 11 the operations of the company remain in the hands of its management.
- A receivership resembles a chapter 7 bankruptcy, in which the debtor is simply wound up—its assets sold and creditors paid off based on their priority.

There are two requirements for a successful exit from chapter 11—the necessary financing (known as debtor-in-possession, or DIP financing) to keep the debtor operating as a going concern, and the agreement of the debtor's creditors to take something less than what they would get in a liquidation in the hope that the debtor will eventually be able to pay them in full. In chapter 11, the debtor prepares a plan for recovery, for approval by the creditors voting by class. If the creditors decide that the company's prospects for eventual profitability are not sufficiently good to give them a chance at recoupment of their losses, they can vote down a plan for recovery and the debtor will be liquidated.

Similarly, if the resolution agency (acting as a conservator) established under the administration's plan determines that there is no further danger of a systemic breakdown, it can liquidate the company—perhaps reimbursing itself for the funds it has extended—or return the company to financial viability if that is feasible and warranted by the circumstances.

What will occur under the administration's plan?

Taking the administration's proposal at face value, it is clear that an "orderly" resolution will begin as something like a conservatorship. This seems essential because—under the administration's assumptions-- the failure of a systemically important company will, by definition, cause a systemic breakdown. In order to avoid that result, the company will have to be kept in operation for a period of time. Assuming that the necessary financing is provided by the government (an issue discussed later), the failed financial institution will be operated by the conservator, at least for a period of time necessary to assure that there is no systemic breakdown when the institution is eventually closed. Under these circumstances, there are three possible outcomes for the failed institution's creditors.

Option 1

If the objective of an orderly resolution is to avoid a systemic breakdown, then all creditors whose loans mature when the government controls the institution will likely be paid in full as these obligations mature. Immediately stopping payments to creditors could—under the rationale for a resolution agency—cause the systemic breakdown that is feared.

Option 2

Another possibility is that the institution's long term creditors are paid currently, but advised that they will not be paid in full at the end of the government's control. This would presumably prevent the immediate losses that would occur if payments to creditors were stopped entirely. In this scenario, the short-term creditors might be paid in full or paid a portion of what they are owed when their loans mature. These options would not be available in bankruptcy, where pre-bankruptcy creditors can only be paid in special circumstances.

Option 3

A third option might be to stop all payments to creditors. This would be closest to a bankruptcy, where the debtor in possession is not generally able to pay pre-bankruptcy creditors unless there is an exemption from the stay provisions that normally apply.

For purposes of the following discussion, we will assume that the administration's plan will involve the use of either option 1 or 2.

Is a resolution authority necessary?

What is the problem for which a resolution authority is the solution? The administration's argument is that the collapse of a large nonbank financial institution could cause a systemic breakdown; to avoid this outcome, the government should have the authority to take over any such firm and resolve it in an orderly manner. However, this idea raises a number of questions.

Systemic breakdown vs. economic disruptions

Is it possible to know in advance whether the failure of a particular firm will cause a systemic breakdown—rather than simply an economic disruption of some kind? The failure of any large company will cause disruption—loss of jobs, losses to creditors, or perhaps the disappearance of an important intermediary. It would not be good policy to set up a resolution system that is used to prevent mere disruption. That would create extensive moral hazard, and have the effect of preserving companies and managements that should be eliminated. If weak business models and bad managements are preserved by government action that would weaken our economic system overall by preventing better business models and better managements from moving up to take their place. The administration has not suggested how a systemic risk would be distinguished from a mere risk of economic disruption, and I do not believe that it is possible to determine, in advance, whether a failing company will create a systemic breakdown or simply a temporary disruption in the economy. Before the government is given the authority to take over failing financial institutions, there should be some understanding of the limits associated with this power. Without such limits, it is highly likely that the power will be used to prevent ordinary disruptions in the economy. The recent rescues of General Motors and Chrysler are examples of government action to prevent economic disruption; no one has contended that the failure of either company—or both—would have created a systemic breakdown.

The recent internal administration debate about whether to rescue CIT is a good example of the pressures that will be brought to bear on the government if a resolution authority exists, and the arguments that will be advanced to promote its use. Again, as in the case of GM and Chrysler, no one, I think, would argue that CIT is a systemically important company. Yet, if newspaper reports are credited, there was active consideration within the administration about rescuing CIT with TARP funds, primarily because its financing was said to be essential for the survival of many small businesses. It is impossible to know whether CIT would have been rescued if a resolution authority had been in place when this debate was carried on, but the political pressure to do so would have been substantial. The only valid reason for setting up a special government resolution authority for financial institutions is to prevent a systemic breakdown, but since it is impossible to tell in advance whether a firm like CIT will create a systemic breakdown if it were to fail, there will be compelling grounds for a government rescue if the authority to do so exists.

What causes a systemic breakdown?

It is very difficult to identify a mechanism through which the failure of a large *nonbank* financial institution could create a systemic breakdown. Although many observers seem to assume that what followed the bankruptcy of Lehman was a systemic breakdown, this is far from clear. First, as John Taylor's analysis has shown, the global freeze-up in lending occurred several days *after* the Lehman failure, and was actually coincident with the Treasury-Fed request for what ultimately became TARP funds. Second, what happened after Lehman is better described as the result of a *common shock* to the market rather than a systemic event. A common shock can occur as a result of any major event that creates widespread uncertainty about the future. Lehman was such a shock, largely because of the moral hazard created by the rescue of Bear Stearns six months earlier. After that rescue, market participants were justified in believing that any firm larger than Bear would also be rescued. When that did not occur with Lehman, all market participants had to recalibrate the risks they faced in dealing with others and the hoarding of cash began. Under this analysis, what followed Lehman's bankruptcy could have been provoked by the assassination of an important world leader, the collapse of the government of a major oil exporting country, or an earthquake in major developed country. A common shock caused by any of these events would of course not be prevented either by regulating systemically important companies or setting up a special government authority to resolve them when they fail.

On the other hand, the term "systemic risk" (what precedes a systemic breakdown) usually refers to the possibility that the failure of a single large firm will cause the failure of others through a contagion-like process in which a cascade of losses flows through an economy. The administration's concern about "systemically important firms" seems based on this idea. However, if a systemic breakdown is the result of losses others actually incurred because of the failure of a large *nonbank* financial institution, then the mechanism by which this contagion or cascading series of losses actually occurs has to be explained. Lehman's bankruptcy did not seem to cause major or systemic losses; with the single exception of the Reserve Fund, no such Lehman-caused failures have been reported. In a market in which there was none of the panic that existed in September 2008, Lehman's failure would not have caused a freeze-up that many have identified as a systemic breakdown. It is noteworthy in this connection that when the large securities firm Drexel Burnham Lambert failed in 1990 there was no major adverse effect on the markets, even though Drexel Burnham was as significant a firm at that time as Lehman was 18 years later.

It is not clear that there *is* a mechanism through which the failure of a *nonbank* financial institution, say, a bank holding company, would be able to transmit losses to other institutions so as to cause the cascade of losses that characterizes a systemic event. It is easy to see how such a cascade of losses could be caused by the failure of a *bank*. Bank borrowings—deposits—are withdrawable on demand. Businesses deposit payrolls in banks, individuals use bank accounts to pay their daily obligations, small banks deposit funds in large banks and rely on large banks for access to the payment system. If a large bank fails, all these parties and many others suffer immediate cash losses and may be unable to meet their obligations, creating a cascade of losses through an economy. This is why the FDIC has the powers it does to step in and resolve a bank immediately.

However, nonbank financial firms borrow for long and short terms, and their short-term borrowings are usually collateralized through repos or asset-backed commercial paper. If such an institution fails, there are no or very few immediate cash losses. The long-term creditors are generally diversified and can take the eventual losses without failing themselves, and the short term or repo creditors have collateral with which to reimburse themselves.

Thus, a strong argument can be made that systemic risk or a systemic breakdown cannot be created by the failure of a *nonbank* financial institution, and if so there is no reason to create a special resolution authority to prevent the failure of such an institution. The same reason also nullifies the argument that a resolution authority would be more flexible in treating pre-bankruptcy creditors (option 2 above), since these creditors do not need special treatment in order to avoid a systemic breakdown.

Even if nonbank financial firms could create a systemic breakdown, is a resolution authority a good idea?

Even if we concede that the failure of a nonbank financial institution *could* create systemic risk, there are still several reasons why a government resolution agency for nonbank financial institutions would be bad policy.

Excessive use

The existence of authority to take over a nonbank financial institution will make takeovers more likely. As discussed above in connection with the CIT issue, once the authority is institutionalized through legislation, regulators will use it to prevent relatively minor disruptions in the economy, not just to prevent systemic risk. Regulators will fear being criticized for the disruption that the failure of a large nonbank financial institution will cause—unemployment, a decline in stock prices, the temporary dislocations that occur to some counterparties or customers—but will be congratulated and treated as heroes if they step in to prevent these events. This is especially likely to occur because, as noted above, there is no effective way to determine in advance whether a particular failure will cause a systemic breakdown or simply a temporary disruption in the economy. And of course, when a rescue has occurred, there will be no way to know whether a particular failure would have resulted in a systemic breakdown if officials had not acted.

Another important factor to consider is the ability of large companies and their managements to influence the government. This cannot be underestimated. There will be pressure on regulators to rescue firms with influential managements, or from states or districts that are represented by influential lawmakers. If the resolution authority exists, it will be used to favor these companies, to the detriment of others, and the probably the taxpayers.

Finally, rescues of firms that should otherwise have failed hurt the firms with better business models and better managements that might have moved up to take the place of the failed firm. Even in the unlikely event that a rescued firm is eventually liquidated, the time between the takeover by the government, the introduction of government funds to keep the company operating and competing, and the prospect that the firm might one day return as a competitor will weaken other, better managed firms in the same market.

Moral hazard

The frequent use of the resolution authority will create moral hazard. A strong case can be made that the rescue of Bear Stearns did just this. After the Bear rescue in March 2008, creditors apparently expected firms larger than Bear to be saved. When Lehman was allowed to fail this expectation was shattered, causing every market participant to reassess the safety and soundness of its counterparties.

So the danger is that, as the resolution authority is used more frequently to prevent economic or financial disruptions, it will tend to create similar expectations for more and more firms, resulting in more moral hazard—and maybe even common shocks on a global scale—any time the authority is *not* used.

Cost

The FDIC administers a fund maintained by deposit insurance levies on all insured banks, and uses that that fund to finance the closing of failed banks and the compensation of the insured depositors. It then reimburses itself by selling off the assets of the failed institution. Any remaining funds are used to pay off the uninsured depositors and other creditors. If the resolution authority were to use options 1 or 2 outlined above in order to avoid what the government believes will be a systemic breakdown, the funds to keep the failed institution operating will have to come from somewhere. One source might be the industry in which the failed company operated; another might be all large nonbank financial institutions. In either case, it would be difficult to set up a fund similar to the bank insurance fund, because the amount necessary for a credible fund would be very high. The total government contribution to AIG is about $175 billion at this point and is likely to go higher. To collect this in advance or to recover it afterward would be a serious tax on the companies called upon to make the contribution, perhaps jeopardizing their health. The likelihood, then, is that the government would have to put up the funds in advance, as it has with AIG, and hope to recover its advances at some later point.

The question then becomes whether the creditors of the failed institution (through bankruptcy), or the taxpayers, should bear this risk or take this loss. There is a credible argument that the taxpayers should pay for something that prevents a systemic breakdown—it is after all something that protects them—but given the difficulty of determining whether a failure will be a systemic event or merely a disruption, this could be a needless expense for the taxpayers, who should not be called upon to pay for mere disruptions. In a very real sense, the administration's proposal could become a permanent TARP system, with the government standing by to rescue any firm that can muster the necessary political backing.

Of course, the more frequently the rescue authority is used, the larger the companies eligible for resolution will become. This is because moral hazard will encourage their creditors to believe they are protected and the restraints of market discipline will grow weaker.

Lack of Expertise

The administration's plan does not propose to establish a new agency for resolving nonbank financial institutions, but rather to turn over the resolution responsibility to the existing supervisor of the failed institution. This is problematic; even if the existing supervisor is familiar with the way institutions of this kind operate, it's unlikely that the agency will have the specialized expertise that is necessary to resolve a failed institution. Nor is it likely that the agency would maintain this expertise on its staff as the FDIC does. The number of institutions that are likely to be resolved through this process—even if the authority is used excessively—is not likely to be large enough to warrant a permanent staff. Even in the current crisis—which is unlikely to be repeated any time soon—there were only three nonbank financial institutions that would have been candidates for special resolution—Bear Stearns, Lehman and AIG.

The alternative—authorizing the FDIC to resolve nonbank financial institutions—is not attractive either. Resolving a bank is nothing like resolving a failed nonbank financial institution. For one thing, most banks are small and are resolved over a weekend. There is almost always a buyer for the assets, and unless the bank is so large as to create a danger of a systemic effect the only creditors the FDIC has to be concerned about are the insured depositors; these are often made whole simply by transferring the deposits to a healthy institution. Because the objective of the resolution authority will be to make sure that the failed institution does not cause a systemic breakdown (assuming it can), the resolution authority will have to be concerned about all its creditors. This factor makes it likely that when a nonbank financial institution fails, there will be no useful expertise anywhere in the government to take it over and resolve it. If we want an example of what that will be like, AIG provides it. Moreover, the FDIC is no paragon. Despite the requirements of prompt corrective action (which means the bank can be closed before it is actually insolvent), the FDIC's average loss on the banks it has closed in 2008 and 2009 has been close to 30%.

Bankruptcy, if necessary, can be improved, and is a better foundation to work from

The absence of any expertise in resolving failed nonbank financial institutions anywhere in the federal government is one strong reason for relying on bankruptcy for most failures. If there is likely to be expertise anywhere in resolving failed financial institutions, it would be in the bankruptcy courts. Bankruptcy judges are appointed for terms of 14 years and develop expertise in all aspects of insolvency and workouts. In particular, bankruptcy judges, magistrates and special masters in large cities are likely to have acquired the specialized knowledge necessary to resolve financial institutions—certainly more knowledge than government officials who have never seen an insolvent securities firm, insurance company, finance company or hedge fund. Any deficiencies in the bankruptcy system for handling large nonbank financial institutions can be addressed by legislation if these deficiencies can be identified. For example, if in a special case the government believes that it has to provide DIP financing, the Treasury could have an advance permanent appropriation of an amount that would be necessary to tide over a bankrupt estate until Congress can act.

Bankruptcy as the first choice for disposing of a failed nonbank financial institution would avoid many of the problems, discussed above, that are associated with creating a government resolution authority. It would assure that the pre-bankruptcy creditors take losses of some kind—avoiding moral hazard and maintaining market discipline—and the rules are known in advance, so creditors will be aware of their rights as well as their risks. Both the Drexel Burnham Lambert bankruptcy in 1990 and the Lehman bankruptcy show that very large nonbank financial institutions can be resolved by the bankruptcy courts without difficulty. Finally, bankruptcy provides a market-based judgment on whether a firm should return to viability. The creditors ultimately decide whether they believe the company has prospects to repay them that outweigh the risk of throwing good money after bad. When a firm is taken over by the government, however, political pressures are more likely to be the determinants of whether the company is returned to viability.

Availability of Debtor-in-possession (DIP) financing

In all but the most extreme cases, debtor in possession financing is likely to be available in bankruptcy. DIP lenders have priority over all pre-bankruptcy creditors, who cannot receive any payment before the DIP financer has been fully paid. So when a distressed nonbank financial institution files for bankruptcy, it is likely to be able to obtain private financing to continue its operations under chapter 11. Again, unless the losses to the pre-bankruptcy creditors are so large that they can cause a systemic breakdown—an outcome that I have argued cannot occur in the case of a nonbank financial firm, no matter what the size-- there seems no reason to set up a government authority to do what the bankruptcy system can do on its own. If, for some reason, DIP financing were unavailable, the government could, as noted above, be authorized to provide the necessary DIP financing to allow the debtor-in-possession to continue operating, but this authority should be available only if there is a showing not only of need but of no available credit elsewhere at any cost.

Uncertainty and unpredictability

Finally, the existence of a government resolution authority creates uncertainty about when it will be invoked. Although, as argued above, it is likely to be invoked more frequently than it should—i.e., to prevent disruption rather than a real systemic breakdown—there will always be companies just on the other side of the "disruption line" that will not be rescued. The unpredictability about whether these borderline cases will be rescued will create arbitrary gains and losses and otherwise be harmful to investors, counterparties and creditors.

The reasons for authorizing a government resolution regime are weak

Most of the reasons to support a federal resolution authority are weak, or can be accommodated equally well in bankruptcy.

Panic runs

Highly leveraged financial institutions are subject to "panic runs" because their liabilities tend to be short-term while their assets are long term. The mismatch means that creditors who can run first are better off than those who run later. This is true, but not relevant. Above, I argue that a nonbank financial institution cannot create a systemic breakdown. Under these circumstances, there is no reason to be concerned about runs at these institutions. To be sure, runs on financial institutions are disruptive and distribute losses arbitrarily by penalizing those who do not act quickly enough to withdraw their assets from a failing institution. However, these are not sufficient reasons for the government to step in and prevent runs. Indeed, the possibility of a run on a financial institution causes investors to pay more attention to monitoring, especially monitoring of leverage. Moreover, a run causes an institution quickly to shut down, putting a stop to its losses and preserving its assets for its creditors. It is also likely to cause a change in management, which in many cases will be an improvement.

Fire sales

Without a government rescue facility, it is argued, a failing nonbank financial institution might be required to engage in a "fire sale" of its assets, driving down the value of the same assets held by other companies that are still solvent. Assuming that the institution is insolvent rather than merely illiquid (in which case Fed liquidity lending under 13(3) would be adequate), a bankruptcy filing invokes an automatic stay on collections by creditors, which prevents the necessity for a fire sale. Of course, this leaves the creditors with losses, but again there is a question whether these losses would result in a systemic breakdown.

Some experts have proposed that bankruptcy law be amended so that repo lenders and credit default swap counterparties—both of which are now exempt from the automatic stay in bankruptcy—would in the future be subject to the stay in cases where systemically important firms enter bankruptcy. There appear to be two reasons for this. First, it is argued that allowing these counterparties to sell their collateral all at once could drive down asset values and weaken other firms that hold the same collateral, and second, subjecting these creditors to the stay would force them to monitor the activities of the borrower more closely. However, it is questionable whether the sale of the collateral of a single institution, no matter how large, would have a significant effect over any extended period in the value of collateral that is otherwise of good quality, and there are many other creditors with the incentives to monitor. In addition, allowing CDSs to retain their exemption from the automatic stay may be necessary because the management (in a DIP case) or the trustee in bankruptcy has discretion whether to accept or reject CDS contracts. This can take time, and meanwhile the CDS counterparty does not know whether to buy a replacement hedge. Finally, and probably most important, there is the difficulty of identifying systemically significant companies in advance; the uncertainty about whether a particular company is within that charmed circle—and thus will have all its repos and CDS transactions stayed—could impair financing or the ability to hedge for companies that are not ultimately rescued.

Bank holding companies

Although there is a procedure (through the FDIC) for working out failed banks, there is no such procedure for BHCs. There is no obvious reason why BHCs should be treated any differently than other nonbank financial institutions. All the arguments above about whether nonbank financial institutions can create a system breakdown apply to BHCs, which are nothing more than ordinary corporations. Banking laws severely restrict transactions between banks and their holding companies, so that the failure of a holding company would not have any adverse impact on the condition of the bank. There may be ways for holding companies to make it difficult for the FDIC to resolve failing banks (For example, the FDIC has a found cases where the failed bank had no employees—they were all employees of the BHC), but the FDIC has sufficient regulatory authority to address minor issues like this. They are not an argument for a special regulatory system for BHCs.

Ironically, the purpose of separating banks and BHCs has been to keep the "safety net" for banks from extending to the riskier activities of the holding company. Now, some in Congress who always argued for keeping holding companies from engaging in commercial activities want to spread the safety net to the financial activities of the holding company—such as securities and insurance, which are said to be riskier than banking. It is sometimes argued that BHCs should be treated differently from other financial institutions because they have an obligation to provide capital to their subsidiary banks, and if the holding company goes into bankruptcy that downstreaming won't be possible. The idea that a BHC has an obligation to be a "source of strength" for a subsidiary bank is a Fed policy, not a law. The Fed has many times asked Congress to enact this idea, and Congress has not done so. There is in fact no obligation for BHCs to support their subsidiary banks.

Complexity

It is sometimes argued that large nonbank financial institutions such as BHCs are very complex and involve many different activities carried on all over the world. That's true, but again that doesn't distinguish BHCs or other nonbank financial institutions from other large companies that operate many subsidiaries involved in many different businesses globally. These companies can and do go into bankruptcy, and there's no sound reason to say that financial institutions must be treated differently. It is very difficult to unwind a global company because of many conflicts of laws and national interests, but again that has not been a reason not to use bankruptcy for nonfinancial institutions. The many airlines that went through the bankruptcy process and emerged to continue in business are testimony to the fact that bankruptcy can handle complex international insolvencies. In addition, the continuing progress of the Lehman bankruptcy, without major problems, is strong evidence that no new government based system is necessary.

Loss of franchise value

Unlike operating companies, financial institutions are particularly vulnerable to the loss of assets if they go into bankruptcy. Their counterparties may not want to trade with them, and their employees might leave for firms with better prospects. Operating companies, like airlines, are able to keep going because they continue to own their equipment and it doesn't make any difference to a passenger whether the airline is in bankruptcy as long as it flies from one place to another. However, many counterparties may not want to deal with a bankrupt financial institution. It is true that financial institutions—which rely more than other firms on public confidence—can disappear overnight if that confidence is lost. However, the first question we should ask is why we should care about this particular weakness. There is no obvious reason why *nonbank* financial firms should be preserved, or their creditors protected against loss, unless it can be shown that their failure will cause a systemic breakdown. BHCs, securities firms, finance companies and hedge funds are risk-takers. They should be allowed to fail; not only does the possibility of failure promote market discipline, but failure itself eliminates bad business models and weak managements, strengthening the market as a whole. So we are back to the same question about how a nonbank financial institution can create systemic risk. If that cannot be established, preserving financial institutions from failure would be very bad policy; it would preserve bad managements and business models and prevent better managements and business models from taking their place.

Conclusion

The administration's proposal to establish a government resolution authority for certain large "systemically important" firms would be a major policy mistake. The administration has not shown how a nonbank financial institutional could cause a systemic breakdown, and in the absence of such a showing there is no reason to create a special resolution authority. Moreover, even if a nonbank financial firm could create systemic risk, the administration has not made clear how officials will be able to determine in advance whether a particular company will cause a systemic break down—rather an merely a temporary economic disruption—if it fails. In the absence of a standard for making such a determination, it is likely that the authority will be used frequently to rescue companies that might only create economic disruption if they fail. This will be especially true with respect to firms with politically powerful backers. Frequent and unnecessary rescues will introduce moral hazard and be costly to the taxpayers, who will end up paying the bills. Under these circumstances, it would be a better policy to use the existing bankruptcy system for failing nonbank financial companies. Not only is there no reason to rescue nonbank financial firms from bankruptcy, sending them through the bankruptcy system provides a degree of certainty to creditors that would not be available in a government run system, and the costs of a bankruptcy are borne by the failed company's creditors rather than the taxpayers. Most important, the bankruptcy system encourages creditors to monitor the companies they lend to, reducing moral hazard and enhancing market discipline.

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TARP Baby: The Administration's Resolution Authority for Nonbank Financial Firms

By Peter J. Wallison

The Obama administration's proposal for a resolution authority to unwind large nonbank financial institutions is another example of its misplaced effort to expand the government's role in the economy. The plan's fundamental flaw is its failure to explain how this or any other government will distinguish in advance between companies whose failure would cause a systemic breakdown and those whose failure will cause only an economic disruption of some kind. Without a way to make this distinction, the resolution authority will simply become a permanent TARP (Troubled Asset Relief Program). Other conceptual flaws in the administration's plan are its effect in creating moral hazard, enhancing the competitive advantages of large nonbank financial firms, increasing the uncertainty faced by creditors of nonbank financial institutions, and adding yet another burden for the taxpayers. In the end, the existing bankruptcy system, which has done a far better job of resolving Lehman Brothers than the Fed has done with AIG, seems a superior policy choice to creating yet another government agency with wide-ranging but ill-defined powers.

One of the most remarkable things about Washington is the fact that poor performance by regulators is regularly rewarded with more funds and broader powers, both conferred by a grateful (and apparently forgetful) Congress. So, we see the Securities and Exchange Commission (SEC) receive more resources and staffing after failing to detect the accounting frauds in Enron and WorldCom and the same agency calling (without shame) for more staff and funding after failing to recognize that Bernard Madoff was running a Ponzi scheme; we have seen all the banking supervisors—the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve—obtain enhanced authority after the savings and loan debacle (when almost 1,600 banks also failed), and now being offered new authority by the Obama administration after failing to use the earlier powers to avert the near collapse of the banking system; and most remarkable of all, we watch in awe as the administration tries to make the Fed the regulator of virtually the entire financial system even though the agency—the closest thing we have had to a systemic monitor—abjectly failed to detect the housing

Key points in this *Outlook*:

- The Obama administration's proposals for regulation of the financial system reveal a misplaced confidence in the efficacy of government regulation.
- The failure of a nonbank financial institution is highly unlikely to create a systemic breakdown, so there is no reason to create a special resolution authority to prevent such a failure.
- Without a way to distinguish a potential systemic breakdown from a simple disruption in the economy, a government-run mechanism for the "orderly resolution" of nonbank financial firms will inevitably become a permanent TARP.
- The bankruptcy system avoids many of the problems associated with creating a government resolution authority and is a superior way of dealing with failed or failing nonbank financial firms.

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bubble that ultimately caused the very kind of crisis the Fed is supposed to prevent in the future. I recently listened to a speech by Christina Romer, the chair of the administration's council of economic advisers, who argued with a straight face that giving this new authority to the Fed would assure "accountability." Orwell would have been envious.

> The point here is that Washington cannot seem to think of any response to a crisis except to increase the power and reach of the government's regulatory system.

The point here is that Washington cannot seem to think of any response to a crisis except to increase the power and reach of the government's regulatory system, despite compelling evidence that it consistently fails to protect the public or maintain the health of the financial system. Many studies, in addition, have shown that regulation adds costs, suppresses competition, and reduces innovation; indeed, in the many areas of the economy in which *deregulation* has occurred—air travel, telecommunications, trucking, and securities brokerage, to name a few—it has uniformly produced innovation and lowered costs. It is time to think of something new, but imagination is not Washington's strong point.

The reigning liberal faith in the efficacy of regulation and government control is nowhere more clearly exhibited than in the proposals of the Obama administration for the regulation of the financial system. A number of earlier *Outlooks* have addressed the deficiencies and simple wrongheadedness of the Obama proposals,[1] but one idea has not received the extensive consideration it warrants—the notion that we need a government-run mechanism for the "orderly resolution" of systemically significant nonbank financial firms when they fail.[2] Of all the Obama proposals for expanding government authority, this is the only one that seems now to have any real traction on Capitol Hill—probably because both the regulatory establishment and the big financial institutions can see benefits in it for them. The administration's argument—building on the aftermath of the Lehman Brothers bankruptcy—is that allowing a "systemically significant" nonbank financial institution to enter an ordinary bankruptcy proceeding will produce a "disorderly" collapse and thus contribute to a systemic breakdown. The proposal applies only to nonbank financial institutions because insured banks and other depository institutions are already covered by a resolution system run by the FDIC.

According to the administration, nonbank financial institutions that might be systemically important include bank holding companies, insurance companies, securities firms, finance companies, hedge funds, private equity firms, and any other financial-related firm that might—because of its "size, leverage or interconnectedness"—cause a systemic breakdown if it fails. The fact that none of those terms has any definitive content is a tip-off that what we are talking about is unfettered discretion.

This *Outlook* argues that while the terms "systemic risk" or "systemic breakdown" can be defined in words, they cannot be used as an effective guide for policy action. We have no way of knowing when or under what circumstances the failure of a particular company will cause something as serious as a systemic breakdown—as distinguished from a simple disruption in the economy. Government officials' inability to forecast or predict the effect of a particular company's failure will mean that the government will take over or rescue from bankruptcy many companies that should be allowed to fail in the normal way. As the late Irving Kristol observed, "it is politically impossible for any state to cope with the bankruptcies associated with economic risk taking."[3] Once the government takes responsibility for preventing systemic breakdowns, it will use that authority liberally to prevent mere economic disruption. The bailouts of General Motors and Chrysler make clear how this will work. Moreover, it will be impossible to tell, after the government resolution authority has acted, whether the particular failure would actually have caused a systemic breakdown, making Congress's ability to oversee the use of this new power wholly ineffective. The result will be to introduce moral hazard into the financial system, as creditors come to believe that large financial companies will be rescued; the advantage this will confer on large firms will be competitively significant, driving small firms out of markets in which they could formerly compete and weakening the financial system as inferior managements and business models are saved from extinction by government action—all ultimately paid for by the taxpayers.

In addition, a resolution system for *nonbank* financial institutions is unnecessary to prevent a systemic breakdown. Such an event occurs when the failure of one financial institution causes such large losses to others that they are unable to meet their own obligations, thus causing losses to cascade through the entire economy. Losses of this kind, however, can only be caused by the failure of a large commercial bank, which deprives other banks of the funds they were expecting to be paid, deprives businesses of access to their working capital or payroll funds, and deprives individuals of the funds they use for their daily needs. The losses that occur when a nonbank financial institution fails are not of this character; they occur over time as obligations that come due are not paid and affect creditors and counterparties that are generally diversified and able to withstand an occasional loss. For example, a bank failure could deprive a business of the cash with which to meet its payroll, but it is highly unlikely that the failure of a nonbank financial institution will have a similar effect on the diversified lenders that are likely to be its counterparties.

Accordingly, there is no sound policy basis for providing the government with authority to resolve nonbank financial institutions, and granting such authority would be harmful to the financial system and the economy generally. Instead, failing nonbank financial institutions, both large and small, should be allowed to go into bankruptcy. This *Outlook* will show that the administration's proposal is both unnecessary and potentially harmful to the future stability of the financial system.

The Administration's Plan Compared to Bankruptcy

The administration's plan includes two possible scenarios—a conservatorship, in which the institution is managed back to viability, and a receivership, in which the institution is probably sold or liquidated. A conservatorship resembles a chapter eleven bankruptcy proceeding, in which the debtor remains in possession of its assets and continues to operate the business. In both cases, the objective is to return the firm to viability rather than to unwind it. However, in a government-mandated conservatorship, the firm is managed by a government agency, while in chapter eleven the operations of the company remain in the hands of its management. A receivership resembles a chapter seven bankruptcy, in which the debtor is simply wound up—its assets sold and creditors paid off based on their priority.

There are two requirements for a successful exit from chapter eleven—the necessary financing (known as debtor-in-possession, or DIP financing) to keep the debtor operating as a going concern, and the creditors' agreement to take less than they would get in a liquidation, in the hope that the debtor will eventually be able to pay them in full. In chapter eleven, the debtor prepares a plan for recovery, for approval by the creditors voting by class. If the creditors decide the company's prospects for eventual profitability are not sufficiently good to give them a chance to recoup their losses, they can vote down a plan for recovery, and the debtor will be liquidated.

Similarly, under the administration's plan, if the resolution agency (acting as a conservator) determines that there is no further danger of a systemic breakdown, it can liquidate the company—perhaps reimbursing itself for the funds it has extended—or return the company to financial viability if that is feasible and warranted by the circumstances. The administration's plan would, under most circumstances, assign the responsibility for resolving a failing financial firm to the FDIC and is thus another example of rewarding an agency whose performance has not been exemplary. In the last two years, the FDIC has resolved approximately 124 failing financial institutions. It does this under rules established in the FDIC Improvement Act of 1991, which empowered the agency to take over failing banks before they become insolvent. The purpose of this authority—called "prompt corrective action" (PCA)—was added to the FDIC's bank resolution arsenal so the agency could better protect the deposit insurance fund from the losses that occur when a failing bank's liabilities exceed the value of its assets. Nevertheless, the agency is seldom able to do so. The FDIC's average loss on the assets of the banks it has closed over the last two years is approximately 25 percent.[4] If this is the record with respect to banks, it is fanciful to believe that the losses will be less for the much more complex and substantially larger nonbank financial institutions that the administration expects the FDIC to resolve—with no special expertise in the matter—in the future.

What Will Occur under the Administration's Plan?

Taking the administration's proposal at face value, an "orderly" resolution will begin as something like a conservatorship. This seems essential because—under the administration's assumptions—the failure of a systemically important company will, by definition, cause a systemic breakdown. In order to avoid that result, the company will have to be kept in operation for a period of time. Assuming that the necessary financing is provided by the government (an issue discussed later), the failed financial institution will be operated by the conservator, at least for a period of time necessary to assure there is no systemic breakdown when the institution is eventually closed. Under these circumstances, there are three possible outcomes for the failed institution's creditors.

Option One. If the objective of the orderly resolution is to avoid a systemic breakdown, then all creditors whose loans mature when the government controls the institution will likely be paid in full. This is because the establishment of a conservatorship for the failing company is likely to be an event of default under its loan arrangements, which normally accelerates the maturity of its obligations. It is unlikely that the FDIC or any other government agency that takes over a nonbank financial institution will immediately stop payments to these creditors. This could—under the rationale for establishing a resolution agency—cause the systemic breakdown that the entire resolution structure is supposed to prevent.

Option Two. Another possibility is that the institution's long-term creditors are paid a portion of what they are owed but advised that they will not be paid in full at the end of the government's control. This would presumably prevent the immediate losses that would occur if payments to creditors were stopped entirely. This option would not be available in bankruptcy, in which prebankruptcy creditors can be paid only in special circumstances.

Option Three. A third option might be to stop all payments to creditors. This would be closest to a bankruptcy, where the debtor in possession is not generally able to pay prebankruptcy creditors unless there is an exemption from the stay provisions that normally apply. However, this is highly unlikely, since it would vitiate the entire rationale for setting up a government agency to resolve a failing nonbank financial firm. For this reason, in the following discussion, we will assume that the administration's plan will involve the use of either option one or two.

Is a Resolution Authority Necessary?

What is the problem for which a resolution authority is the solution? The administration's argument is that the collapse of a large nonbank financial institution could cause a systemic breakdown; to avoid this outcome, the government should have the authority to take over any such firm and resolve it in an orderly manner. However, the administration's rationale for its proposal is highly questionable.

Systemic Breakdown versus Economic Disruption. Is it possible to know in advance whether the failure of a particular firm will cause a systemic breakdown, rather than simply an economic disruption of some kind? The failure of any large company will cause disruption—loss of jobs, losses to creditors, or perhaps the disappearance of an important intermediary. Although setting up a resolution system that would actually prevent a systemic breakdown might make sense, it would not be good policy to authorize a resolution system that, in practice, is used to prevent mere disruption. That would create extensive moral hazard and have the effect of preserving companies and managements that should be eliminated. If weak business models and bad managements are preserved by government action, that would weaken our economic system overall by preventing better business models and better managements from moving up to take their place.

It appears that there was a collapse of market confidence when the U.S. government appeared to be panicking, rather than a fear in the market that Lehman's collapse would cause losses to cascade through the world's economy.

The administration has not suggested how a systemic risk would be distinguished from a mere risk of economic disruption, and it is far from clear that it is possible to make such a determination in advance. Yet the distinction between the two is crucial; it provides the only limitation on the government's power to take over failing financial institutions. Without such limits, it is highly likely that the power will be used to prevent ordinary economic disruption rather than the far more dangerous systemic breakdown. The recent rescues of General Motors and Chrysler are examples of government action to prevent economic disruption; no one has contended that the failure of either company, or both, would have created a systemic breakdown. Without clear limits, the resolution authority the administration is proposing will inevitably become a permanent TARP for the financial system.

What Causes a Systemic Breakdown? In advancing its various proposals, the administration has gotten a free pass on the question of what a systemic risk actually is and how a systemic breakdown might occur. Administration spokespersons regularly describe systemically important firms as those that are the "largest, most leveraged and most interconnected"[5] but never say how these factors might create systemic risk. Even assuming that the administration could describe how it would distinguish between a systemic breakdown and an economic disruption, it still would be necessary to explain how a nonbank financial firm would cause a systemic breakdown if it were to fail.

Pointing to the events that occurred after Lehman's collapse a year ago is not sufficient. Although many observers seem to assume that what followed the bankruptcy of Lehman was a systemic breakdown, this is far from clear. The term systemic risk usually refers to the possibility that the failure of a single large firm will cause the failure of others through a contagion-like process in which a cascade of losses flows through an economy. The administration's concern about systemically important firms seems based on this idea since the Treasury proposes to regulate all large firms as a way of preventing systemic risk. However, applying this standard, Lehman's bankruptcy did not seem to cause major or systemic losses. With the single exception of the Reserve Fund—a money market mutual fund that had invested heavily and imprudently in Lehman's commercial paper—no such Lehman-caused failures have been reported. In a market in which there was none of the panic that existed in September 2008, Lehman's failure would not have caused a freeze-up that many have identified as a systemic breakdown. It is noteworthy in this connection that when the large securities firm Drexel Burnham Lambert failed in 1990, there was no major adverse effect on the markets, even though Drexel Burnham was as significant a firm at that time as Lehman was eighteen years later.

> The more moral hazard is introduced into the system, the greater the competitive advantage it will provide to the larger companies that will be eligible for resolution.

What happened after Lehman is better described as the result of a "common shock" to the market rather than a systemic breakdown. A common shock can occur as a result of any major event that creates widespread uncertainty about the future. Lehman was such a shock, largely because of the moral hazard created by the rescue of Bear Stearns six months earlier. After the Bear rescue, market participants were justified in believing that any firm larger than Bear would also be saved from bankruptcy. When that did not occur in Lehman's case, all market participants had to recalibrate the risks they faced in dealing with others, and the hoarding of cash began. Under this analysis, what followed Lehman's bankruptcy could have been provoked by the assassination of an important world leader, the collapse of the government of a major oil exporting country, or an earthquake in a major developed country. A common shock caused by any of these events would, of course, not be prevented either by regulating systemically important companies or setting up a special government authority to resolve them when they fail. For example, as Stanford University economist John B. Taylor's analysis has shown,[6] the global freeze-up in lending occurred several days *after* the Lehman failure, and was actually coincident with the Treasury-Fed request for what ultimately became TARP funds; it appears that there was a collapse of market confidence when the U.S. government appeared to be panicking, rather than a fear in the market that Lehman's collapse would cause losses to cascade through the world's economy.

If a systemic breakdown is the result of losses others actually incur because of the failure of a large nonbank financial institution, then the administration should explain the mechanism by which this contagion or cascading series of losses actually occurs. Indeed, it is not clear that there is a mechanism through which the failure of a nonbank financial institution—say, a bank holding company—would be able to transmit losses to other institutions. It is easy to see how such losses could be caused by the failure of a large depository institution such as a commercial bank. Bank borrowings—deposits—are withdrawable on demand. Businesses deposit payrolls in banks, individuals use bank accounts to pay their daily obligations, small banks deposit funds in large banks and rely on large banks for access to the payment system. If a large bank fails, all these parties and many others suffer immediate cash losses and may be unable to meet their obligations, creating an expanding series of defaults through an economy. This is the classic systemic breakdown and why the FDIC has the power to step in and resolve a large commercial bank immediately.

Nonbank financial firms borrow for long and short terms, however, and their short-term borrowings are usually collateralized through repurchase (repo) agreements or asset-backed commercial paper. Both long- and short-term creditors of nonbank financial institutions are generally diversified and can take the eventual losses without becoming insolvent or illiquid themselves. In addition, the short-term or repo creditors have collateral that should enable them to recoup at least a substantial portion of their losses. Some observers argue that repo financing used by nonbank financial institutions can create conditions very similar to a bank run.[7] However, these discussions generally do not explain what is systemically harmful about a run of this kind on a nonbank financial institution. Repo lenders are very different from depositors; in addition to the collateral they hold, they are much more likely to be diversified and thus less affected by the failure of a nonbank financial institution to which they have lent funds. In other words, although a "run" on a nonbank financial institution has similarities to a run on a bank, it does not have—it probably cannot have—the same systemic effects as a depositors' run that causes a large depository institution like a commercial bank to close.

Thus, one can make a strong argument that systemic risk or a systemic breakdown cannot be created by the failure of a *nonbank* financial institution, and if so, there is no reason to create a special resolution authority to prevent the failure of such an institution. The same reasoning also nullifies the argument that a resolution authority would be more flexible in treating prebankruptcy creditors (option two above), since these creditors—which are largely diversified institutional lenders who would not be severely affected by the failure of large nonbank financial institution—do not need special treatment in order to avoid a systemic breakdown.

Resolving a bank is nothing like resolving a failed nonbank financial institution.

Additional Dangers From a Resolution Authority

Even if we concede that the failure of a nonbank financial institution *could* create systemic risk, there are still several reasons a government resolution agency for nonbank financial institutions would be bad policy.

Excessive Use. The existence of authority to take over a nonbank financial institution will make such takeovers more likely. As discussed above, once the authority is institutionalized through legislation, officials will use it to prevent disruptions in the economy, not just a systemic breakdown. Regulators will fear being criticized for the disruption that the failure of a large nonbank financial institution will cause—unemployment, a decline in stock prices, the temporary dislocations that occur to some counterparties or customers—but will be congratulated and treated as heroes if they step in to prevent these events. This is especially likely to occur because, as noted above, there is no effective way to distinguish in advance between a failure that will cause a systemic breakdown and one that will merely cause a temporary economic disruption.

Another important factor to consider is the ability of large companies and their managements to influence the government, and the ability of influential constituencies and powerful lawmakers to force government into granting special benefits and dispensations. This cannot be underestimated. There will be pressure on regulators to rescue firms with influential managements, or from states or districts that are represented by influential lawmakers. If the resolution authority exists, it will be used to favor these companies, to the detriment of others, and probably the taxpayers.

Finally, as noted above, rescue of a firm that should otherwise have failed hurts the firms with better business models and better managements that might have moved up to take the place of the failed firm. Even in the unlikely event that a rescued firm is eventually liquidated, rather than simply returned to health under government control, the time between the takeover by the government, the introduction of government funds to keep the company operating and competing, and the prospect that the firm might one day return as a competitor will suppress competition from other, better-managed firms in the same market.

Moral Hazard and Competitive Advantages for Large Companies. The frequent use of the resolution authority will create moral hazard. A strong case can be made that the rescue of Bear Stearns did just this. After the Bear rescue in March 2008, creditors apparently expected firms larger than Bear to be saved. When Lehman was allowed to fail, this expectation was shattered, causing every market participant to reassess the safety and soundness of its counterparties.

So the danger is that as the resolution authority is used more frequently to prevent economic or financial disruptions, it will tend to create similar expectations for more and more firms, resulting in more moral hazard—and maybe even common shocks on a global scale—any time the authority is *not* used. The more moral hazard is introduced into the system, the greater the competitive advantage it will provide to the larger companies that will be eligible for resolution. This is because the potential of government support to prevent failure will encourage their creditors to believe they are less risky than other companies, weakening the usual restraints of market discipline. These apparently protected companies will be able to attract more capital and credit than their smaller competitors, which will gradually be forced out of contested markets.

Cost. As outlined above, the administration's concept of an "orderly" resolution must involve placing a failed or failing institution in a kind of conservatorship so that it continues operating. Otherwise, abruptly closing it down will cause what the resolution authority was supposed to prevent—a systemic breakdown. Accordingly, the agency in charge of the conservatorship will have to provide the necessary funding so the company can continue to operate under government control. This will entail paying off its creditors in whole or in part and retaining its employees and necessary offices and equipment. All of this will require the expenditure of taxpayer funds, unless there is another funding source. The FDIC administers a fund maintained by deposit insurance levies on all insured banks and uses that fund to finance the closing of failed banks and the compensation of the insured depositors. It then reimburses itself by selling off the assets of the failed institution. Any remaining funds are used to pay off the uninsured depositors and other creditors.

Where will the funds come from for the resolution of nonbank financial institutions? One source might be the industry in which the failed company operated while another might be all large nonbank financial institutions. In either case, it would be difficult to set up a fund similar to the bank insurance fund, because the amount necessary for a credible fund would be very high. The total government contribution to AIG exceeds $100 billion at this point. This is considerably more than the FDIC's bank insurance fund which was $52.4 billion at its highest point in 2007.[8] To collect a sum this large in advance or to recover it afterward would require a serious levy on the companies called upon to make the contribution, perhaps jeopardizing their health but certainly jeopardizing their ability to compete outside the United States with foreign companies not subject to such a cost. The likelihood, then, is that—if a resolution agency is established—the taxpayers will ultimately end up footing the bill.

Lack of Expertise. The administration does not propose to establish a new agency for resolving nonbank financial institutions, but rather to turn over the resolution responsibility to the FDIC. This is problematic: resolving a bank is nothing like resolving a failed nonbank financial institution. For one thing, most banks are small and are resolved over a weekend. There is almost always a buyer for the deposits, and unless the bank is so large as to create a danger of a systemic effect, the only creditors the FDIC has to be concerned about are the insured depositors; these are often made whole simply by transferring the deposits to a healthy institution. However, the institutions that will be covered by the administration's proposed resolution authority will be very large and complex. Because the objective of the resolution authority will be to make sure the failed institution does not cause a systemic breakdown (assuming it can), the resolution authority will have to be concerned about all its creditors, not just depositors. The FDIC will have no more experience in rescuing a large and complex nonbank financial institution than any other agency. If we want an example of what that will be like, AIG provides it. That takeover has resulted in a huge transfer of government funds to AIG with no end yet in sight. AIG's once-healthy subsidiaries have not yet been sold to reimburse the taxpayers, and the final status of AIG is not yet resolved—a year after it was taken over.

When Bankruptcy is a Better Foundation. The absence of any expertise in resolving failed nonbank financial institutions anywhere in the federal government is one strong reason for relying on bankruptcy for most failures. If there is likely to be expertise anywhere in resolving failed financial institutions, it would be in the bankruptcy courts. Bankruptcy judges are appointed for terms of fourteen years and develop expertise in all aspects of insolvency and workouts. In large cities, bankruptcy judges, magistrates, and special masters are likely to have acquired the specialized knowledge necessary to resolve financial institutions—certainly more knowledge than government officials who have never seen an insolvent securities firm, insurance company, finance company or hedge fund. Any deficiencies in the bankruptcy system for handling large nonbank financial institutions are beyond the scope of this *Outlook*, but in any event can be addressed by legislation if these deficiencies are identified with specificity.

Bankruptcy as the first choice for disposing of a failed nonbank financial institution would avoid many of the problems associated with creating a government resolution authority. It would assure that the prebankruptcy creditors take losses of some kind—avoiding moral hazard and maintaining market discipline—and the rules are known in advance, so creditors will be aware of their rights as well as their risks. Both the Drexel Burnham bankruptcy in 1990 and the Lehman bankruptcy show that very large nonbank financial institutions can be resolved by the bankruptcy

Bankruptcy as the first choice for disposing of a failed nonbank financial institution would avoid many of the problems associated with creating a government resolution authority.

courts without difficulty. Indeed, the bankruptcy system has done a much more efficient job in resolving Lehman Brothers than the Fed has done with AIG. Within a few weeks of Lehman's filing, the trustee had sold off Lehman's broker-dealer, its investment management, and its investment banking business to four different buyers. None of this dispatch has been present in the AIG case. Finally, bankruptcy provides a market-based judgment on whether a firm should return to viability. The creditors ultimately decide whether they should forgo the partial repayment they will receive in a liquidation, in the hope that they will eventually receive full repayment if the debtor is returned to viability. When a firm is taken over by the government, however, political pressures—by important members of Congress or powerful constituencies—are more likely to be the determinants of whether the company survives. Again, General Motors and Chrysler are examples of this phenomenon. Sending failed nonbank financial institutions to the bankruptcy courts is the resolution mechanism embodied in HR 3310 (The Consumer Protection and Regulatory Enhancement Act), introduced in late July by the House Republican leadership. This seems a sensible alternative to the administration's plan.

Uncertainty and Unpredictability. Finally, the existence of a government resolution authority creates uncertainty about when it will be invoked and which creditors will be paid in what order. Although, as argued above, it is likely to be invoked more frequently than it should—that is, to prevent disruption rather than a real systemic breakdown—there will always be companies just on the other side of the "disruption line" that will not be rescued. The unpredictability about whether these borderline cases will be rescued will create moral hazard, arbitrary losses as well as arbitrary gains, and otherwise pervert the incentives of investors, counterparties, and creditors.

Other Special Cases

Bank Holding Companies. Although there is a procedure (through the FDIC) for working out failed banks, there is no such procedure for resolving bank holding companies (BHCs). There is no obvious reason why BHCs, which are companies that control banks, should be treated any differently than other nonbank financial institutions. All the points above about whether nonbank financial institutions can create a systemic breakdown apply to BHCs. Banking laws severely restrict transactions between banks and their holding companies, so that the failure of a holding company would not have any adverse effect on the condition of the bank and vice versa. There may be ways for holding companies to make it difficult for the FDIC to resolve failing banks (for example, the FDIC has found cases in which the failed bank had no employees—they were all employees of the BHC), but the FDIC has sufficient regulatory authority to address minor issues like this. They are not an argument for a special regulatory system for BHCs.

Ironically, the purpose of separating banks and BHCs has been to keep the "safety net" for banks from extending to the riskier activities of the holding company. Now, some in Congress and elsewhere who have always argued for keeping holding companies from engaging in commercial activities in order to "protect the safety net," appear willing to spread the safety net to the financial activities of BHCs—such as securities and insurance—which are said to be riskier than banking and not appropriate for safety net coverage. The administration's proposal for a resolution authority and other proposals to allow the FDIC to take control of BHCs would now extend the safety net to BHCs, reversing many years of congressional policy, putting much more pressure on the deposit insurance fund, and raising doubt about the priority of BHC creditors. It is sometimes argued that BHCs should be treated differently from other financial institutions because they have an obligation to provide capital to their subsidiary banks, and if the holding company goes into bankruptcy, the FDIC will not have access to the capital that could be downstreamed to the bank. The idea that a BHC has an obligation to be a "source of strength" for a subsidiary bank is a Fed policy, not a law. It is one of those policies that the Fed uses to justify its continued authority to regulate and supervise BHCs. The Fed has asked Congress many times to enact this idea, and Congress has not done so. There is in fact no legal obligation for BHCs to support their subsidiary banks.

Complexity and International Operations. One other argument in support of a government resolution authority for nonbank financial institutions such as BHCs is that they are very complex and involve many different activities carried on all over the world. When such an institution fails, the many conflicts of laws and national interests make it difficult to unwind. That is certainly true, but the problem is not solved by turning it over to a government resolution authority. Resolving the many differences and conflicts among countries with jurisdiction over a failed financial institution is a task for diplomacy and intergovernmental organizations such as the International Monetary Fund and the Financial Stability Board. Whether the actual resolution of a company is handled by a government agency like the FDIC or through an ordinary bankruptcy proceeding will not make these problems more or less tractable.

Conclusion

The enactment of the administration's proposal to establish a government resolution authority for certain large systemically important firms would be a major policy mistake. The administration has not shown how a nonbank financial institutional could cause a systemic breakdown, and in the absence of such a showing, there is no reason to create a special resolution authority. Moreover, even if a nonbank financial firm could create systemic risk, the administration has not made clear how officials will be able to determine in advance whether a particular company will cause a systemic breakdown—rather than merely a temporary economic disruption—if it fails. In the absence of a standard for making such a determination, it is likely that the authority will be used frequently to rescue companies that might only create economic disruption if they fail. This will be especially true with respect to firms with politically powerful backers. Frequent and unnecessary rescues will introduce moral hazard and be costly to the taxpayers, who will end up paying the bills.

Under these circumstances, it would be better policy to use the existing bankruptcy system for failing nonbank financial companies. Not only is there no reason to rescue nonbank financial firms from bankruptcy, but sending them through the bankruptcy system also provides a degree of certainty to creditors that would not be available in a government run system, and the costs of a bankruptcy are borne by the failed company's creditors rather than the taxpayers. Most importantly, the bankruptcy system encourages creditors to monitor the companies they lend to, reducing moral hazard and enhancing market discipline.

Notes

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2. U.S. Department of the Treasury, "Financial Regulatory Reform: A New Foundation," FinancialStability.gov, www.financialstability.gov/docs/regs/FinalReport_web.pdf (accessed September 30, 2009).

3. Editorial, "Irving Kristol's Reality Principles," *Wall Street Journal*, September 19, 2009.

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5. See, for example, House Financial Services Committee, "Timothy F. Geithner, Written Testimony on Financial Regulatory Reform," 111th Cong., 1st sess., September 23, 2009, 3, available at www.house.gov/apps/list/hearing/financialsvcs_dem/testimony_-_sec_ geithner.pdf (accessed September 28, 2009).

6. John B. Taylor, *Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis* (Stanford, CA: Hoover Institution Press, 2009).

7. See, for example, Gary Gorton, "Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007" (presentation, Federal Reserve Bank of Atlanta's 2009 Financial Markets Conference: Financial Innovation and Crisis, Jekyll Island, GA, May 11–13, 2009), available at www.frbatlanta.org/news/CONFEREN/09fmc/gorton.pdf (accessed September 21, 2009).

8. FDIC, "Statistics at a Glance: Historical Trends as of June 30, 2009," available at www.fdic.gov/bank/statistical/stats/2009jun/FDIC.pdf (accessed September 21, 2009).

American Enterprise Institute for Public Policy Research

On the Issues

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Getting the Story Right: The True Origin of the Financial Crisis

One year ago, on September 14, Lehman Brothers declared bankruptcy. The next day the Dow fell five hundred points. Soon thereafter, the government essentially nationalized AIG, made Goldman Sachs and Morgan Stanley into bank-holding companies, and petitioned Congress for aid. In early September, Fannie Mae and Freddie Mac had been placed in government conservatorship. These events followed the bursting of the housing bubble. We present here three essays written by AEI scholars in the spring and summer of 2009 on the origins of the financial crisis whose reverberations we continue to feel today. Vincent R. Reinhart sets the stage by reminding us of the importance of getting the story of what happened right, as policy recommendations flow from our understanding of what occurred. He also tells us that "the narrative first written about the Great Depression was wrong in many important respects." John H. Makin and Peter J. Wallison focus on the misguided policies that contributed to the crisis. In a new Economic Outlook, *Makin discusses three important lessons of the financial crisis that should be understood in order to enable a faster, more effective policy response to future crises.*

The High Cost of Getting the Story Wrong

By Vincent R. Reinhart

The global financial crisis has been with us for more than a year. Despite all its twists and turns, the United States is only now entering the most expensive phase of the crisis. Given the current political climate and widespread misunderstanding of the origins of our problems, the cost is unfortunately going to be very considerable and long lasting.

The most expensive stage of a financial crisis is not the initiating economic loss—in our case, an unsustainable boom in residential construction that left too many houses and a mountain of debt. Nor are the largest losses racked up as investors withdraw from risk, markets freeze, and balance sheets implode. Policy missteps, including the continuing confusion of solvency problems for liquidity ones, no doubt add to the tab. These costs, while they may be big, pale to insignificance compared to what follows.

The most expensive stage of a financial crisis occurs when society tries to explain to itself what just happened. The resulting narrative is not the product of one person or institution. Rather, it gets written in the tell-all "tick-tocks" of major

Key points in this *On the Issues*:

- Determining the true causes of the financial crisis has significant impact on America's response to it.
- Distorted explanations of the financial crisis are pervasive and destructive.
- Government policies, not market failure, were the main causes of the financial crisis.

newspapers, the inside accounts in bestsellers, the speeches of leading officials, and the punch lines of late-night comedians. The narrative determines our attitudes toward the actors and events of the crisis. It also identifies the structural problems thought suitable for legislative and regulatory remedy.

Why are compensation limits on the administration's list of needed reforms? Why has a bipartisan desire for new regulatory powers and additional layers of supervision emerged? Why was it easy to invert the order of debt repayment in the bankruptcy of Chrysler? Indeed, why do, as suggested in recent polls, an increasing share of twenty-somethings view socialism with interest? As of now, the draft narrative supports those judgments. We have thus far written a morality play pointing to corporate greed, supervisory incompetence, and misplaced faith in markets. With the outline so distinct in black and white, the policy implications are similarly self-evident.

Before government officials rush to codify the current understanding, they should reflect upon the last time we were in this position. Over the past year, there have been all manner of comparisons to the experience of the Great Depression, the prior episode when global financial markets and the economy were so stricken. There is, indeed, an apt parallel to the current stage of our crisis. The narrative first written about the Great Depression was wrong in many important respects.

By the 1940s, the educated consensus was that fiscal stimulus was the only effective means to engineer revival. In particular, this followed because it was believed that the Federal Reserve ran out of effective tools once the policy interest rate fell to zero. The Great Crash was agreed to have followed in part from excessive competition among financial institutions. And restraints on the trade of goods, services, and capital helped to anchor an otherwise unstable system.

Having learned these lessons, fiscal policymakers viewed themselves as given a mandate to smooth the business cycle, as enshrined in the Employment Act of 1946, and the Federal Reserve was pushed to a supporting role. The Congress legislated and regulators promulgated numerous restraints on the baser nature of commerce. Financial institutions were split by function and policed by different agencies. Limits were placed on deposit and lending rates. And tariffs rested near century highs.

Over the next few decades, the U.S. economy expanded rapidly, and the gains from this growth were shared relatively equitably. But this owed more to the rewards of winning a world war on foreign land masses. In fact, institutions at home were calcifying around an elaborate regulatory apparatus. The nation was poorly positioned for and too rigid to cope with the energy and environmentalism shocks of the 1970s.

Meanwhile, leading academic—including Milton Friedman, Anna Schwartz, Ben Bernanke, and Christina Romer—pushed back against the prevailing worldview. As they won the field and the false lessons of the Great Depression were unlearned, deregulation followed.

So here we are, still paying the cost of writing the wrong narrative almost three-quarters of a century ago.

Incremental policy change fostered innovation in all aspects of commerce. However, deregulation did not attack the fundamental infrastructure of our post-1930s regulatory framework. As a result, financial institutions stretched into the gaps between regulators' watch, becoming more complicated and harder to govern. Self-interested lobbying groups made sure that significant subsidies to housing remained inviolate. More generally, the gains from economic progress were not broadly shared. The system as a whole was less resilient and more vulnerable than it could have been.

Greed, no doubt, was an accelerant when a spark struck. However, the critical question is not whether people are greedy. People have been, are, and always will be greedy. Rather, we should ask why restraints on the exercise of that greed did not work.

Perhaps enlightened policymaking at the time of crisis in 2007 and 2008 could have compensated for these underlying fragilities. But we will never know. In the event, the triumvirate of Henry Paulson, Bernanke, and Timothy Geithner failed to identify the solvency problem at the root, acted in an inconsistent manner when resolving institutions that set problematic precedents, and generally inflamed fears.

So here we are, still paying the cost of writing the wrong narrative almost three-quarters of a century ago. The most important lesson to draw as we write the new one is that many blows brought us low.

Under any plausible scenario, finance will get more expensive. Banks will hold more capital. Constraints will be placed on individual choice. How those changes are enacted through supervision and proscription will depend on the lessons we are learning now. And we will live with the results for a long time.

There is an opportunity to help society get the story straight. The Financial Crisis Inquiry Commission was established in a provision of recently enacted mortgage fraud legislation. This bipartisan body is to find "the causes, domestic and global, of the current financial and economic crisis." The precedent is not encouraging. But as William of Orange admonished, "One need not hope to undertake, nor succeed to persevere."

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A Government Failure, Not a Market Failure

By John H. Makin

The idea that homeownership confers special benefits on American society is deeply embedded in our culture—so much so that our national tax policy confers a special benefit of its own on it. Homeownership is granted an advantage over all other forms of ownership in the form of an enormous deduction on the interest payments most individuals incur in financing their homes. Nothing else in the tax code comes anywhere near that deduction in scope or size. We have decided, as a nation, that homeownership is not only a good thing for an individual or a family, but that it is beneficial for the public at large and the country as a whole. Otherwise, why would it be necessary for the government to give it this kind of preferential treatment? Without it, clearly, we believe that the national rate of homeownership would be lower and that a lower rate of homeownership would be deleterious to our common weal.

After 2000, the national push toward homeownership intensified in three dimensions, leading to a doubling of housing prices in just five years' time. First, the Federal Reserve Board's interest-rate policy drove down the cost of borrowing money to unprecedented lows. Second, a common conviction arose that homeownership should be available even to those who, under prevailing conditions, could not afford it. Finally, private agencies charged with determining the risk and value of securities were exceptionally generous in their assessment of the financial products known as "derivatives" whose collateral resided in the value of thousands of mortgages bundled together. The rating agencies understated the risks from these bundled mortgages by assuming that home prices were simply going to rise forever.

When the housing bubble burst in 2006, the damage to the financial system pushed the global economy into the worst contraction since the Great Depression. In the midst of the pain and suffering that have accompanied financial collapse and economic contraction—over $15 trillion in wealth has been lost by American households alone while, by July 1, more than 6 million job losses had boosted the unemployment rate to 9.4 percent—much of the blame has been placed on unregulated financial markets whose behavior is said to have revealed a terrible flaw in the foundation of capitalism itself.

This was a market failure, we are told, and the promise of capitalism has always been that the self-correcting mechanisms built into the system would preclude the possibility of a systemic market failure. But the housing bubble burst only after government subsidies pushed house prices up so fast that marginal buyers could no longer afford to chase prices even higher. A bubble created by rigged financial markets and a government-sponsored obsession with homeownership is not a result of market failure, but rather, a result of bad public policy. The belief that homeownership, per se, is such a benefit that no amount of government support could be too great and no pace at which home prices rise could be too fast, is the root of the crisis. There was no market failure.

According to *The New Palgrave Dictionary of Economics*, an invaluable collection of precise summaries of virtually every topic in the dismal science: "The best way to understand market failure is first to understand market success, the ability of a collection of idealized competitive markets to achieve an equilibrium allocation of resources which is Pareto optimal." Allow me to translate. Pareto optimality, a term named after the Italian economist Vilfredo Pareto (1848–1923), is defined as an allocation of economic resources that produces the greatest good. Thus, if one changes the allocation of resources away from Pareto optimality for the purpose of making someone better off, that change will make someone else worse off. Economists have expended a great deal of effort to demonstrate that free and competitive markets produce an outcome that is Pareto optimal.

This is not to say that there is no such thing as market failure. There are many instances of market failure. Someone may possess information that others do not, as in insider trading, and thereby gain an illegitimate leg up. There may be too few players in a given market, which allows them to manipulate, hoard, and toy with prices. Capricious government intervention in cases in which it is neither required nor appropriate constitutes another condition that may create a market failure.

There are also cases of market failure in which some people get a free ride while others bear a disproportionate burden. This is the case in national defense, for example, in which soldiers bear a burden nonsoldiers do not. Consequently, a government subsidy for national defense is necessary for the maintenance of security and power, and the overwhelming majority of citizens acknowledges it and does not complain about it. National defense is a public good, perhaps the original public good.

Owner-occupied housing is something else that has been deemed a public good. Herbert Hoover's affirmation of the need for encouragement of homeownership "at all times" came in 1932 at the fiercest stage of the Great Depression. Others have made powerful arguments that homeowners make better citizens and contribute to stable communities. Why renters do not and cannot offer the same contribution to the public good is never specified, but existing homeowners, homebuilders, mortgage lenders, and mortgage servicers have all seized on the idea that subsidizing homeownership is Pareto optimal. It isn't.

Subsidies for homeownership—in the form of full deductibility of mortgage interest, lower mortgage borrowing rates derived from government guarantees for mortgage lenders like Fannie Mae and Freddie Mac, and deductibility of local real-estate taxes—have long benefited those who own homes at the expense of those who do not. The size and severity of the burst bubble makes a mockery of the argument that the disproportionate gains to homeowners also improved the welfare of renters. By erasing, in just a few years, nearly one-third of the wealth on the national balance sheet, the collapse has created a substantial loss in national welfare, including for renters.

Homeownership should not be considered a public good deserving of government subsidies even without the bubble collapse for a simple reason: those who receive the subsidy get to capture the benefits in the form of home prices that are higher than they would otherwise be without government support. The subsidies make homeowners better off while they make renters worse off. They are, therefore, not Pareto optimal. In addition, homeownership subsidies are inherently unjust. They favor the relatively well-off at the expense of those who are poorer. Why? Because the value of an owned home and the size of the government subsidy both grow as income increases. A tax deduction tied to homeownership for a well-to-do American with a $1 million mortgage and a $60,000 annual interest payment is worth $22,000 (assuming the American is in the 35 percent tax bracket). The higher the marginal tax rate rises, the more valuable the mortgage-interest deduction is to the homeowner. For a family with a modest income that may pay little or no income tax, the mortgage-interest deduction is worth virtually nothing. And yet, for the past fifteen years, even the party in the United States most associated with preferential treatment for the poor began preaching the evangel of homeownership as a form of class salvation.

> The belief that homeownership, per se, is such a benefit that no amount of government support could be too great and no pace at which home prices rise could be too fast, is the root of the crisis.

During Bill Clinton's first term, government housing policy changed substantially. After decades in which liberal politicians and thinkers devoted themselves to arguments for expanding the number of public housing units, the disastrous condition of those units led the president, a "new Democrat," to a dramatic ideological shift in emphasis. No longer would public housing be at the top of the liberal Democratic agenda. Instead, borrowing from conservative ideas about the inestimable benefit of homeownership to the striving poor, the Clinton administration and members of his party in the House and Senate decided to use government power to achieve that aim.

In 1994, the National Homeownership Strategy of the Clinton administration advanced "financing strategies fueled by creativity to help homeowners who lacked the cash to buy a home or the income to make the down payments" to buy a home nonetheless. It became U.S. government policy to intervene in the marketplace by lowering the standards necessary to qualify for mortgages so that Americans with lower incomes could participate in the leveraged purchases of homes.

The goal of expanding homeownership led to the creation of new mortgage subsidies across the board. The loosening of standards became the policy of Fannie Mae and Freddie Mac, the pseudo-private government-sponsored enterprises that bought mortgages from originating lenders. A particular change in the tax law in 1997 encouraged many households to make buying and improving a home the primary vehicle by which they enhanced net worth. By eliminating any capital gains tax on the first $500,000 of profits from the sale of an owner-occupied residence once every two years, Washington encouraged enterprising American families to purchase homes, fix them up, resell them, and then repeat the process. Flipping became a financial pastime for millions because this special advantage created a new incentive—which did not exactly fit the model of encouraging people to remain in a stable home for many years and thereby help to stabilize the neighborhood around them.

There was, however, a rival to homeownership as a way of building wealth in the late 1990s—the run-up in the stock market, which was caused by another bubble, this one in the technology sector. Given the size of the gains in the stock market, which were running 20 percent or more per year, the relative desirability of homeownership eroded. But when, in 2000, the tech bubble burst, households were left in search of an alternative way to store and enhance wealth. Homeownership emerged as the most promising alternative. After 2000, and especially after 2002, U.S. real house prices began to surge.

Everything I have described thus far constituted a necessary but not sufficient precondition for a full-fledged housing bubble. It took the addition of a new market in derivatives to drive bankers, lenders, and credit agencies to create the conditions for an implosion by expanding mortgage financing to borrowers who could not possibly afford the homes they were purchasing.

In February 2003, Angelo Mozilo, then head of the major mortgage supplier called Countrywide, declared that the need to provide a down payment should no longer be an impediment to homeownership for any American. Was it any wonder that a home-buying frenzy occurred when Countrywide's chieftain was suggesting that there was no need for a purchaser to supply even a minimal equity stake in his purchase? During 2004 and 2005, the rise in home prices accelerated. That, in turn, caused Americans to refinance their homes to remove their equity—their accumulated wealth, in other words—and convert it into disposable income. They did so because they were confident the equity would simply be recreated by continued growth in the value of their homes.

> Homeownership should neither be penalized nor favored under government policy.

The hunger for more mortgages that could serve as backing for more new securities led to the acceleration of undocumented, no-down-payment, negative-amortization mortgage loans to individuals with virtually no prospect of servicing them. The designers of derivative securities effectively collaborated with the rating agencies, such as Standard & Poor's and Moody's, that were relied upon (often through government mandate) by pension funds and other gigantic repositories of wealth with identifying the securities safe enough to invest in.

A situation in which creators of derivatives provide the monetary compensation for the very agencies that are tasked with determining the riskiness of their securities hardly constitutes a competitive market. Indeed, it constitutes dangerous collusive behavior. But that collusion, again, was made possible by the distorting actions of government agencies, which effectively provided a subsidy for risk-taking that was, by definition, unsustainable.

It is fair to ask, in the light of past bubbles that have burst—like the entire economy of Japan in the 1990s and the tech-stock tragicomedy—why investors were prepared to take on the substantial risks tied to unfamiliar derivative securities whose value was tied to the continued rise in house prices. A substantial part of the answer lies with the Federal Reserve Board. It deliberately adopted a policy that it would not seek to identify bubbles and then to act in ways that would let the air out slowly. Instead, Fed chairman Alan Greenspan allowed bubbles to inflate and then stepped in to repair any damage afterward. This constituted a substantial subsidy to excessive risk-taking.

The policy became clear in 1998, the year in which the unwinding of the Asian currency crisis, together with Russia's defaulting on its debt, created huge volatility in the credit markets. At the time, Long Term Capital Management, a hedge fund, was on the verge of collapse, and an aggressive intervention was staged to save it. The New York Fed provided its offices and encouragement to bring financial firms together to contain it.

The salvation of Long Term Capital Management suggested a new reality for the marketplace: aggressive risk-taking in pursuit of huge profits was manageable even if bubbles were created, just so long as the Fed was around to raise the "systemic risk flag" in the event of serious trouble. There would always be a rescue; the trick was to get out before everything began to collapse. It was this fact that led Charles Prince, then-head of Citicorp, to give the game away in July 2007 about the reckless and imprudent nature of his bank's conduct. "When the music is playing," Prince said, "you've got to get up and dance."

The housing bubble was thus a fully rational response to a set of distortions in the free market—distortions created primarily by the public sector. The heads of large financial institutions, as Prince's remark suggested, recognized the risk-taking subsidy inherent in public policy, but felt they had no choice but to play along or fall behind the other institutions that were also responding rationally to the incentives created by government intervention.

The housing collapse and its painful aftermath, including that $15 trillion wealth loss for U.S. households (so far), do not, therefore, represent a market failure. Rather, they represent the dangerous confluence of three policy errors: government policy aimed at providing access to homeownership for American households irrespective of their ability to afford it; the Fed's claim that it could not identify bubbles as they were inflating but could fix the problem afterward; and a policy of granting monopoly power to rating agencies like Standard & Poor's, Moody's, and Fitch's to determine the eligibility of derivative securities for what are supposed to be low-risk portfolios, such as pension funds.

The Fed's bubble policy has evolved in a constructive direction since the bursting of the U.S. housing bubble. The trauma of dealing with the aftermath, including the fire sale of the investment bank Bear Stearns and the outright failure of Lehman Brothers, has convinced the Fed that more effort should be directed toward identifying bubbles before they grow too large.

Now the collusive relationship between rating agencies and creators of derivative securities needs to be ended by bringing more market discipline to the process. Free entry into the rating business should be permitted. The monopoly of a small number of rating agencies to determine the eligibility of new securities for investment by massive pension funds is unjustifiable. The practice whereby the creators of such derivative securities compensate the rating agencies for the ratings also needs to be ended.

Alas, the federal government's response to the collapse of the housing bubble has been deeply problematic. It has chosen to provide additional subsidies to homeowners while nationalizing the government-sponsored enterprises, Fannie Mae and Freddie Mac, that helped to subsidize lower mortgage-interest rates. While the extreme distress visited on American households by the collapse of the housing bubble certainly needs some alleviation, over the longer run we must have a serious national debate on the question of the degree to which we still want to consider homeownership a public good.

The long-term solution is for government to stop playing favorites, as it has for decades with housing. Homeownership should neither be penalized nor favored under government policy. We have seen how that distortion led inexorably to a degree of wealth destruction we have not seen in our lifetimes. The distortion of the market introduced by government intervention can and must be brought to an end. The market that would take its place after this dramatic and admittedly difficult change would allow Americans to allocate their resources more effectively. It would no longer create an unjust advantage for the wealthy homebuyer. And it would, finally, make it possible for Americans to see their homes as they should be seen—not as investment vehicles, but rather, as the places they live in, the hearthstones of their families.

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The True Origins of the Financial Crisis

By Peter J. Wallison

Two narratives seem to be forming to describe the underlying causes of the financial crisis. One, as outlined in a *New York Times* front-page story on December 21, 2008, is that President Bush excessively promoted growth in homeownership without sufficiently regulating the banks and other mortgage lenders that made the bad loans. The result was a banking system suffused with junk mortgages, the continuing losses on which are dragging down the banks and the economy. The other narrative is that government policy over many years—particularly the use of the Community Reinvestment Act (CRA) and Fannie Mae and Freddie Mac to distort the housing credit system—underlies the current crisis. The stakes in the competing narratives are high. The diagnosis determines the prescription. If the *Times* diagnosis prevails, the prescription is more regulation of the financial system; if government policy is to blame instead, the prescription is to terminate those government policies that distort mortgage lending.

There really is not any question of which approach is factually correct: right on the front page of the *Times* edition of December 21 is a chart that shows the growth of homeownership in the United States since 1990. In 1993, it was 63 percent; by the end of the Clinton administration, it was 68 percent. The growth in the Bush administration was about 1 percent. The *Times* itself reported in 1999 that Fannie Mae and Freddie Mac were under pressure from the Clinton administration to increase lending to minorities and low-income home buyers—a policy that necessarily entailed higher risks. Can there really be a question, other than in the fevered imagination of the *Times*, of where the push to reduce lending standards and boost homeownership came from?

The fact is that neither political party, and no administration, is blameless; the honest answer, as outlined below, is that government policy over many years caused this problem. The regulators, in both the Clinton and Bush administrations, were the enforcers of the reduced lending standards that were essential to the growth in homeownership and the housing bubble.

There are two key examples of this misguided government policy. One is the CRA. The other is the affordable housing "mission" that the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac were charged with fulfilling. As originally enacted in 1977, the CRA vaguely mandated regulators to consider whether an insured bank was serving the needs of the "whole" community. For sixteen years, the act was invoked rather infrequently, but 1993 marked a decisive turn in its enforcement. What changed? Substantial media and political attention were showered upon a 1992 Boston Federal Reserve Bank study of discrimination in home mortgage lending. This study concluded that, while there was no overt discrimination in banks' allocation of mortgage funds, loan officers gave whites preferential treatment. The methodology of the study has since been questioned, but, at the time, it was highly influential with regulators and members of the incoming Clinton administration; in 1993, bank regulators initiated a major effort to reform the CRA regulations.

> The fact is that neither political party, and no administration, is blameless; the honest answer is that government policy over many years caused this problem.

In 1995, the regulators created new rules that sought to establish objective criteria for determining whether a bank was meeting CRA standards. Examiners no longer had the discretion they once had. For banks, simply proving that they were looking for qualified buyers was not enough. Banks now had to show that they had actually made a requisite number of loans to low- and moderate-income (LMI) borrowers. The new regulations also required the use of "innovative or flexible" lending practices to address credit needs of LMI borrowers and neighborhoods. Thus, a law that was originally intended to encourage banks to use safe and sound practices in lending now required them to be "innovative" and "flexible." In other words, it called for the relaxation of lending standards, and it was the bank regulators who were expected to enforce these relaxed standards.

The effort to reduce mortgage lending standards was led by the Department of Housing and Urban Development through the 1994 National Homeownership Strategy, published at the request of President Clinton. Among other things, it called for "financing strategies, fueled by the creativity and resources of the private and public sectors, to help homeowners who lacked the cash to buy a home or to make the payments." Once the standards were relaxed for low-income borrowers, it would seem impossible to deny these benefits to the prime market. Indeed, bank regulators, who were in charge of enforcing CRA standards, could hardly disapprove of similar loans made to better-qualified borrowers.

Sure enough, according to data published by the Joint Center for Housing Studies of Harvard University, the share of all mortgage originations that were made up of conventional mortgages (that is, the thirty-year fixed-rate mortgage that had always been the mainstay of the U.S. mortgage market) fell from 57.1 percent in 2001 to 33.1 percent in the fourth quarter of 2006. Correspondingly, subprime loans (those made to borrowers with blemished credit) rose from 7.2 percent to 18.8 percent, and Alt-A loans (those made to speculative buyers or without the usual underwriting standards) rose from 2.5 percent to 13.9 percent. Although it is difficult to prove cause and effect, it is highly likely that the lower lending standards required by the CRA influenced what banks and other lenders were willing to offer to borrowers in prime markets. Needless to say, most borrowers would prefer a mortgage with a low down payment requirement, allowing them to buy a larger home for the same initial investment.

The problem is summed up succinctly by Stan Liebowitz of the University of Texas at Dallas:

> From the current handwringing, you'd think that the banks came up with the idea of looser underwriting standards on their own, with regulators just asleep on the job. In fact, it was the regulators who relaxed these standards—at the behest of community groups and "progressive" political forces. . . . For years, rising house prices hid the default problems since quick refinances were possible. But now that house prices have stopped rising, we can clearly see the damage done by relaxed loan standards.

The point here is not that low-income borrowers received mortgage loans that they could not afford. That is probably true to some extent but cannot account for the large number of subprime and Alt-A loans that currently pollute the banking system. It was the spreading of these looser standards to the prime loan market that vastly increased the availability of credit for mortgages, the speculation in housing, and ultimately the bubble in housing prices.

In 1992, an affordable housing mission was added to the charters of Fannie and Freddie, which—like the CRA—permitted Congress to subsidize LMI housing without appropriating any funds. A 1997 Urban Institute report found that local and regional lenders seemed more willing than the GSEs to serve creditworthy LMI and minority applicants. After this, Fannie and Freddie modified their automated underwriting systems to accept loans with characteristics that they had previously rejected. This opened the way for large numbers of nontraditional and subprime mortgages. These did not necessarily come from traditional banks, lending under the CRA, but from lenders like Countrywide Financial, the nation's largest subprime and nontraditional mortgage lender and a firm that would become infamous for consistently pushing the envelope on acceptable underwriting standards.

> The gradual decline in lending standards came to dominate mortgage lending in the United States.

Fannie and Freddie used their affordable housing mission to avoid additional regulation by Congress, especially restrictions on the accumulation of mortgage portfolios (today totaling approximately $1.6 trillion) that accounted for most of their profits. The GSEs argued that if Congress constrained the size of their mortgage portfolios, they could not afford to adequately subsidize affordable housing. By 1997, Fannie was offering a 97 percent loan-to-value mortgage. By 2001, it was offering mortgages with no down payment at all. By 2007, Fannie and Freddie were required to show that 55 percent of their mortgage purchases were LMI loans, and, within that goal, 38 percent of all purchases were to come from underserved areas (usually inner cities) and 25 percent were to be loans to low-income and very-low-income borrowers. Meeting these goals almost certainly required Fannie and Freddie to purchase loans with low down payments and other deficiencies that would mark them as subprime or Alt-A.

The decline in underwriting standards is clear in the financial disclosures of Fannie and Freddie. From 2005 to 2007, Fannie and Freddie bought approximately $1 trillion in subprime and Alt-A loans. This amounted to about 40 percent of their mortgage purchases during that period. Moreover, Freddie purchased an ever-increasing percentage of Alt-A and subprime loans for each year between 2004 and 2007. It is impossible to forecast the total losses the GSEs will realize from a \$1.6 trillion portfolio of junk loans, but if default rates on these loans continue at the unprecedented levels they are showing today, the number will be staggering. The losses could make the \$150 billion savings and loan bailout in the late 1980s and early 1990s look small by comparison.

The GSEs' purchases of subprime and Alt-A loans affected the rest of the market for these mortgages in two ways. First, it increased the competition for these loans with private-label issuers. Before 2004, private-label issuers—generally investment and commercial banks—specialized in subprime and Alt-A loans because GSEs' financial advantages, especially their access to cheaper financing, enabled them to box private-label competition out of the conventional market. When the GSEs decided to ramp up their purchases of subprime and Alt-A loans to fulfill their affordable housing mission, they began to take market share from the private-label issuers while simultaneously creating greater demand for subprime and Alt-A loans among members of the originator community.

Second, the increased demand from the GSEs and the competition with private-label issuers drove up the value of subprime and Alt-A mortgages, reducing the risk premium that had previously suppressed originations. As a result, many more marginally qualified or unqualified applicants for mortgages were accepted. From 2003 to late 2006, conventional loans (including jumbo loans) declined from 78.8 percent to 50.1 percent of all mortgages, while subprime and Alt-A loans increased from 10.1 percent to 32.7 percent. Because GSE purchases are not included in these numbers, in the years just before the collapse of home prices began, about half of all home loans being made in the United States were nonprime loans. Since these mortgages aggregate more than \$2 trillion, this accounts for the weakness in bank assets that is the principal underlying cause of the current financial crisis.

In a very real sense, the competition from Fannie and Freddie that began in late 2004 caused both the GSEs and the private-label issuers to scrape the bottom of the mortgage barrel. Fannie and Freddie did so in order to demonstrate to Congress their ability to increase support for affordable housing. The private-label issuers did so to maintain their market share against the GSEs' increased demand for subprime and Alt-A products. Thus, the gradual decline in lending standards—beginning with the revised CRA regulations in 1993 and continuing with the GSEs' attempts to show Congress that they were meeting their affordable housing mission—came to dominate mortgage lending in the United States.

U.S. housing policies are the root cause of the current financial crisis.

Federal housing initiatives are not the only culprits in the current mortgage mess—state-based residential finance laws give homeowners two free options that contributed substantially to the financial crisis. First, homeowners may, without penalty, refinance a mortgage whenever interest rates fall or home prices rise to a point at which there is significant equity in the home, enabling them to extract any equity that had accumulated between the original financing transaction and any subsequent refinancing. The result is so-called cash-out refinancing, in which homeowners treat their homes like savings accounts, drawing out funds to buy cars, boats, or second homes. By the end of 2006, 86 percent of all home mortgage refinancings were cash-outs, amounting to \$327 billion that year. Unfortunately, this meant that when home prices fell, there was little equity in the home behind the mortgage and frequently little reason to continue making payments on the mortgage.

The willingness of homeowners to walk away from their "underwater" mortgages was increased by the designation of mortgages as "without recourse" in most states. In essence, nonrecourse mortgages mean that defaulting homeowners are not personally responsible for paying any difference between the value of the home and the principal amount of the mortgage obligation or that the process for enforcing this obligation is so burdensome and time-consuming that lenders simply do not bother. The homeowner's opportunity to walk away from a home that is no longer more valuable than the mortgage it carries exacerbates the effect of the cash-out refinancing.

Tax laws further amplified the problems of the housing bubble and diminished levels of home equity, especially the deductibility of interest on home equity loans. Interest on consumer loans of all kinds—for cars, credit cards, or other purposes—is not deductible for federal tax purposes, but interest on home equity loans is deductible no matter how the funds are used. As a result, homeowners are encouraged to take out home equity loans to pay off their credit card or auto loans or to make the purchases that would ordinarily be made with other forms of debt. Consequently, homeowners are encouraged not only to borrow against their homes' equity in preference to other forms of borrowing, but also to extract equity from their homes for personal and even business purposes. Again, the reduction in home equity has enhanced the likelihood that defaults and foreclosures will rise precipitously as the economy continues to contract.

Bank regulatory policies should also shoulder some of the blame for the financial crisis. Basel I, a 1988 international protocol developed by bank regulators in most of the world's developed countries, devised a system for ensuring that banks are adequately capitalized. Bank assets are assigned to different risk categories, and the amount of capital that a bank holds for each asset is pegged to the asset's perceived riskiness. Under Basel I's tiered risk-weighting system, AAA asset-backed securities are less than half as risky as residential mortgages, which are themselves half as risky as commercial loans. These rules provided an incentive for banks to hold mortgages in preference to commercial loans or to convert their portfolios of whole mortgages into a mortgage-backed securities (MBS) portfolio rated AAA because doing so would substantially reduce their capital requirements.

Though the banks may have been adequately capitalized if the mortgages were of high quality or if the AAA rating correctly predicted the risk of default, the gradual decline in underwriting standards meant that the mortgages in any pool of prime mortgages often had high loan-to-value ratios, low FICO scores, or other indicators of low quality. In other words, the Basel bank capital standards, applicable throughout the world's developed economies, encouraged commercial banks to hold only a small amount of capital against the risks associated with residential mortgages. As these risks increased because of the decline in lending standards and the ballooning of home prices, the Basel capital requirements became increasingly inadequate for the risks banks were assuming in holding both mortgages and MBS portfolios.

Preventing a recurrence of the financial crisis we face today does not require new regulation of the financial system. What is required instead is an appreciation of the fact—as much as lawmakers would like to avoid it—that U.S. housing policies are the root cause of the current financial crisis. Other players—greedy investment bankers; incompetent rating agencies; irresponsible housing speculators; shortsighted homeowners; and predatory mortgage brokers, lenders, and borrowers—all played a part, but they were only following the economic incentives that government policy laid out for them. If we are really serious about preventing a recurrence of this crisis, rather than increasing the power of the government over the economy, our first order of business should be to correct the destructive housing policies of the U.S. government.

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Testimony of Paul G. Mahoney

Dean, University of Virginia School of Law

Before the

United States House of Representatives

Committee on Financial Services

Tuesday, July 21, 2009

Chairman Frank, Ranking Member Bachus, and members of the committee, my name is Paul Mahoney. I am the dean of the University of Virginia Law School, where my teaching and research interests include contracts, securities regulation, derivatives regulation, and law and development.

I appreciate the opportunity to present my views, simply as an observer of the financial services industry and not on behalf of any industry or organization. I will discuss those portions of the Obama Administration's financial regulatory reform proposals that deal with the largest financial institutions—so-called "Tier 1 Financial Holding Companies". The Treasury Department's white paper *Financial Regulatory Reform: A New Foundation* defines a Tier 1 FHC as "any financial firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability." That definition makes clear that the proposal accepts the view that these large and interconnected institutions are "too big to fail" because of their systemic importance.

The white paper proposes creation of a special resolution regime outside the normal bankruptcy process for financial holding companies that would be triggered when, in the Treasury's view, the "stability of the financial system is at risk." It appears that this standard would typically be met in the case of the failure of a Tier 1 FHC in light of the definition of that term. When Treasury triggers the special resolution regime, it will have the authority to lend the institution money, purchase its assets, guarantee its liabilities, or provide equity capital. I think it is fair to use the term "bailout" to describe that combination of powers and I use it as such.

Federal regulators have not paid sufficient attention to sources of systemic risk, or risks that affect the entire financial sector rather than a single firm. The creation of a council tasked with identifying and warning functional regulators about sources of systemic risk is a good idea. Taking a close look at the process for resolving insolvent financial holding companies in order to prevent uncertainty and delay is also a good idea. Nevertheless, the identification of particular firms as too big to fail and, therefore, the beneficiaries of an implicit government guarantee, is a bad idea. I also believe oversight and enforcement powers should remain with the functional regulators and the systemic risk council should serve in an advisory role.

Since the beginning of the current financial downturn, the federal government has provided cash infusions, guarantees, and subsidies potentially amounting to trillions of dollars to prevent the collapse of large financial institutions. Given the cost of these bailouts and the potential they create for future moral hazard, Congress is rightly determined to minimize the likelihood of their repetition in the future.

There are two general schools of thought on how best to avoid future bailouts. The first holds that it was an error to help creditors of the failed institutions avoid losses that they would have realized in a normal bankruptcy proceeding and that the focus of policy going forward should be to make it clear that the mistake will not be repeated. While the government cannot easily commit never to do something in the future, Congress could limit the Treasury's and Federal Reserve's authority to commit funds to distressed financial holding companies institutions outside the ordinary bankruptcy or resolution process.

The alternative is to concede that the government will not refuse to bail out large and systemically important financial institutions. Under this approach, Congress should focus on limiting the risks that these institutions may take in order to minimize the likelihood that they will become financially distressed. If these efforts fail and a systemically important institution becomes financially distressed, a bailout will follow as a matter of course. The administration's financial reform blueprint takes this approach.

I believe the first approach will produce a healthier financial services industry that will make fewer claims on taxpayer dollars. It is based on a sounder premise—that the best way to reduce moral hazard is to ensure that economic agents bear the costs of their own mistakes. The administration's plan is premised on the view that regulatory oversight will compensate for misaligned incentives.

The central argument for trying to avoid bailouts through regulatory oversight rather than insisting that financial institutions bear the cost of their mistakes is that some financial institutions are "too big to fail." Putting such institutions through bankruptcy or a similar resolution process, and thereby requiring their creditors and counterparties to recognize losses or sell collateral, could spread contagion, meaning that other banks or financial institutions may also fail as a consequence. Widespread bank failures, in turn, may reduce the availability of credit to the real economy, causing or exacerbating a recession.

These arguments are plausible but it is not clear that the magnitude of the problem is sufficient to justify the scale of government intervention that we have seen in the past year. It is important to note that the loss of bank capital in the recent crisis was not just the result of a temporary liquidity problem—it was the consequence of sharp declines in real estate and other asset values. A bailout can redistribute those losses to taxpayers, but it cannot avoid them. The TARP fund was conceived initially as a system for purchasing illiquid bank assets and then selling them back once the perceived liquidity crisis was past. Once it became clear that the problem was solvency, not liquidity, the program was changed and the funds used to recapitalize financial institutions.

The bankruptcy process is an alternative means of recapitalizing an insolvent institution. Bankruptcy does not imply or require that the firm's assets, employees, and know-how disappear. Instead, it rearranges the external claims on the firm's assets and cash flows. The holders of the firm's equity may be wiped out entirely, while unsecured creditors may have to substitute part or all of their debt claims for equity claims, thereby re-establishing a sound capital structure. If the insolvent financial institution still has the skill and experience to facilitate credit formation, it will continue to do so under new ownership, management, and financial structure. Of course, the bankruptcy process is subject to inefficiencies and delays and these should be addressed when possible. But they do not require an alternative regime of bailouts.

A bailout regime creates substantial moral hazard problems that impose costs on the banking sector continuously, not just during crises.[1] Because creditors of too big to fail financial institutions anticipate that they will be able to shift some or all of their losses to taxpayers, they do not charge enough for the capital they provide. The financial institution, in turn, does not pay a sufficient price for taking risk. The result is a dangerous feedback loop: large banks have access to cheap capital, which causes them to grow even larger and more systemically important while taking excessive risks, all of which increase the probability of a crisis. Thus a bailout regime leads to more frequent crises even as it attempts to insulate creditors from them.

The Administration believes that its proposal will alleviate moral hazard and decrease the concentration of risk in "too big to fail" institutions. The idea is that so-called "Tier 1" financial holding companies will be subject to more stringent capital rules that will simultaneously reduce the amount of risk they can take and create a disincentive to become a Tier 1 FHC in the first place.

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[1] This point is made in detail in Gary H. Stern & Ron J. Feldman, *Too Big to Fail: The Hazards of Bank Bailouts* (Washington, DC, Brookings Institution 2004).

I believe that these disincentives are insufficient and implementation of the plan would increase, not decrease, the concentration of risk. Once a firm has been designated a Tier 1 FHC, other financial institutions will view it as having an implicit government guarantee, as they did Fannie Mae and Freddie Mac. The theory behind the Administration's proposal is that this advantage will be offset by stricter capital requirements and other regulatory costs that will, on balance, make the cost of capital higher, not lower, for Tier 1 FHCs.

Such a system would put greater demands on the Federal Reserve than any regulator could reasonably meet. Having an implicit government guarantee, Tier 1 FHCs will be extremely attractive counterparties because risk transferred to a Tier 1 FHC will be in effect transferred to the federal government. Tier 1 FHCs will have a valuable asset (the implicit guarantee) that they can sell in quantities limited only by the Fed's oversight. They will have powerful incentives to find mechanisms—new financial products and creative off-balance-sheet devices—to evade any limits on the risks they can purchase from the remainder of the financial sector. And banks that are not Tier 1 FHCs will have similarly strong incentives to grow to the point that they become Tier 1 FHCs in order to guarantee access to bailout money. The fastest way to grow larger, of course, is to take bigger risks. Any institution that can keep its gains while transferring catastrophic losses to the government will find a way to engage in excessive risk-taking and expansion, and the financial system as a whole will suffer more frequent financial crises

This analysis is not meant to suggest that the current bankruptcy process cannot be improved or that it should work exactly the same for financial holding companies as it does for industrial corporations. Substantively, however, the resolution of financial holding companies should follow the same fundamental principle that creditors take losses in order of their contractual priorities. The Lehman Brothers bankruptcy proceeding will undoubtedly provide lessons for resolving financial institutions more efficiently in the future. But a credible threat that failure will lead to a resolution proceeding in which the marginal loss will fall on creditors, not taxpayers, will do a better job of disciplining risk-taking than the combination of oversight and an implicit government guarantee.

Resolving Non-Bank Financial Institutions

Testimony Before the House Financial Services Committee, 9/24/2009

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Chairman Frank, Ranking Member Bachus, and Committee Members:

Let me begin by expressing my thanks for the opportunity to present my views on the matter before this committee.

The question I will address in my testimony is whether Congress should adopt Title XII of the proposed Resolution Authority for Large, Interconnected Financial Companies Act of 2009. This Act would grant the Federal Deposit Insurance Corporation (FDIC) powers for resolving insolvent non-bank financial institutions similar to those the FDIC currently possesses for resolving banks. My answer to the question is an emphatic and unequivocal "No." Let me explain.

The fundamental problem that resolution systems attempt to address is that when a financial or other institution fails, the value of the claims on that institution's assets exceed the value of the assets themselves. Thus, someone must decide who gets what, and it is impossible by virtue of the assumption that we are dealing with a failed institution -- to make everyone whole. The size of the pie owned by the failing institution has shrunk, so those who were expecting a slice of that pie face, collectively, the necessity of going somewhat or substantially hungry. The resolution authority decides who gets moderately well-fed and who starves, but the unchangeable reality is that someone goes wanting.

It is in society's broad interests to have clear, simple, and enforceable procedures for resolving failed institutions, principally to insure that investors are willing to commit their funds in the first place. If the rules about resolution were arbitrary or ever-changing, investors would be loath to invest, and economic investment, productivity, and growth would be greatly reduced. A well-functioning resolution process is part of a good system for defining and enforcing property rights, which economists broadly agree is essential to a smoothly functioning, capitalist system.

The crucial thing to remember here is that someone has to lose. Just as importantly, it is actually valuable to society as a whole, although not to the directly harmed parties, that those who invested in the failed institutions suffer economic losses. This process releases resources to better uses, it provides signals to the economy about what are good and bad investments, and it rewards those who made smart economic decisions rather than less adept ones. When an economic activity has not turned out well, denying this simple reality makes matters worse.

The flip side of the fact that standard resolution systems, like bankruptcy, impose an institution's losses on that institution's stakeholders, is the fact that a standard resolution authority – such as a federal court – puts none of its own resources into the failed institution, nor does it ever own the failed institution's assets, or make it loans, or anything like that. The resolution authority is resolving claims and dividing the pie; it is not adding more pie that it has taken from somewhere else.

Under the powers that would be granted to the FDIC under the bill being considered, however, the FDIC would have the power to make loans to the failed institution, to purchase its debt obligations and other assets, to assume or guarantee this institution's obligations, to acquire equity interests, to take liens, and so on. This means the FDIC would be putting its own – that is to say, the taxpayers's – skin in the game, a radical departure from standard bankruptcy, and an approach that mimics closely the actions the U.S. Treasury took under TARP. Thus, this bill institutionalizes TARP for bank holding companies.

A crucial implication of this departure from standard bankruptcy is that taxpayer funds foot the bill for the loans, asset purchases, guarantees, and other kinds of financial support that FDIC would provide to prevent failing institutions from going under. These infusions of taxpayer funds come with little meaningful accountability; it will be impossible to know that they have been paid back, and often that will not occur. The proposed new authority for FDIC also generates the impression that society can avoid the losses that failures imply, but that is false: the proposed FDIC actions would merely shift those losses to taxpayers. The new approach is institutionalized bailouts, plain and simple.

Thus, under the expansion of FDIC resolution authority to cover non-bank financial institutions, bank holding companies would forever more regard themselves as explicitly, not just implicitly, backstopped by the full faith and credit of the U.S. Treasury. That is moral hazard in the extreme, and it will be disastrous for keeping a lid on inappropriate risk-taking by these institutions.

Now, a possible response to my concerns might be that the FDIC is already the resolution authority for banks, which makes sense given its role in insuring deposits, so extending this authority to include bank holding companies might seem to be a logical step. In particular, many have argued that under current law, the FDIC does not have the authority to resolve the banks owned by bank holding companies, which leaves it in limbo with respect to insured deposits at those institutions.

This legal grey area is a potential concern, but the right response is to modify that aspect – and only that aspect – of existing FDIC authority, not to grant it the vastly expanded powers under the proposed bill.

This technicality aside, then, the right alternative to expanding FDIC authority – that is, to the bailout approach – is good old-fashioned bankruptcy. It has become "accepted wisdom" that bankruptcies by financial institutions cause great harm, and it is asserted in particular that letting Lehman Brothers fail last September was the crucial misstep that caused the financial crisis. In fact, nothing could be further from the truth.

As I explain in more detail in my written testimony – a paper recently published in the Cato Journal – the ultimate causes of the financial crisis were two misguided federal policies, namely, the enormous subsidies and pressures provided for mortgage lending to non-credit-worthy borrowers, and the implicit guarantees provided by both Federal Reserve actions and the U.S. history of protecting financial institution creditors. These forces generated an enormous misallocation of investment capital away from plant and equipment toward housing, created a housing price bubble, and established a setting where numerous financial institutions were inevitably going to fail because their main assets – the ones backed by housing – were highly overvalued relative to economic fundamentals. Lehman's failure was one part of the adjustment this situation implied, and a necessary part. If anything, too few financial institutions have failed or shrunk, since the massive interventions in credit and housing markets that have occurred over the past year have artificially propped up housing prices, delaying more inevitable adjustments.

Thus the better way to resolve non-bank financial institutions is bankruptcy, not bailout. This is not to say that existing bankruptcy law is perfect; one can imagine ways it might be faster and more transparent, which would probably be beneficial. Nor should one assume that, had bankruptcy been allowed to operate fully in the Fall of 2008, the economy would have escaped without some degree of panic and recession. A significant economic downturn, in particular, was both inevitable and necessary given the fundamental misallocation of capital that had occurred in the years preceding the panic. But nothing in historical data or recent experience suggests these bankruptcies would have caused anything worse than what we have experienced, and broader bankruptcy would have meant that in future both banks and non-banks would recognize that the losses from excessive risk-taking must be borne by those who take these risks.

In light of these assessments, I urge the members of this committee to vote against this bill, since it codifies an approach to resolution that is fundamentally misguided. We need to learn from our mistakes and trust bankruptcies, not bailout, going forward, as we should have done in the recent past.

Thank you for your time and attention.

BAILOUT OR BANKRUPTCY?

A LIBERTARIAN PERSPECTIVE ON THE FINANCIAL CRISIS

Jeffrey A. Miron

At the end of September 2007, the U.S. economy had experienced 24 consecutive quarters of positive GDP growth, at an average annual rate of 2.73 percent. The S&P 500 Index stood at roughly 1,500, having rebounded over 600 points from its low point in 2003. Unemployment was below 5 percent, and inflation was low and stable.

Roughly 12 months later, in September 2008, U.S. Treasury Secretary Henry Paulson announced a major new intervention in the U.S. economy. Under the bailout plan, as explained at the time, the Treasury proposed holding reverse auctions in which it would buy the troubled assets of domestic financial institutions.[1] Further, as the plan developed, Treasury proposed using taxpayer funds to purchase equity positions in the country's largest banks. These policies aimed to stabilize financial markets, avoid bank failures, and prevent a credit freeze (see Paulson 2008).

In the weeks and months after Paulson announced the bailout, enormous changes occurred in the U.S. economy and in the global financial system. Stock prices fell sharply, housing prices continued the decline they had begun in late 2006, and the real economy

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[1] I use the terms financial institution and bank interchangeably to include both banks and investment banks. The distinction became irrelevant on September 22, 2008, when the last major investment banks (Goldman Sachs and Morgan Stanley) became traditional banking institutions.

contracted markedly. The House of Representatives initially voted down the bailout bill, but Congress approved an expanded version less than a week later. The Federal Reserve and other central banks pursued a range of rescue efforts, including interest rate cuts, expansions of deposit insurance, and the purchase of equity positions in banks.

In this article, I provide a preliminary assessment of the causes of the financial crisis and of the most dramatic aspect of the government's response—the Treasury bailout of Wall Street banks. My overall conclusion is that, instead of bailing out banks, U.S. policymakers should have allowed the standard process of bankruptcy to operate.[2] This approach would not have avoided all costs of the crisis, but it would plausibly have moderated those costs relative to a bailout. Even more, the bankruptcy approach would have reduced rather than enhanced the likelihood of future crises. Going forward, U.S. policymakers should abandon the goal of expanded homeownership. Redistribution, if desirable, should take the form of cash transfers rather than interventions in the mortgage market. Even more, the U.S. should stop bailing out private risk takers to avoid creating moral hazards.

The article proceeds as follows. First, I characterize the behavior of the U.S. economy over the past several years. Next, I consider which government polices, private actions, and outside events were responsible for the crisis. Finally, I examine the bailout plan that the U.S. Treasury adopted in response to the crisis.

[2] To simplify the discussion, I use the term bankruptcy to indicate any official reorganization or liquidation procedure, meaning both those under the bankruptcy code and those conducted by regulatory bodies such as the FDIC. The former applies to nonbanks, the latter to banks.

What Happened?

I begin by examining the recent behavior of the U.S. economy. This sets the stage for interpretation of both the financial crisis and the bailout.

Figure 1 shows the level of real GDP over the past five years.[3] GDP increased consistently and strongly until the end of 2006, and then again during the middle of 2007. GDP fell in the final quarter of 2007, rose modestly during the first half of 2008, and then declined again in the third quarter of 2008. Thus, GDP grew on average over the first three quarters of 2008, but at a rate considerably below the post-war average (1.05 percent vs. 3.27 percent at an annual rate).

Figures 2–4 present data on industrial production, real retail sales, and employment. For industrial production, growth was robust for several years but flattened in the second half of 2007 and turned negative by the second quarter of 2008. A similar pattern holds for retail sales, except that the flattening occurred in the final quarter of 2007 and negative growth began in December 2007. For employment, the flattening also occurred in the final quarter of 2007 and negative growth began in December 2007.

The overall picture is thus consistent across indicators. A significant slowdown in the U.S. economy began in the final quarter of 2007 and accelerated dnring early 2008. This performance is consistent with the determination by the National Bureau of Economic

[3] The data on GDP (GDPC1), industrial production (INDPRO), real retail sales (RRSFS), employment (USPRIV), residential investment (PRFIC1), the CPI (CPIAUCSL), and the federal funds rate (FEDFUNDS) are from the St. Louis Federal Reserve data bank, http://research.stlouisfed.org/fred2/. The Case-Shiller housing price data are from Standard and Poor's, http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/0,0,0,0,0,0,0,0,0,1,1,0,0,0,0,0.html. The data on homeownership are from the U.S. Census, http://www.census.gov/hhes/www/housing/hvs/historic/index.html. The data on stock prices are from Shiller (2000), updated at http://www.irrationalexuberance.com/.

Research's Business Cycle Dating Committee that a recession began in December 2007 (see www.nber.org/cycles/dec2008.html).

Figure 5 shows the Case-Shiller Housing Price Index, adjusted for inflation, for the period 1987–2008. Housing prices increased enormously over 1997–2005, especially in 2004 and 2005. The increase was large, roughly 80–90 percent in real terms. From the end of 2005, housing prices declined slowly through early 2007 and then at an accelerating pace from that point. Despite these declines, housing still appeared to be overvalued in late 2008 and needed to fall another 20–30 percent to reach the pre-2001 level.

Figure 6 shows the U.S. homeownership rate for the past four decades. After fluctuating in the 63–66 percent range for about three decades, homeownership began increasing in the mid 1990s and climbed to unprecedented values in the subsequent decade. Beginning in 2005 the rate stabilized and declined slightly, but in 2008 it was still well above the level observed for most of the sample.

Figure 7 displays residential investment in the United States over the past several decades. Housing construction fluctuated substantially but displayed an overall upward trend through the early 1990s. From that point the trend accelerated and continued for over a decade before beginning a marked decline starting in early 2006. Even after the substantial decline, however, housing investment in late 2008 was about where one would have predicted based on the trend line through the mid-1990s.

For 10–12 years, therefore, the U.S. economy invested in housing at a rate above that suggested by historical trends. This boom coincided with a substantial increase in homeownership. These facts suggest that the United States overinvested in housing during this period. Housing prices rose substantially over the same period. The fact that housing quantity and price increased together suggests that higher demand for housing was a major determinant of the housing boom.

Figure 8 shows the real value of the S&P 500 stock price index over the past 150 years. This value soared during the 1990s to a level above that implied by historical rates of return, and growth after 9/11 and the 2001 recession was robust. Even after the large declines in the fall of 2008, therefore, the market was not obviously below a reasonable estimate of its long-term trend. Standard predictors of stock prices, such as the price-earnings ratio, tell the same story.[4]

Figure 9 shows the effective federal funds rate, a standard measure of the stance of monetary policy. The low rate from the early 2000s through much of 2004 was plausibly one factor in the housing and stock market booms. Inflation was low and stable during this period, averaging 2–3 percent for the most part, so the real interest rate was negative. This implies that the demand for stocks and housing should have expanded, driving up their prices. The substantial increase in interest rates from mid-2004 through mid-2006 is plausibly one factor that slowed the economy starting in 2007.[5]

To summarize, the U.S. economy had overinvested in housing as of early 2006, and housing and stock prices were high relative to historical norms. Thus, the economy was misaligned, and a major adjustment—such as a recession—was plausibly necessary to correct the misallocation. The subsequent declines in housing and stock prices (along with the increase in oil prices) reduced the economy's real wealth, providing one impetus for a

[4] For further examination of this issue, see Cochrane (2008) and Hamilton (2008).

[5] An additional cause of low real interest rates may have been a surge in the demand for U.S. assets (a savings glut) caused by global financial imbalances. See Caballero, Fahri, and Gourinchas (2008).

slowdown. Monetary policy stimulated during much of the boom and contracted in advance of the slowdown.[6]

What Caused the Economic Events of the Past Five Years?

Policymakers, pundits, and academics have blamed the financial crisis on various factors, such as excessive risk taking by the private sector, inadequate or inappropriate regulation, deficient rating agencies, and so on. My assessment is that all these factors played a role, but the crucial, underlying problem was misguided federal policies.[7]

The first misguided policy was the attempt to increase homeownership, a goal the federal government has pursued for decades. A (partial) list of policies designed to increase homeownership includes the Federal Housing Administration, the Federal Home Loan Banks, Fannie Mae, Freddie Mac, the Community Reinvestment Act, the deductibility of mortgage interest, the homestead exclusion in the personal bankruptcy code, the tax-favored treatment of capital gains on housing, the HOPE for Homeowners Act, and, most recently, the Emergency Economic Stabilization Act (the bailout bill).[8]

Government efforts to increase homeownership are problematic. Private entrepreneurs have adequate incentives to build and sell houses, just as individuals and families have adequate incentives to purchase them. Thus, government intervention to

[6] See Mulligan and Threinen (2008) for a more detailed analysis of the role of wealth effects in the propogation of the financial crisis.

[7] For analyses similar to that presented here, see Dorn (2008) and Taylor (2009). For alternative views about the causes of the crisis, see Baily, Litan, and Johnson (2008), Brunnermeier (2008) and Hall and Woodward (2008).

[8] See Slivinski (2008) for further discussion of the government role in promoting homeownership.

expand homeownership has no justification from an efficiency perspective and is instead an indirect method of redistributing income. If government redistributes by intervening in the mortgage market, however, it creates the potential for large distortions of private behavior.

The U.S. government's pro-housing policies did not have noticeable negative effects for decades. The reason is likely that the interventions mainly substituted for activities the private sector would have undertaken anyway, such as providing a secondary market in mortgages.

Over time, however, these mild interventions began to focus on increased homeownership for low-income households. In the 1990s, the Department of Housing and Urban Development ramped up pressure on lenders to support affordable housing. In 2003, accounting scandals at Fannie and Freddie allowed key members of Congress to pressure these institutions into substantial risky mortgage lending.[9] By 2003–04, therefore, federal policies were generating strong incentives to extend mortgages to borrowers with poor credit characteristics. Financial institutions responded and created huge quantities of assets based on risky mortgage debt.

This expansion of risky credit was especially problematic because of the second misguided federal policy, the long-standing practice of bailing out failures from private risk-taking. As documented by Laeven and Valencia (2008), bailouts have occurred often and widely, especially in the banking sector. In the context of the recent financial crisis, a crucial example is the now infamous "Greenspan put," the Fed's practice under Greenspan of lowering interest rates in response to financial disruptions in the hope that expanded liquidity would prevent or moderate a crash in asset prices. In the early 2000s, in particular, the Fed

[9] See Roberts (2008), Leibowitz (2008), Wallison and Calomiris (2008), White (2008), and Pinto (2008).

appeared to have made a conscious decision not to burst the housing bubble and instead "fix things" if a crash occurred.

The banking sector's history of receiving bailouts meant that financial markets could reasonably have expected the government to cushion any losses from a crash in risky mortgage debt.[10] Since government was also exerting pressure to expand this debt, and since it was profitable to do so, the financial sector had every reason to play along.[11] It was inevitable, however, that at some point a crash would ensue. As explained in Gorton (2007), the expansion of mortgage credit made sense only so long as housing prices kept increasing, but this could not last forever. Once housing prices began to decline, the market had no option but to suffer the unwinding of the positions built on untenable assumptions about housing prices.

This interpretation of the financial crisis therefore puts primary blame on federal policy rather than on Wall Street greed, inadequate regulation, failures of rating agencies, or securitization. These other forces played important roles, but it is implausible that any or all would have produced anything like the recent financial crisis had it not been for the two misguided federal polices.[12] Wall Street greed, for example, certainly contributed to the situation if, by greed, one means profit-seeking behavior. Many on Wall Street knew or

[10] Gerardi et al. (2008) find that analysts in the mortgage market realized that a fall in housing prices would mean a drastic fall in the value of mortgage assets, but assigned only a low probability to that outcome. One interpretation is that the analysts (and their employers) trusted the Greenspan put to keep prices from falling.

[11] A mandate that banks issue risky debt might not generate significant problems if the risk is appropriately priced (Stock 2008). When government mandates that banks issue debt they would not have provided on their own, however, a market-clearing price might not exist. An implicit government guarantee of this debt, moreover, virtually ensures the risk will be underpriced.

[12] See Kashyap, Rajan, and Stein (2008) or Calomiris (2008) for a discussion of the regulatory issues and Lucchetti and Ng (2007) for a discussion of the role of ratings agencies.

suspected that their risk exposure was not sustainable, but their positions were profitable at the time. Further, markets work well when private actors respond to profit opportunities, unless these reflect perverse incentives created by government. The way to avoid future crises, therefore, is for governments to abandon policies that generate such incentives.

Was the Treasury Bailout Good Policy?

The Treasury's bailout plan was an attempt to improve bank balance sheets and thereby spur bank lending. The justification offered was that, as of early September 2008, major banks were facing imminent failure because their mortgage-backed assets had declined rapidly in value.

No one disputes that several banks were in danger of failing, but this does not justify a bailout. Failure is an essential aspect of capitalism. It provides information about good and bad investments, and it releases resources from bad projects to more productive ones. As noted earlier, housing prices and housing construction were too high at the end of 2005. This condition implied a deterioration in bank balance sheets and a retrenchment in the banking sector, so some amount of failure was both inevitable and appropriate.

Thus, an economic case for the bailout needed to show that failure by some banks would harm the economy *beyond* what was unavoidable due to the fall in housing prices. The usual argument is that failure by one bank forces other banks to fail, generating a credit freeze. That outcome is possible, but it does not mean the Treasury's bailout plan was the right policy.

To see why, note first that allowing banks to fail does not mean the government plays no role. Federal deposit insurance would prevent losses by insured depositors, thus limiting the incentive for bank runs. Federal courts and regulatory agencies (such as the FDIC) would supervise bankruptcy proceedings for failed institutions. Under bankruptcy, moreover, the activities of failing banks do not necessarily disappear. Some continue during bankruptcy, and some resume after sale of a failed institution or its assets to a healthier bank. In other cases, merger in advance of failure avoids bankruptcy entirely. Private shareholders and bondholders take the losses required to make these mergers and sales attractive to the acquiring parties. Taxpayer funds go only to insured depositors (see Fama 2009, Zingales 2008).

Consider, therefore, how bailout compares to bankruptcy from three perspectives: the impact on the distribution of wealth, the impact on economic efficiency, and the impact on the length and depth of the financial crisis.

From a distributional perspective, bailout is unambiguously perverse; it transfers resources from the general taxpayer to well-off economic actors who profited from risky investments. This is not a criticism of risk-taking; that is appropriate so long as those benefiting in good times bear the costs in bad times. This is exactly what occurs under the bankruptcy approach.

From an economic efficiency perspective, bailout is again problematic. Mere consideration of a bailout distracts attention from the fact that government was the single most important cause of the crisis. Relatedly, bailout creates a moral hazard, thereby generating excessive risk-taking in the future. Bailouts often adopt goals that are not economically sensible, such as propping up housing prices, limiting mortgage defaults, or preventing the failure of insolvent institutions. More broadly, a bailout encourages perverse actions by institutions that are eligible for the money, such as acquiring toxic assets that the Treasury might buy or taking huge risks with Treasury capital injections.

The Treasury bailout of 2008 also initiated a government ownership stake in the financial sector. This means that, going forward, political forces are likely to influence decisionmaking in the extension of credit and the allocation of capital. Government, for example, might push banks to aid borrowers with poor credit histories, to subsidize politically connected industries, or to lend in the districts of powerful legislators. Government pressure is difficult for banks to resist, since government can threaten to withdraw its ownership stake or promise further injections whenever it wants to modify bank behavior. Further, bailing out banks sets a precedent for bailing out other industries. Thus, the long-run implications of bailout are unambiguously bad.

Bailout is superior to bankruptcy, therefore, only if allowing bank failures would cause or exacerbate a credit crunch. Neither theory nor evidence, however, makes a compelling case for such an effect. As a theoretical matter, failure by a bank means that it cannot extend credit, but this means a profit opportunity exists for someone else. As an empirical matter, it is difficult to establish whether panics cause credit freezes or underlying adverse shocks to the economy cause both reduced lending and panics. Ben Bernanke's famous paper on the Great Depression (Bernanke 1983) suffers exactly this problem; it shows that bank failures and output losses are correlated, but it does not pin down the direction of causation.

This is not to deny that credit freezes occur and cause harm, nor to assert that credit markets would have been healthy under the bankruptcy approach. Rather, the claim is that overinvestment in housing and the excessive level of housing prices that existed in the United States meant that an unwinding was necessary to make the economy healthy. This restructuring implied reduced residential investment, declines in housing prices, plus shrinkage and consolidation of the banking sector. All of this would plausibly have generated a recession, even without any credit freeze, and the recession—along with increased awareness of the risks of mortgage lending—would have caused lending to contract, again even without a credit crunch. Thus, it is not obvious how much of the credit freeze was due to bank failures versus negative shocks to the underlying fundamentals.

In fact, the bailout might have exacerbated the credit crunch. The announcement that the Treasury was considering a bailout likely scared markets by suggesting the economy was worse than markets recognized (see Macey 2008). Likewise, the announcement may have encouraged a credit freeze because bankers did not want to realize their losses or sell their institutions to acquiring firms if government was going to get them off the hook. The bailout introduced uncertainty because no one knew what the bailout meant: how much, what form, for whom, for how long, with what restrictions, and so on.[13] The bailout also did little to make bank balance sheets transparent, yet the market's inability to determine who was solvent was plausibly a key reason for the freeze. Plus, banks can respond to capital injections by paying bonuses to executives and dividends to shareholders, or by hoarding cash; nothing guarantees they will lend out capital injections.[14]

Thus, the bailout had huge potential for counterproductive impacts and at best an uncertain prospect of alleviating the credit crunch or ameliorating the recession. This means

[13] Higgs (1997) provides suggestive evidence that uncertainty created by policymakers contributed to the length of the Great Depression.

[14] See Bordo and Schwartz (1998, 2000) for evidence on both the tendency for bailouts to exacerbate moral hazard and the ability of bailouts to improve economic performance.

that allowing further failures would have been a price worth paying. In particular, the process of failure and bankruptcy would have countered the financial sector's temptation to "bank" on government largesse, so the bankruptcy approach would have created better incentives going forward for private behavior toward risk.

Lessons for the Future

In my assessment, the financial crisis yields two main lessons. The first is that redistribution to low-income households should be direct and on budget, not indirect and off-budget, as in subsidized mortgage credit. The second lesson is that the moral hazards from bailing out private risk-taking are substantial, even when these do not always appear immediately.

Adjusting policy to incorporate the first lesson is relatively easy: it requires elimination of specific, pre-existing policies such as Fannie Mae, Freddie Mac, the Federal Housing Administration, and so on. This might be hard politically, but at least the target is well defined.

Adjusting policy to avoid the creation of moral hazard is harder. A few specific programs, such as the Pension Benefit Guarantee Corporation, are ripe for elimination from this perspective, but policymakers have many ways to bail out private risk-taking. Even elimination of agencies like the FDIC and the Federal Reserve—setting aside whether this makes sense overall—would not prevent a determined Treasury from bailing out banks. Thus, the only real constraint on such flawed government policy is increased recognition of its long-term costs.

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Figure 1: Real GDP

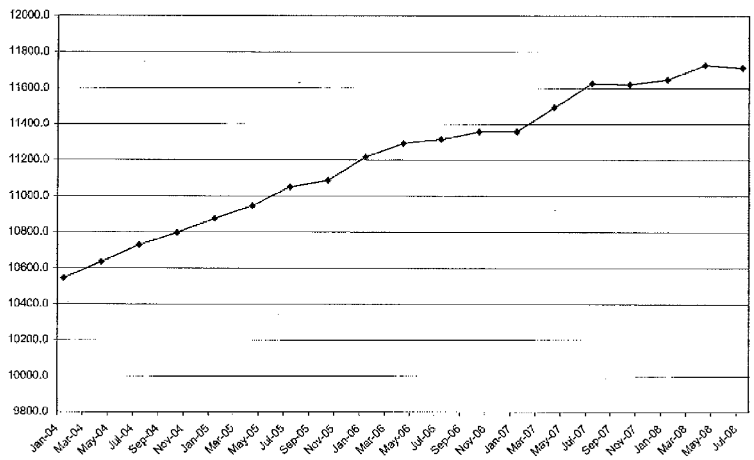


Figure 2: Index of Industrial Production

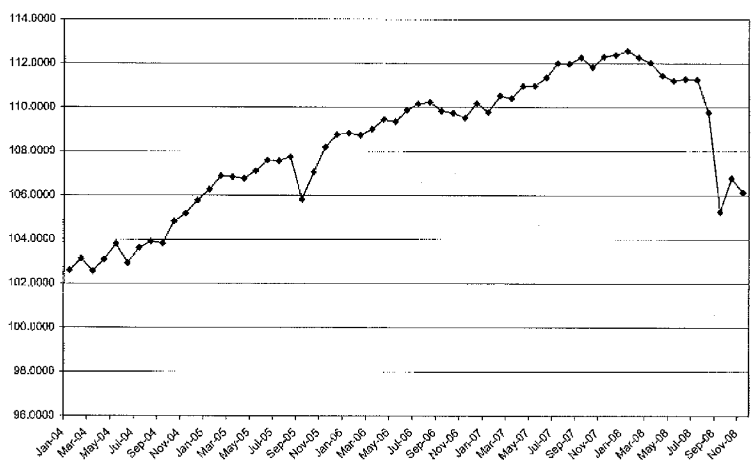


Figure 3: Real Retail Sales

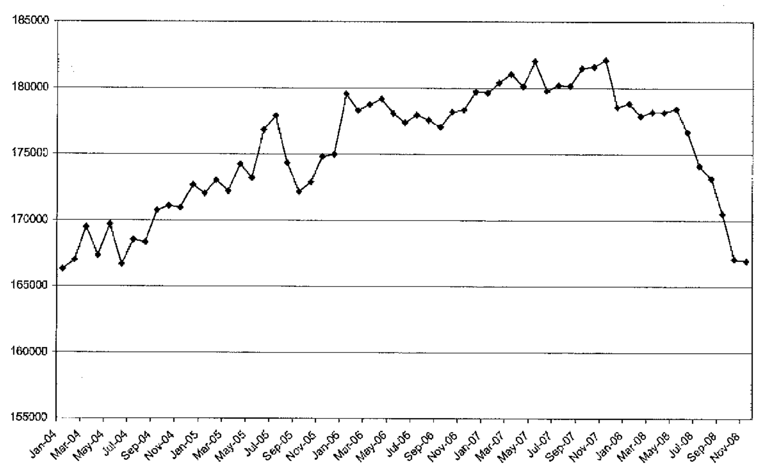


Figure 4: Employment

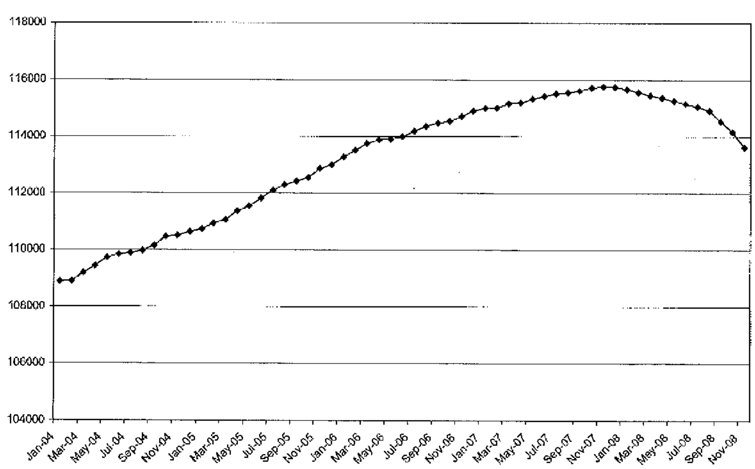


Figure 5: Housing Prices (Case-Shiller)

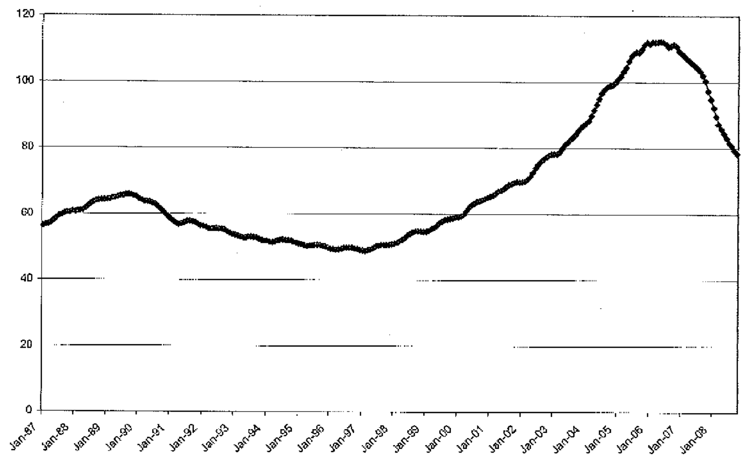


Figure 6: Homeownership Rate

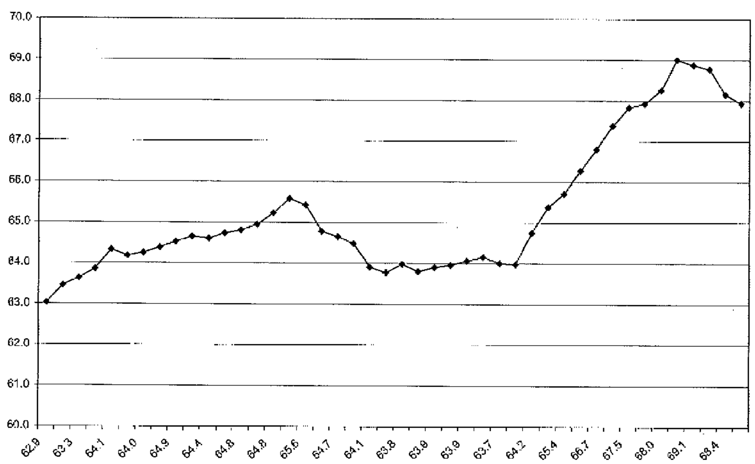


Figure 7: Real Housing Investment

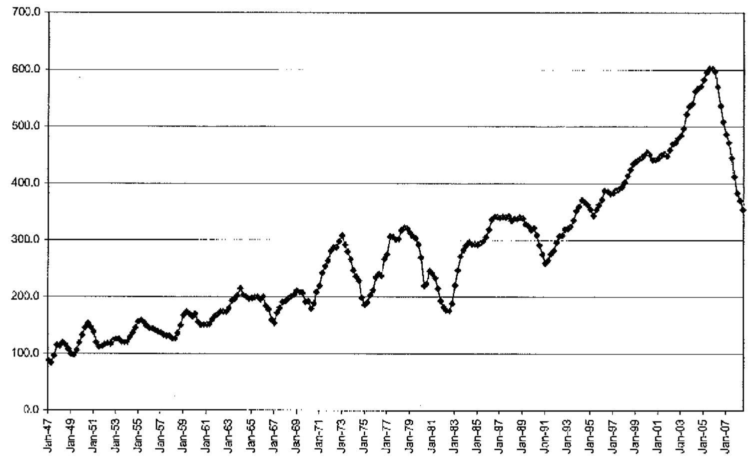


Figure 8: Real Stock Prices

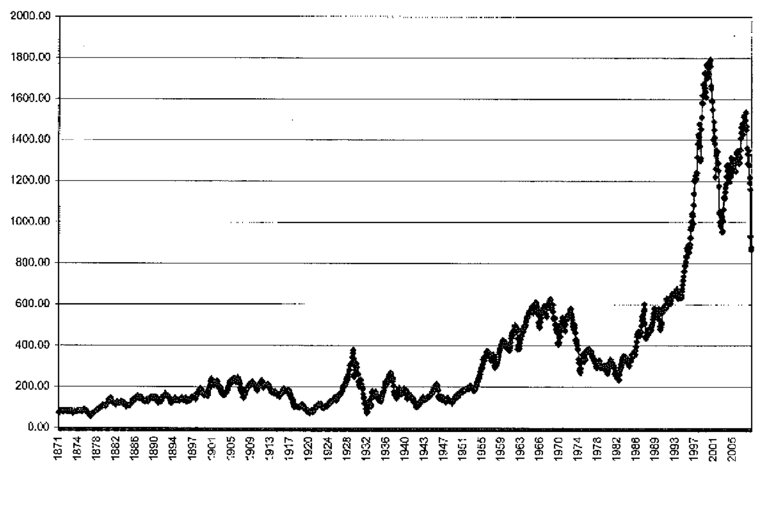
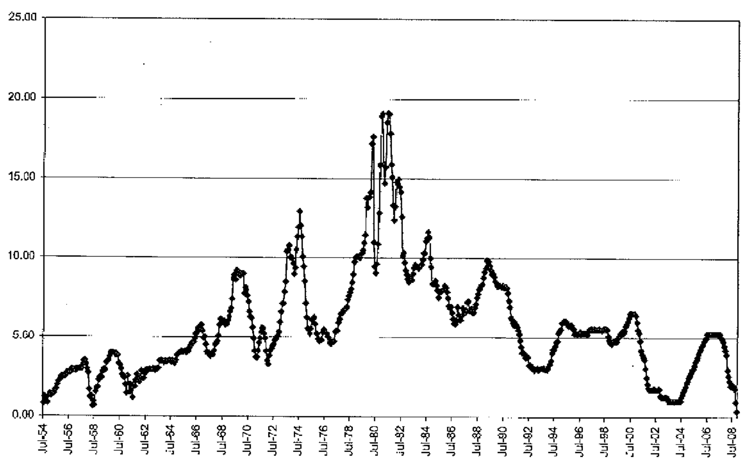


Figure 9: Effective Federal Funds Rate



Testimony

By John B. Taylor

Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
United States House of Representatives

October 22, 2009

Thank you for the opportunity to provide testimony for this hearing on bankruptcy and non-bankruptcy alternatives for failing non-bank financial institutions.

Concern that failure of a large financial institution could severely damage the economy has created a policy of government bailouts in the United States. As a consequence of that policy, the federal government has committed huge amounts of funds, intervened in many private-sector activities, and induced excessive risk-taking by people expecting bailouts to continue. An alternative to this bailout policy is sorely needed.

Two Alternative Proposals

Two main alternative proposals are currently under consideration. One has been put forth as part of the Administration's financial reform proposals. It would establish a special resolution regime under which the Secretary of the Treasury, with the approval of the President and agreement of the regulatory authorities, could apply an expanded FDIC-like resolution process to any financial firm if its failure would have "serious adverse effects on the financial system or the economy." The firm would be placed into conservatorship or receivership and the government could provide the firm with loans, purchase its assets, or guarantee its liabilities.

The other proposal would have the failing financial firm go through a bankruptcy process designed specifically to deal with some of the financial firm's assets and liabilities, which are an integral part of the financial system. The bankruptcy proposal in H.R 3310 is an example of such an approach. The conceptual idea is that the bankruptcy would permit important financial transactions to continue without significant disruption during bankruptcy.

In my view the expanded resolution regime has significant disadvantages in comparison with a bankruptcy process designed specifically for financial firms. First, the new resolution regime would essentially institutionalize the kinds of bailouts that have occurred in the recent crisis. Hence, rather than providing an alternative to policy of bailouts, it would permanently establish such a policy. Second, the expanded resolution authority would be operated with a considerable degree of discretion about when to start the intervention and about the priority to give different creditors. In contrast a bankruptcy process relies on an established rule of law rather than the discretion, and treats creditors in a known way that is understood by lenders and investors in advance. Compared to the resolution authority, bankruptcy is a more predictable process.

Relevant Lessons from the Crisis

Studying carefully what happened during the recent financial crisis is important for determining which approach to take. Understanding the events surrounding the Lehman bankruptcy is particularly important. Some argue that the cause of the panic in the fall of 2008 was the failure of the government to intervene and prevent the bankruptcy of Lehman. This view gives a rationale for continued extensive government bailouts and now to proposals for a more expansive resolution process. I do not think the evidence supports that view. Of course the surprise decision not to bailout Lehman's creditors and the run on certain money market funds was a jolt to the markets. But far worse was the chaotic intervention by the government in the following weeks, most significantly the rollout of the TARP, including the less than credible description of how the toxic assets would be removed from banks' balance sheets, the huge amount of money asked for with only 2-1/2 pages of legislation, and the scare stories of another great depression if legislation were not passed, and even if it were passed.

The government did not articulate a clear predictable strategy for lending and intervening into a financial sector. Such a strategy could have been put forth in the weeks after the Bear Stearns rescue. Instead market participants had to guess what the government would do in other similar situations. The lack of a strategy became quite evident in the confusing roll out of the TARP plan. According to event studies of interest rate spreads in the interbank market this was a more likely reason for the panic than the failure to intervene with Lehman.

My empirical research on the crisis has led me to this view and I first wrote about in November 2008 and later in my book, *Getting Off Track,* published early this year. Consider Figure 1, which is drawn from that book. It examines the spread between longer term interbank loans (Libor) and an expectation of what the overnight interest rate (federal funds rate) will be over the maturity of the loan (OIS). The Libor-OIS spread is one of the leading measures of stress in the money markets. Observe that Figure 1 focuses on events from September 1 through October 2008.

For the year previous to the events in Figure 1, the spread had been mainly fluctuating in the 50 to 100 basis point range which was where it was through the first half of September 2008. The spread moved a bit on September 15th, which is the Monday after the weekend decisions not to intervene in Lehman Brothers. It then bounced back down a little bit on September 16 around the time of the AIG intervention. While the spread did rise during the week following the Lehman Brothers decision, it was not far out of line with the events of the previous year.

On Friday of that week the Treasury announced that it was going to propose a large rescue package. Over the weekend the package was put together and was presented to Congress in testimony the following week. As shown in Figure 1, it was following this testimony that one really begins to see the crises deepening, as measured by the relentless upward movement in Libor-OIS spread for the next three weeks. Things steadily deteriorated and the spread went through the roof to 3.5 per cent.

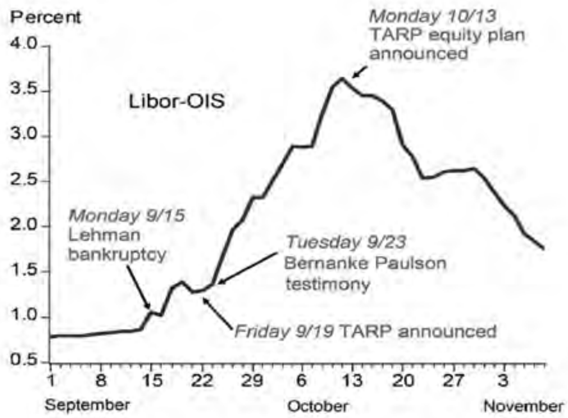


Figure 1

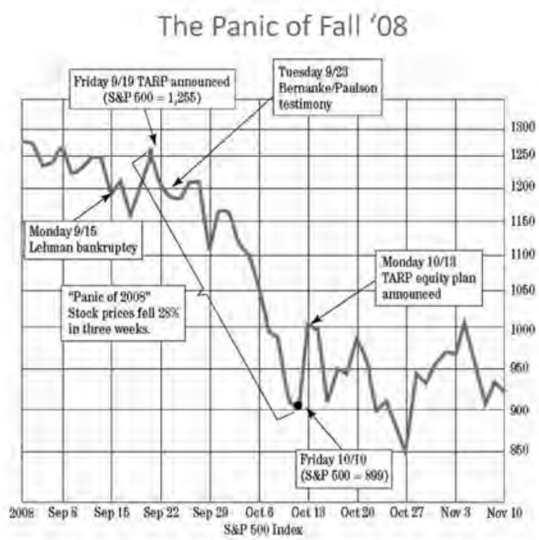


Figure 2

The government interventions during this panic period were part of a pattern of ad hoc responses starting with the Bear Stearns bailout. No guidance was given following Bear Stearns about the circumstances under which another firm, such as Lehman, would be intervened. So when the decision was made—without a good legal or economic reason—not to intervene with Lehman, no one was prepared. But the problem was not the lack of intervention per se; it was the unpredictable, unprincipled pattern of intervention that had been followed for months, which the TARP rollout revealed clearly.

With the passage of time, evidence is accumulating that such confusing and unpredictable government interventions made things worse, though we are still very close to the crisis and the issues are complex. The data on equity markets tell a similar story. Consider the S&P 500 shown in Figure 2. The S&P 500 closed at 1252 on Friday, September 12, 2008, before the Lehman bankruptcy. It was off on Monday after the news of the bankruptcy but recovered during the week closing on the following Friday, September 19 at 1255, *above* the level before the bankruptcy. It was not until the following week and the rollout of the TARP that the market began to fall sharply. And it continued to fall until October 10 when the S&P 500 hit 899 and the government finally clarified that the TARP would actually be used for equity injections.

There were many other events affecting interest rate spreads in the interbank market and equity prices around this time. Careful empirical research is needed to determine their impact on the data provided in Figures 1 and 2. Some of these events involve other government interventions and are thereby very relevant to the analysis of proposals for expanded resolution authority in comparison to bankruptcy approaches. For example, the seizure by the FDIC of Washington Mutual and its sale to JP Morgan Chase was followed quickly by a sharp drop in the price of Wachovia's bank debt, its aborted FDIC-driven acquisition by Citigroup, and its eventual acquisition by Wells Fargo. Examination of these complex bank resolution cases will help assess how an even more complex non-bank resolution process will work in practice.

Conclusion

An empirical review of the data and corresponding events in the fall of 2008 provides two important lessons. First, it shows that the bankruptcy of Lehman was unlikely the direct cause of the panic during the fall of 2008. Second, it shows that an ad hoc interventionist government policy, which was revealed for the world to see in the following weeks, was what caused the panic. Both lessons favor a rule-like bankruptcy process rather than an expanded discretionary resolution authority.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

October 21, 2009

BEN S. BERNANKE
CHAIRMAN

The Honorable Lamar S. Smith
Ranking Member
Committee on the Judiciary
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Experience over the past two years clearly demonstrates that the United States needs a comprehensive strategy to help reduce and contain systemic risk and address the related problem of financial institutions that are deemed too big--or perhaps too interconnected--to fail. In light of the topic of the Committee's October 22 hearing, I will focus on one critical aspect of such an agenda for reform--establishment of a new resolution regime for systemically important financial firms.

The Federal Reserve believes that, whenever possible, the difficulties experienced by financial firms in distress should be addressed through private-sector arrangements, such as, for example, by capital injections from private sources, as many financial firms have done or by reorganization or liquidation under the bankruptcy code like other types of firms. However, in the midst of a crisis and when no private sector solution is available, authorities--acting in the public's interest--may need an alternative to the disorderly failure of a large, highly interconnected financial firm because of the risks such a failure would pose to the financial system, the broader economy, and ultimately households and businesses.

Large, complex financial institutions tend to be highly interconnected with other financial firms and markets. Indeed, in recent years the interlinkages within the financial system have become even closer as a result of, among other things, the integration of lending activities with financial markets through increased use of securitization, the expansion of derivative hedging and trading activities among counterparties, and the growth of arrangements--such as tri-party repurchase and securities lending arrangements--through which holders of securities can obtain short-term financing from risk averse investors through collateralized loans.

In light of these and other factors, the bankruptcy of a large, complex financial firm can have serious adverse consequences for other firms and financial markets, and, consequently, for the flow of credit and for economic conditions more broadly. Such spillovers may be particularly large at times when financial markets and institutions already are under stress and the economy is weak. In such periods, the disorderly failure of a large, interconnected financial firm may result in substantial pressures on other firms seen by investors as having similar exposures or business models, dislocations in a range of financial markets, and disruptions in the flow of credit to households and businesses. Losses sustained by other financial firms could erode their financial strength, limiting their ability to play their intermediation role, or even cause them to fail, reinforcing financial pressures. Moreover, the disorderly failure of a large, interconnected firm during a time of pre-existing financial and economic stress could undermine confidence in the U.S. financial sector more broadly, potentially triggering a widespread withdrawal of funding by investors and an additional tightening of credit conditions, which could, in turn, cause a further reduction in economic activity. Historical experience shows that, once begun, a financial panic can spread rapidly and unpredictably.

Indeed, this is precisely what happened following the bankruptcy of Lehman Brothers Holdings, Inc. (Lehman) in September 2008. At that time, the U.S. and global financial system had already been under significant strains for more than a year, strains that initially were triggered by the end of the housing boom in the United States and other countries and the associated problems in markets for mortgage-related assets. These developments had resulted in a sharp decline in the valuations of mortgage-related assets, widespread pressures in funding markets, tighter credit conditions for businesses and households, and substantial declines in business and consumer confidence around the world. Over the months leading up to Lehman's failure, a weakening U.S. economy and continued financial turbulence led to a broad loss of confidence in financial firms. These strains were punctuated by the government's decision in early September to place the government-sponsored enterprises Fannie Mae and Freddie Mac into conservatorship due to concerns about their solvency.

In this environment, the bankruptcy of Lehman on September 15 led to a substantial intensification of the financial crisis, with corresponding negative effects on the flow of credit and economic conditions more broadly, both here and abroad. Concerns about the potential direct and indirect losses that Lehman's failure could impose on other firms undermined confidence in wholesale bank funding markets, leading to further increases in bank borrowing costs and a tightening of credit availability from banks. Other investment banks, which were perceived to have weaknesses similar to those at Lehman, faced substantial pressures as investors pulled back from exposures to them, thus requiring the Federal Reserve to step up its provision of liquidity to such firms as well as to banking institutions. Nonetheless, in the following weeks, several large financial institutions failed, came to the brink of failure, or were acquired by competitors under distressed circumstances.

Moreover, on September 16, the Reserve Primary Fund, a money market mutual fund, announced that it "broke the buck" as a result of losses on its holdings of Lehman commercial paper. This announcement prompted investors to withdraw large amounts not only from the Reserve Primary Fund, but also from other so-called prime funds, which usually invest mainly in private debt securities and which were seen by investors as having exposures potentially similar to those of the Reserve Primary Fund. A severe run on much of the prime money market fund industry ensued, with withdrawals totaling hundreds of billions of dollars and more than 100 funds losing a substantial volume of assets in the span of just a few weeks. The magnitude of these withdrawals decreased only after the Treasury announced a guarantee program for money market mutual fund investors and the Federal Reserve established a new lending program to support liquidity in the asset-backed commercial paper market. Nevertheless, these massive outflows undermined the stability of short-term funding markets, particularly the commercial paper market, upon which corporations rely heavily to meet their short-term borrowing needs.

Against this backdrop, investors pulled back broadly from risk-taking in September and October. Liquidity in short-term funding markets vanished for a time, and prices plunged across asset classes. Securitization markets--a key source of financing for consumers and businesses--essentially shut down with the exception of those for government-supported mortgages. Reflecting in part these developments, economic activity dropped sharply in late 2008, with the pace of job losses accelerating, continued steep declines in housing activity, and widespread cutbacks in capital spending by business.

It was precisely to avoid these types of consequences that the Federal Reserve, with the full support of the Treasury Department, acted to prevent the disorderly failure of Bear Stearns in March 2008 and of American International Group, Inc. (AIG) the day after Lehman's failure.[3] While these actions were necessary in the environment then prevailing to address unacceptable risks to the global financial system and our economy, these actions have exacerbated the belief of market participants that some financial firms are too big to fail. This belief has many undesirable effects. While shareholders of Bear Stearns and AIG suffered significant losses, creditors of the firms were shielded from loss, creating an expectation among managers and investors of similar treatment going forward. This outcome reduces market discipline and encourages excessive risk-taking by financial firms that are perceived as being too big to fail. It also provides an artificial incentive for firms to grow in order to be perceived as too big to fail. And it creates an unlevel playing field with smaller firms, which may not be regarded as having the same degree of government support. Moreover, government rescues of too-big-to-fail firms can, as we have seen in the current crisis, involve the commitment of substantial amounts of public funds.

For these reasons, it is essential that policymakers make changes to the financial rules of the game to address the too-big-to-fail problem. This will require actions on two fronts. First, we must reduce the potential for large, highly interconnected firms to place the financial system at risk. To do so, policymakers must ensure that all systemically important financial institutions are subject to a robust and effective regime for consolidated supervision. Supervision also must be strengthened to better protect the safety and soundness of individual institutions and must be reoriented to better take account of the risks that an institution may pose on the financial system as a whole. The Federal Reserve has already taken a number of important steps to improve its

[3] In light of the tools available at the time, the U.S. government was unable to prevent the failure of Lehman. The amount of available collateral at Lehman fell well short of the amount needed to secure a Federal Reserve loan of sufficient size to meet Lehman's funding needs for survival. Also, at the time of Lehman's demise, Treasury lacked the ability to inject capital into financial institutions to maintain financial stability because the Emergency Economic Stabilization Act of 2009 had not yet been enacted. Thus, when attempts to find a buyer for the company and develop an industry solution proved unavailing, Lehman's failure became unavoidable.

regulation and supervision of large financial groups along these lines, building on lessons from the current crisis.[4]

Second, and the focus of the Committee's hearing, a new, alternative resolution process should be created that would allow the government to wind down in an orderly manner a failing systemically important financial institution whose disorderly collapse would pose substantial risks to the financial system and the broader economy. Indeed, after the Lehman, Bear Stearns, and AIG experiences, there is little doubt that there needs to be a third option to the existing choices of bankruptcy and bailout for these firms.

In most cases, the federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose substantial risks to the financial system and to the economy. An alternative, orderly resolution regime already exists for banks: If a bank approaches insolvency, the Federal Deposit Insurance Corporation (FDIC) is empowered to intervene as needed to protect depositors, sell the bank's assets, and take any necessary steps to prevent broader consequences to the financial system. A similar regime should be established for systemically important *nonbank* financial institutions, including bank holding companies.

Such a regime should provide the government with the tools to restructure or wind down a failing systemically important firm in a way that mitigates the risks to financial stability and the economy and thus protects the public interest. For example, such tools should include the ability to take control of the management and operations of the failing firm; to sell assets, liabilities, and business units of the firm; to transfer the viable portions of the firm to a new "bridge" entity that can continue these operations with minimal disruptions while preserving value; and to repudiate contracts of the firm, subject to appropriate recompense. In addition, establishing credible processes for imposing losses on shareholders and creditors of the firm is essential to restoring a meaningful degree of market discipline and addressing the too-big-to-fail problem.

As I noted at the outset, financial firms--including those that might be considered systemically important--should be resolved under the bankruptcy code whenever possible. Thus, this new regime should serve as an alternative to the bankruptcy code only when needed to address systemic concerns, and its use should be subject to high standards and checks and balances. The Administration's proposal would allow the new regime to be invoked with respect to a particular firm only with the approval of multiple agencies, including the Federal Reserve, and only upon a determination that the firm's failure and resolution under the bankruptcy code or otherwise applicable law would have serious adverse effects on financial stability and the U.S. economy. These standards, which are similar to those governing use of the systemic risk exception to least-cost resolution in the Federal Deposit Insurance Act (FDI Act), appear appropriate. The Federal Reserve's participation in this decision-making process would be an extension of our long-standing role in fostering financial stability, involvement in the current

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4 See Ben S. Bernanke (2009), testimony before the House Financial Services Committee, Oct. 1.

process for invoking the systemic risk exception under the FDI Act, and status as consolidated supervisor for large banking organizations. The Federal Reserve, however, is not well suited, nor do we seek, to serve as the resolution agency for systemically important institutions under the new framework.

As we have seen during the recent crisis, a substantial commitment of public funds may be needed, at least on a temporary basis, to stabilize and facilitate the orderly resolution of a large, highly interconnected financial firm. The Administration's proposal provides for such funding needs to be addressed by the Treasury, with the ultimate costs of any assistance to be recouped through the sale or dissolution of the troubled firm supplemented by assessments on financial firms over an extended period of time if necessary. We believe this approach provides the appropriate source of funding for the resolution of systemically important financial institutions, given the unpredictable and inherently fiscal nature of this function and the importance of protecting taxpayers from losses.

Thank you for the opportunity to provide the views of the Federal Reserve on these important matters. I hope this information is helpful.

Sincerely,

MATERIAL SUBMITTED BY MICHAEL S. BARR, U.S. DEPARTMENT OF TREASURY

NOV 10 2009

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

October 26, 2009

The Honorable Steve Cohen
Chairman
Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Cohen:

Thank you for the opportunity to testify before the Subcommittee on Commercial and Administrative Law. I was pleased to hear that we are in broad agreement regarding the need to end the perception that any financial firm is "too big to fail." As I explained in my testimony, we believe strongly that our proposal for an enhanced resolution authority is necessary to achieve this objective. The market must know that the government has the tools it needs to end large financial firms in an orderly process while protecting taxpayers and the broader economy.

During the hearing, I promised to provide you with additional information regarding the status of the Troubled Asset Relief Program (TARP) program and the proposed standard for applying our enhanced resolution process. In keeping with that promise, attached please find a copy of Treasury's Monthly 105 (a) Report for September, which provides an update on the TARP investments. This includes amounts committed (page 3) and amounts repaid (page 8) under TARP. In addition, I am attaching Sections 1203(b) and 1203(d) of our proposed legislation, which provide our proposed standard for invoking the enhanced resolution authority process.

Thank you again for your assistance. I look forward to working with you and your colleagues in the Congress as we work to solve the "too big to fail" problem and provide the American people with the reform that they need.

Sincerely,

Michael S. Barr

Troubled Assets Relief Program

Monthly 105(a) Report – September 2009

UNITED STATES DEPARTMENT OF THE TREASURY

October 9, 2009

This report to Congress is pursuant to Section 105(a) of the Emergency Economic Stabilization Act of 2008.

Monthly 105(a) Report **September 2009**

Treasury is pleased to present the monthly 105(a) report to Congress for September 2009. This report provides the latest developments on efforts to stabilize the financial system, current status of TARP investments, and background information on all TARP programs.

This report contains summaries of TARP programs and investments. These summaries do not include all the material terms and conditions of such programs and investments. Please see more detailed information available at www.financialstability.gov.

Key Developments

The **Troubled Assets Relief Program** or **TARP** was established pursuant to the Emergency Economic Stabilization Act of 2008 or EESA. This law was adopted on October 3, 2008 in response to the severe financial crisis facing our country. To carry out its duties under the law, Treasury has developed a number of programs to stabilize our financial system and the housing market. These programs are described in this report. These efforts, together with the American Recovery and Reinvestment Act of 2009, help lay the financial foundation for economic recovery.

The following are some key developments that took place in September under Treasury's programs:

- The U.S. Treasury received $140.84 million in dividend, interest and fee payments from all TARP Programs in September 2009.
  - Total dividends, interest and fee payments received since inception of TARP through September 30, 2009 is $9.50 billion.
- Seven banks repaid $403.94 million of Treasury investments in September, bringing the total amount of TARP investments repaid to $70.72 billion through September 2009.
- Treasury made new investments in 14 banks totaling $140.81 million in September 2009.
- 16 new mortgage servicers signed up to participate in the Home Affordable Mortgage Modification Program (HAMP).
  - More than 85 percent of residential mortgages are covered by HAMP-participating servicers.
  - The Home Price Decline Protection (HPDP) Program, a component of HAMP, is underway for HAMP modifications begun after September 1, 2009.
- Two of the initial closings of Public-Private Investment Funds (PPIFs) established under the Legacy Securities Public-Private Investment Program (S-PPIP) took place on September 30, 2009. Each of the fund managers raised at least $500 million of private capital for the PPIF, and following the initial closing, will have up to six months and two subsequent closings to raise additional private capital. Treasury's maximum equity obligation to each PPIF is $1.11 billion. Treasury also will make a loan to each PPIF, up to a maximum of $2.22 billion.
- Negotiations were terminated with Bank of America concerning the asset guarantee arrangement announced in January 2009. In connection with that termination and in recognition of the benefits provided by entering into the term sheet for such arrangement, Bank of America paid the U.S. government $425 million.
- Planned TARP investments for the Asset Guarantee Program decreased from $12.5 billion to $5 billion.

Where is TARP Money Going?

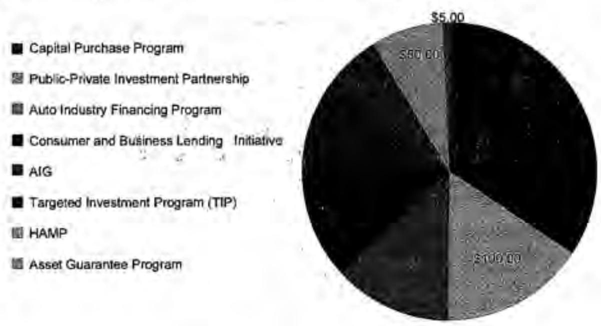
EESA authorized $700 billion for TARP. Treasury has used this authority to make investments that are designed to restore confidence in the strength of our financial institutions, restart markets that are critical to financing American households and businesses, and address the housing market problems.

As of September 30, 2009, Treasury has announced the following uses of TARP funds:

- $636.85 billion has been planned for particular TARP programs, as shown in Figure 1[1].
  - Of that amount, $455.50 billion has been committed to specific institutions under signed contracts.
  - $365.09 billion has been paid out by Treasury under those contracts.

Figure 1 shows the planned TARP investments by program as of September 30, 2009. Please see Appendix 1 for a description of the programs listed in the chart.

Figure 1: Planned TARP investments ($ billions) through September



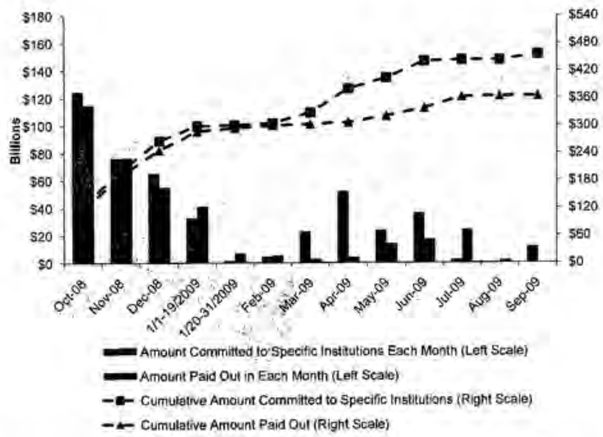
[1] Amounts stated include $1.244 billion of TARP funds to offset costs of program changes mandated by the Helping Families Save their Homes Act of 2009 (P.L. 111-22), and the additional $15 million allocated to the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) under that Act.

The authority to make investments under EESA expires on December 31, 2009. However, the Secretary of the Treasury may extend the authority through October 3, 2010 upon satisfying certain conditions.

A large part of the total investments to date occurred last fall under the Capital Purchase Program (CPP) following the adoption of EESA in October 2008. The more recent commitments include amounts extended under the Obama Administration's Financial Stability Plan. These include funds committed under the Making Home Affordable program, the planned TARP investments in the Legacy Securities Public-Private Investment Program, and those under the other programs described in this report.

Figure 2 shows the amount of TARP investments by month. It shows both the amount obligated – or committed for investment – and the amount disbursed or actually paid out.

Figure 2: Funds committed and paid out under TARP through September



Taxpayers can track progress on all of the financial stability programs and investments, as well as repayments, on Treasury's website. Specifically, taxpayers can look at investments within two business days of closing in our TARP transaction reports at www.financialstability.gov. In addition, on November 16th, Treasury will publish audited annual financial statements under Federal financial reporting standards that will provide detailed information on the value of the TARP portfolio.

Program Updates

Dividends and Interest Received

Most of the TARP money has been used to make investments in preferred stock or loans. Treasury receives dividend or interest payments on these investments from the institutions participating in TARP programs. These payments are a return on Treasury's TARP investments.

- In September, Treasury received $140.84 million in dividends, interest and fees from TARP investments.

- Treasury has received a total of $9.50 billion in dividends, interest and fees through September 30, 2009.

Figure 3 shows the allocation of dividends, interest and fees received since inception of TARP by program through September 30, 2009.

Figure 3: Dividends, interest and fees received by TARP Program through September

Please see Appendix 1 for a description of the programs listed in the chart above.

Dividend payments are a portion of a company's earnings that are paid to equity investors. Most banks participating in the CPP pay Treasury a cumulative dividend rate of 5 percent per year for the first five years and 9 percent per year thereafter. S-corporation banks pay an interest rate of 7.7 percent per year for the first five years and 13.8 percent thereafter. Preferred shares (or stock) are a form of ownership in a company. Preferred shares are senior to common stock, but junior to debt.

Treasury's Dividends and Interest Reports for TARP programs are available at http://www.financialstability.gov/latest/reportsanddocs.html

Capital Purchase Program

A major part of TARP is the Capital Purchase Program (CPP).

Under this program, Treasury invests in banks and other financial institutions to increase their capital. Banks use the CPP money in a number of ways, including shoring up capital, investing in assets, and increasing lending. Treasury continues to accept applications under the CPP from small banks.

During September, Treasury made new investments in 14 banks totaling $140.81 million; Treasury received $104.83 million in dividends, interest and fees from CPP investments, $403.94 million in CPP repayments and $1.63 million from CPP warrant repurchases.

Figure 4: CPP Snapshot through September

CPP Investments
Disbursements in September: **$140.81** million to **14** banks
Total amount disbursed since October 2008: **$ 204.62** billion
CPP investments repaid since October 2008: **$70.72** billion
CPP Banks
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Details on the Capital Purchase Program are available at
http://www.financialstability.gov/roadtostability/capitalpurchaseprogram.html

The CPP was available to banks of all sizes. The CPP remains open for investments in small banks, with terms aimed at encouraging participation by small community banks that are qualified financial institutions (QFIs) under CPP terms, with an application deadline of November 21, 2009.

Figure 5 and Figure 6 show the distribution of CPP funds by size of investment as of September 30, 2009. These charts include all 685 banks that have received funds, including those that have repaid the investment. The CPP investment amount is determined by the size of the bank.

The CPP investments are no less than one percent and no greater than three percent (five percent for small banks) of the recipient's risk-weighted assets.

Figure 5: Number of CPP banks by investment amount through September

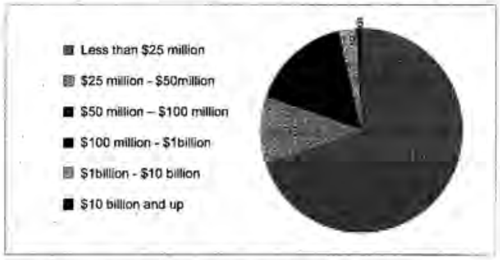
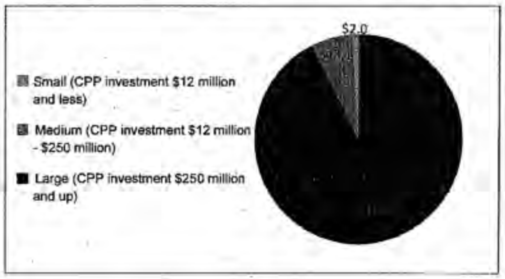


Figure 6: Total CPP funds disbursed by investment amount through September



Treasury receives dividend or interest payments on its CPP investments. Some of the banks that received investments under CPP have repaid Treasury. When a bank repays, it is typically also required to pay any accrued and unpaid dividends or interest. Treasury continues to work with federal banking regulators to evaluate requests from CPP participants interested in repaying Treasury.

Treasury also receives warrants in connection with most of its investments. When a publicly traded bank repays Treasury for a preferred stock investment, the bank has the right to repurchase its warrants. The warrants do not trade on any market and do not have observable market prices. If the bank wishes to repurchase its warrants, an independent valuation process is used to establish fair market value. If an institution chooses not to repurchase its warrants, Treasury is entitled to sell them. Treasury is currently developing an auction process to sell warrants. Privately held banks that received CPP funds issued Treasury a warrant for additional shares of preferred stock, which Treasury immediately exercised. Any proceeds from the repurchases of shares acquired from a warrant are included as cash received from sales of warrants in the chart below.

The chart below shows the amount of dividends, interest and fees, repayments of principal, and warrant proceeds under the CPP through September 2009:

Figure 7: Cash received through the CPP through September

	9/1/2009 – 9/30/2009	Total since inception
Dividends, Interest and Fees	$104.63 million	$6.80 billion
Repayments of Principal	$403.94 million	$70.72 billion
Warrant Proceeds*	$1.83 million	$2.90 billion
Total	$510.40 million	$82.42 billion

* Includes proceeds from the repurchase of shares received through the exercise of warrants.

In July 2009, Treasury exchanged a total of $25 billion of its Fixed Rate Cumulative Perpetual Preferred Stock, Series H (CPP Shares) for Series M Common Stock Equivalent ("Series M") and a warrant to purchase shares of common stock. On September 11, 2009, Series M automatically converted to common stock at a price per share of $3.25 and the associated warrant terminated on receipt of certain shareholder approvals.

Bank Lending and Intermediation Surveys

Capital Purchase Program – Lending Survey Activity

Each month, Treasury asks banks participating in the CPP to provide information about their lending activities and publishes the results in two reports described below. During the reporting period, Treasury released three new Snapshots, covering the period extending from May through July 2009, and three monthly Lending Reports, covering the period from May through July 2009. These two reports are intended to help the public easily assess the lending and intermediation activities of participating banks.

Monthly Lending and Intermediation Snapshots

This monthly report gathers and provides data on the lending and other intermediation activities for the 22 largest financial institutions that received TARP investments under the CPP. In September 2009, Treasury released the following information on July lending:

- The overall outstanding loan balance (of all respondents) fell one percent from June to July at the top 22 participants in the Capital Purchase Program (CPP), due mainly to decreased demand from borrowers, payment of outstanding debt, and charge-offs by banks.

- Total origination of new loans at the 22 surveyed institutions decreased ten percent from June to July. In July, the 22 surveyed institutions originated approximately $282 billion in new loans. Total originations of loans by all respondents rose in one category (other consumer lending products), fell in six loan categories (mortgages, home equity lines of credit (HELOCs) commercial and industrial (C&I) new commitments, and commercial real estate (CRE) renewals and new commitments), and were flat in one category (C&I renewals).

CPP Monthly Lending Report

This monthly lending report provides data on consumer lending, commercial lending, and total lending for all CPP participants.

All CPP Recipients				
Date	**Number of Respondents**	**Total Average Consumer Loans**	**Total Average Commercial Loans**	**Total Average Total Loans**
2/28/2009	521	$2,898,031	$2,380,692	$5,278,662
3/31/2009	553	$2,885,646	$2,353,047	$5,239,745
4/30/2009	540	$2,852,671	$2,329,547	$5,182,212
5/31/2009	580	$2,840,877	$2,337,524	$5,178,418
6/30/2009	559	$2,811,850	$2,429,520	$5,241,370
6/30/2009 (Adjusted)	547	$2,790,775	$2,295,090	$5,085,866
7/31/2009	552	$2,789,506	$2,297,268	$5,086,775
7/31/2009 (Adjusted)	547	$2,764,873	$2,261,140	$5,026,014
Change (June Adjusted to July Adjusted)		*-0.94%*	*-1.50%*	*-1.19%*

Details on the Bank Lending Surveys are available at
http://www.financialstability.gov/impact/surveys.htm

The Quarterly Capital Purchase Program Report

To understand better how the CPP and other stabilization initiatives launched by the Federal Government may have affected financial institutions and their activities, an interagency group was convened to determine and conduct appropriate analyses. This interagency group consists of representatives from Treasury, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. This interagency group has produced a summary of key statistics on lending, funding, and capital levels of institutions receiving TARP capital. The banks are grouped into CPP participants and non-CPP participants for the analysis.

Beginning in October, Treasury will expand the report in response to suggestions from SIGTARP for reporting on use of funds.

Details on the Quarterly Capital Purchase Program Reports are available at http://www.financialstability.gov/impact/CPPreport.html

Legacy Securities Public-Private Investment Program (S-PPIP)

S-PPIP is designed, in part, to support market functioning and facilitate price discovery in the commercial and non-agency residential mortgage-backed securities markets, helping banks and other financial institutions re-deploy capital and extend new credit to households and businesses. Following the announcement by Treasury in July that nine firms had been pre-qualified to participate as fund managers, the initial S-PPIP fund (PPIF) closings occurred on September 30, 2009. Treasury committed a maximum of $1.11 billion of equity capital together with $2.22 billion of debt financing to each PPIF. In addition to the two S-PPIP closings that took place on September 30, Treasury entered into S-PPIP transactions with three more fund managers for additional commitments of $1.11 billion of equity capital and $2.22 billion of debt financing each on October 1 and 2, 2009. Treasury expects that the remaining initial closings for the other PPIFs will occur throughout October, and that total Treasury equity and debt investment in all PPIFs will equal to $30 billion.

Fund managers for the PPIFs have established relationships with small, minority-, and women-owned businesses. Partner firms have roles including: involvement in managing the investment portfolio and cash management services, raising capital from private investors, providing trading related-services, identifying investment opportunities, and providing investment and market research and other advisory services to the PPIFs.

In recent months, financial market conditions have improved and the prices of legacy securities have appreciated. In addition, the results of the Supervisory Capital Assessment Program enabled banks to raise substantial amounts of capital as a buffer against weaker than expected economic conditions. While these developments have enabled Treasury to proceed with the PPIP program at a scale smaller than initially envisioned, Treasury remains prepared to expand the amount of resources committed to PPIP should conditions deteriorate.

Details on the Legacy Securities Public-Private Investment Program are available at http://www.financialstability.gov/roadtostability/publicprivatefund.html.

Office of the Special Master

On June 15, 2009, Treasury published the Interim Final Rule (the "Rule") on executive compensation, promulgated under the EESA as amended by the American Recovery and Reinvestment Act of 2009. The Rule contains distinct requirements for recipients of TARP funding under certain programs, including CPP participants and recipients of exceptional assistance. The exceptional assistance recipients currently include the following firms: American International Group, Inc.; Bank of America Corporation; Citigroup, Inc.; General Motors Company; GMAC, Inc.; Chrysler Financial Services Americas L.L.C; and Chrysler Group L.L.C.

The Rule requires that recipients of exceptional assistance submit proposals with respect to compensation structures for the senior executive officers and certain most highly-compensated employees (in each case, as defined in the Rule). These proposals must be submitted to the Office of the Special Master for TARP Executive Compensation, which was established by the Rule. The Special Master is responsible for the review of the proposed compensation structure for each covered employee. The Office of the Special Master has established the following processes for the submission and review of information related to those proposals.

In July 2009, the Office of the Special Master requested information from each of the exceptional assistance recipients with respect to proposed compensation structures for its senior executive officers and 20 next most highly-compensated employees. Each recipient provided submissions with respect to those employees to the Office of the Special Master on or before the August 14, 2009 deadline. Following a review of those submissions and subsequent discussions with each recipient, on August 31, 2009, the Special Master determined that the submissions were "substantially complete" for purposes of the Rule. Under the Rule, the Special Master's initial determinations with respect to these employees must be issued no later than 60 days following the Special Master's receipt of a substantially complete submission.

In addition to establishing the Office of the Special Master, the Rule provided the Special Master with specific powers designed to ensure that executive pay at these firms is in line with long-term value creation and financial stability. These include:

Review of Structures: For each exceptional assistance recipient, the Special Master is required to review and approve compensation structures for all executive officers and the 100 most highly compensated employees.

Review of Payments: As described above, for recipients of exceptional assistance, the Special Master is required to review and approve compensation structures, including payments made pursuant to those structures, for the senior executive officers and 20 next most highly paid employees.

Interpretation: The Special Master has interpretive authority over the executive compensation provisions of EESA and the Interim Final Rule. Accordingly, the Special Master will make all determinations as to the application of those provisions to particular facts.

Review of Prior Payments: The Special Master is required to review any bonuses, retention awards, and other compensation paid to the five senior executive officers and 20 next most highly-compensated employees of each TARP recipient prior to February 17, 2009, to determine whether the payments were contrary to the public interest. If the payment is determined to be contrary to the public interest, the Special Master will be responsible for negotiating for reimbursements of such payments.

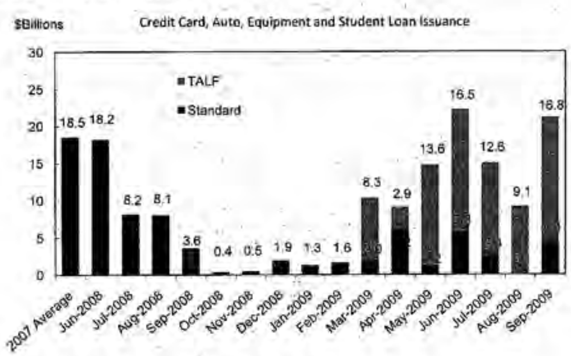
All TARP recipients, including exceptional assistance recipients, are required to adopt a luxury expenditure policy consistent with the requirements of the Rule, provide the policy to Treasury and post the policy on their Internet website, in each case, within 90 days following publication of the Rule (or, if later, 90 days following the closing date of the agreement between the TARP recipient and Treasury). These policies are generally required to address expenses including entertainment or other events, office and facility renovations, and aviation or other transportation services. Office of Financial Stability compliance personnel are currently tracking and recording policies that have been received by Treasury, and are in the process of reviewing these luxury policies.

Separately, the Rule requires that the compensation committee, CEO, and CFO, of each TARP recipient provide certain certifications to Treasury with respect to compliance with the Rule. These certifications are due within 120 days of the completion of the TARP recipient's fiscal year. Processes regarding certifications are currently being developed by Treasury.

Term Asset-Backed Securities Loan Facility

Under the **Term Asset-Backed Securities Loan Facility (TALF)**, the Federal Reserve Bank of New York makes loans to buyers of asset-backed securities in order to stimulate consumer and business lending by the issuers of those securities. Treasury uses TARP funds to provide credit support for the TALF. The asset-backed securities (ABS) that are eligible for the TALF must be backed by new or recently originated auto loans, student loans, credit card loans, small business loans, or commercial mortgage loans that may be either newly originated or legacy loans. The markets for ABS are an important source of credit for consumers and businesses. These markets essentially stopped functioning during the financial crisis. The purpose of TALF is to help restart these markets and help consumers and businesses obtain credit. Since the launch of TALF in March 2009, issuance of ABS has increased, as shown by Figure 8 below.

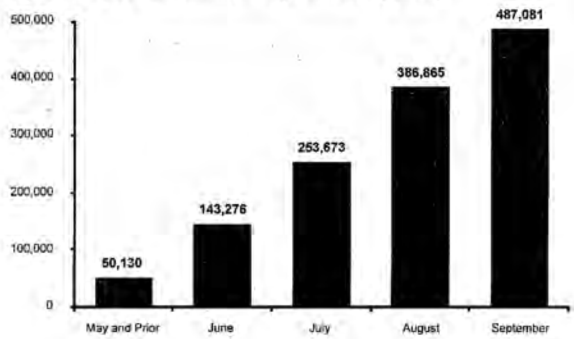
Figure 8: Total Consumer ABS Issuance through September



Source: Markets Room, U.S. Treasury Department (09/30/09)

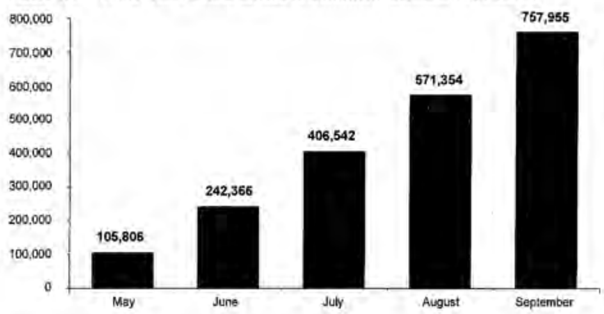
Details on TALF are available at
http://www.financialstability.gov/roadtostability/lendinginitiative.html

Figure 11: HAMP Trial Modifications (Cumulative, by Month)



Source: Trial and permanent modifications as of September 30, 2009; based on numbers reported by servicers to the HAMP system of record.

Figure 12: HAMP Trial Plans Extended to Borrowers (Cumulative, by Month)



Source: Survey data provided by servicers. September data includes October 1.

Certification

As Assistant Secretary for Financial Stability at the United States Department of Treasury, I am the official with delegated authority to approve purchases of troubled assets under the Troubled Assets Relief Program. I certify to the Congress that each decision by my office to approve purchases of troubled assets during this reporting period was based on the office's evaluation of the facts and circumstances of each proposed investment, including recommendations from regulators, in order to promote financial stability and the other purposes of the Emergency Economic Stabilization Act of 2008.

Herbert M. Allison, Jr.
Assistant Secretary
Office of Financial Stability

Appendix 1

Appendix 2

Capital Purchase Program

What is the CPP?

- Treasury created the Capital Purchase Program (CPP) in October 2008 to stabilize the financial system by providing capital to viable banks of all sizes throughout the nation. With a strengthened capital base, banks have an increased capacity to lend to U.S. businesses and consumers and to support the U.S. economy.
- Across the country, many banks are fundamentally sound, but hesitant to lend. During this unprecedented crisis, banks and financial institutions felt the strain of the troubled market conditions, which had suddenly and dramatically impaired their capital. The level of confidence between banks and other financial institutions was also low, so they were unwilling to lend to each other.
- Restoring capital and confidence is essential to allowing the financial system to work effectively and efficiently.

How does the CPP work?

- Through the CPP, Treasury makes investments in banks, increasing their capital and enabling them to continue lending to businesses and consumers and otherwise serving their customers.
- Treasury purchases senior preferred shares and other interests from qualifying U.S.-controlled banks, savings associations, and other financial institutions. Treasury also receives warrants to purchase common shares or other securities from the banks.
- Banks use the CPP money in a number of ways, including shoring up capital, investing in assets, and increasing lending.
- Banks participating in the CPP pay Treasury dividends on the preferred shares at a rate of five percent per year for the first five years following Treasury's investment and at a rate of nine percent per year thereafter. S-corporation banks pay an interest rate of 7.7 percent per year for the first five years and 13.8 percent thereafter. Preferred shares (or stock) are a form of ownership in a company.
- Banks may repay Treasury under the conditions established in the purchase agreements as amended by the American Recovery and Reinvestment Act of 2009. Treasury also has the right to sell the securities. The repayment price is equal to what Treasury paid for the shares, plus any unpaid dividends or interest.
- When a publicly-traded bank repays Treasury for the preferred stock investment, the bank has the right to repurchase its warrants. The warrants do not trade on any market and do not have observable market prices. If the bank wishes to repurchase warrants, an independent valuation process is used to establish fair market value. If an institution chooses not to repurchase the warrants, Treasury is entitled to sell the warrants. Treasury is currently developing a process to auction these warrants.

Supervisory Capital Assessment Program (SCAP) and Capital Assistance Program (CAP)

What are SCAP and CAP?

- The Supervisory Capital Assessment Program and Capital Assistance Program are important components of the Financial Stability Plan to help ensure that banks have a sufficient capital cushion in a more adverse economic scenario. SCAP is a comprehensive capital assessment exercise for the largest 19 U.S. bank holding companies and a complement to the CAP. The SCAP assessments, or "stress tests," are the most comprehensive, forward-looking review of the largest U.S. banks.

How does SCAP work?

- Federal banking supervisors conducted forward-looking assessments to provide the transparency necessary for individuals and markets to judge the strength of the banking system. Results of the stress tests were released on May 7, 2009.
- Some banks were required to take steps to improve the quality and/or the quantity of their capital to give them a larger cushion to support future lending even if the economy performs worse than expected. Banks have a range of options to raise capital in the private markets, including common equity offerings, asset sales and the conversion of other forms of capital into common equity. If these options are not sufficient, they can request additional capital from the government through CAP. Financial institutions must submit a detailed capital plan to supervisors, who will consult with Treasury on the development and evaluation of the plan. Any bank needing to augment its capital buffer at the conclusion of the SCAP was required to develop a detailed capital plan by June 8, 2009, and has until November 9, 2009 to implement that capital plan.

How does CAP work?

- In cases in which the SCAP indicated that an additional capital buffer was warranted, institutions have an opportunity to turn first to private sources of capital, but are also eligible to receive government capital via investment available immediately through the CAP. Eligible U.S. banks that did not participate in the SCAP may apply to their primary federal regulator to receive capital under the CAP.
- Capital provided under CAP will be in the form of a preferred security that is convertible into common equity. CAP securities will carry a nine percent dividend yield.

Targeted Investment Program and AIG Investment

Pursuant to EESA, Treasury has provided additional assistance on a case-by-case basis in order to stabilize institutions that were considered systemically significant to prevent broader disruption of financial markets. Treasury has provided this assistance by purchasing preferred shares in the institutions. As part of those transactions Treasury has also received warrants to purchase common shares in the institutions. As of September 30, 2009, assistance under these programs had been provided to:

Targeted Investment Program (TIP)

- Under the TIP, Treasury purchased $20 billion in preferred stock from Citigroup, Inc. and $20 billion in preferred stock from Bank of America Corporation. Both preferred stock agreements pay a dividend of eight percent per annum. These investments were in addition to CPP investments in these institutions. As part of an exchange offer designed to strengthen Citigroup's capital, Treasury recently exchanged all its preferred shares in Citigroup for a combination of common shares and trust preferred securities. The TIP preferred shares were exchanged for trust preferred securities.

American International Group (AIG)

- In November 2008, Treasury purchased $40 billion in preferred shares from AIG. In April 2009, it also created an equity capital facility, under which AIG may draw up to $29.8 billion as needed in exchange for issuing additional preferred stock to Treasury. As of September 30, 2009, AIG has drawn $3.2 billion from the facility. The preferred stock pays a non-cumulative dividend of ten percent per year.

- The Federal Reserve Bank of New York (FRBNY) also provided loans to AIG. In connection with such loans, the FRBNY received convertible preferred shares representing approximately 79.8% of the current voting power of the AIG common shares. These preferred shares were deposited in a trust, created by the FRBNY. The U.S. Treasury is the beneficiary of the trust.

Asset Guarantee Program

Under the AGP, Treasury supports the value of certain assets held by qualifying financial institutions, by helping them absorb unexpectedly large losses on certain assets. The program was designed for financial institutions whose failure could harm the financial system and has been used in conjunction with other forms of exceptional assistance.

How does AGP work?

- The pool of covered assets is proposed by the financial institution in consultation with federal regulators and Treasury, and then Treasury applies certain credit tests and asset filters in order to determine the final pool of covered assets.

- As compensation for its guarantee, Treasury collects a premium in the form of preferred stock, warrants, or other form approved by Treasury.

- As required by EESA, an actuarial analysis is used to ensure that the expected value of the premium is no less that the expected value of the losses to TARP from the guarantee. The United States government also provides a set of asset management guidelines that the institution must follow with respect to the guaranteed pool.

Who Has Received Assistance Under AGP?

Citigroup

- Treasury has guaranteed up to $5 billion of potential losses incurred on a $301 billion pool of loans, mortgage-backed securities, and other financial assets held by Citigroup. The Federal Reserve and the FDIC are also parties to this arrangement. In consideration for the guarantee, Treasury received $4.03 billion in preferred securities that pay a dividend of eight percent per annum. Treasury also received a warrant to purchase approximately 66 million shares of common stock at a strike price of $10.61 per share.

- As part of the exchange offer noted earlier, Treasury recently exchanged preferred shares received under the AGP program for an equivalent amount of trust preferred securities paying interest at the same rate.

- Treasury does not become obligated to pay on its guaranty unless and until Citigroup has absorbed $39.5 billion of losses on the covered pool. Treasury would then cover 90 percent of all losses on the covered pool, up to a maximum of $5 billion.

Bank of America

- In January 2009, Treasury, the Federal Reserve and the FDIC agreed to share potential losses on a $118 billion pool of financial instruments owned by Bank of America, consisting of securities backed by residential and commercial real estate loans and corporate debt and derivative transactions that reference such securities, loans and associated hedges.

- Bank of America agreed to absorb all eligible losses in the pool up to $10 billion. Treasury and the FDIC agreed to share eligible losses in the pool in excess of that amount, up to $10 billion, with Treasury's share capped at $7.5 billion. All further losses were to be shared ninety percent by the Federal Reserve and ten percent by Bank of America.

- On September 21, 2009, negotiations were terminated with Bank of America concerning the asset guarantee arrangement announced in January 2009. In connection with that termination and in recognition of the benefits provided by entering into the term sheet for such arrangement, Bank of America paid the U.S. government $425 million. Planned TARP investments for the Asset Guarantee Program decreased from $12.5 billion to $5 billion.

Automotive Industry Financing Program

What is the AIFP?

- The Automotive Industry Financing Program (AIFP) was developed in December 2008 to prevent a significant disruption of the U.S. automotive industry, because the potential for such a disruption posed a systemic risk to financial market stability and would have had a negative effect on the economy. AIFP loans have helped to enable General Motors and Chrysler to become more viable auto manufacturing companies.

- In the related Auto Supplier Support Program (ASSP), Treasury provides loans to ensure that auto suppliers receive compensation for their services and products, regardless of the condition of the auto companies that purchase their products.

How does the AIFP work?

- Treasury has provided approximately $76 billion in loans and equity investments to General Motors, GMAC, Chrysler, and Chrysler Financial.

- Short-term funding was initially provided to GM and Chrysler on the condition that they develop plans to achieve long-term viability. In cooperation with the Administration, GM and Chrysler eventually developed satisfactory viability plans and successfully conducted in bankruptcy proceedings sales of their assets to new entities: Chrysler's sale process was completed in 42 days and GM's was completed in 40 days. Treasury provided additional assistance during the respective periods.

- The terms of the assistance impose a number of restrictions on the recipients. Among other things, they must adhere to rigorous executive compensation standards and other measures to protect the taxpayer's interests, including limits on the institution's expenditures and other corporate governance requirements.

See below to learn how AIFP has helped each participating company.

Chrysler

- On January 2, 2009, Treasury loaned $4 billion to Chrysler Holding to give it time to implement a viable restructuring plan. On March 30, the Administration determined that the business plan submitted by Chrysler failed to demonstrate viability and announced that in order for Chrysler to receive additional taxpayer funds, it needed to find a partner with whom it could establish a successful alliance. Chrysler made the determination that forming an alliance with Fiat was the best course of action for its stakeholders.

- Treasury continued to support Chrysler as it formed an alliance with Fiat. In connection with Chrysler's bankruptcy proceedings filed on April 30, 2009, Treasury provided an additional $1.9 billion under a debtor-in-possession financing agreement to assist Chrysler in an orderly restructuring. On June 10, 2009, pursuant to a court-approved order, substantially all of Chrysler's assets were sold to the newly formed entity, Chrysler Group LLC (New Chrysler). Treasury committed to loan $6.6 billion to New Chrysler in working capital funding, and New Chrysler has drawn $4.6 billion of this amount. New Chrysler also assumed $500 million of Chrysler Holding's initial loans from Treasury. When the sale to New Chrysler was completed, Treasury acquired the rights to 9.9% of the common equity in New Chrysler.

- The original loans to Chrysler Holding, less $500 million of debt that was assumed by New Chrysler, remain outstanding and are in default. In July 2009, Chrysler Holding agreed to pay the greater of $1.375 billion or 40% of the equity value of Chrysler Financial to Treasury should Chrysler Holding receive certain distributions from Chrysler

Financial and Treasury agreed to certain forbearance with respect to Chrysler Holding's loans.

- As of September 30, 2009, Treasury owned 9.9% of the equity in New Chrysler, and was owed $5.1 billion of debt from New Chrysler. The original loans to Chrysler remain outstanding, but are reduced by $500 million of debt that was assumed by New Chrysler. Current equity ownership in New Chrysler is as follows: the Chrysler Voluntary Employee Benefit Association (VEBA) (67.7%), Fiat (20%), Treasury (9.9%) and the Government of Canada (2.5%).

Chrysler Financial

- On January 16, 2009, Treasury announced that it would lend up to $1.5 billion to a special purpose vehicle (SPV) created by Chrysler Financial to enable the company to finance the purchase of Chrysler vehicles by consumers. To satisfy the EESA warrant requirement, the Chrysler Financial SPV issued additional notes entitling Treasury to an amount equal to five percent of the maximum loan amount. Twenty percent of those notes vested upon the closing of the transaction, and additional notes were to vest on each anniversary of the transaction closing date. The loan was fully drawn by April 9, 2009. On July 14, 2009, Chrysler Financial fully repaid the loan, including the vested additional notes and interest.

General Motors

- On December 31, 2008, Treasury agreed to make loans of $13.4 billion to General Motors Corporation to fund working capital. Under the loan agreement, GM was also required to implement a viable restructuring plan by March 30. The first plan GM submitted failed to establish a credible path to viability, and the deadline was extended to June 1. Treasury loaned an additional $6 billion to fund GM during this period. To achieve an orderly restructuring, GM filed bankruptcy proceedings on June 1, 2009. Treasury provided $30.1 billion under a debtor-in-possession financing agreement to assist GM through the restructuring period. The new entity, General Motors Company (New GM), began operating on July 10, 2009, following its purchase of most of the assets of the Old GM.
- When the sale to New GM was completed on July 10, Treasury converted most of its loans to 60.8% of the common equity in the New GM and $2.1 billion in preferred stock. Treasury continues to hold loans in the amount of $7.1 billion. The New GM currently has the following ownership: Treasury (60.8%), GM Voluntary Employee Benefit Association (VEBA) (17.5%), the Canadian Government (11.7%), and Old GM's unsecured bondholders (10%).

GMAC

- On December 29, 2008, Treasury purchased $5 billion in senior preferred equity from GMAC LLC, and received an additional $250 million in preferred shares through warrants that Treasury exercised at closing. At the same time, Treasury also agreed to lend up to $1 billion of TARP funds to GM (one of GMAC's owners), to enable GM to purchase additional ownership interests in GMAC's rights offering. GM drew $884 million under that commitment on January 16, 2009. On May 21, 2009, Treasury purchased $7.5 billion more of preferred shares from GMAC and received warrants that Treasury exercised at closing for an additional $375 million in preferred shares.

- On May 29, 2009, Treasury exercised its option to exchange the $884 million loan it had made to GM in January 2009 for about 35% of the common membership interests in GMAC. As of September 30, 2009, Treasury owns $13.1 billion in preferred shares in GMAC, through purchases and the exercise of warrants, in addition to 35% of the common equity in GMAC. At the option of the Federal Reserve, it is possible that additional preferred shares could be converted in the future to permit GMAC to increase its tangible common capital ratio; if all of such preferred shares were converted, Treasury would own up to a maximum of a 79.8% voting interest in GMAC.

Consumer and Business Lending Initiative (TALF and Small Business)

What is the Term Asset-Backed Securities Loan Facility (TALF)?

- The Term Asset-Backed Securities Loan Facility (TALF) is a lending facility operated by the Federal Reserve Bank of New York. The FRBNY provides term non-recourse loans collateralized by AAA-rated asset-backed securities (ABS) backed by new or recently originated auto loans, student loans, credit card loans, small business loans, and commercial mortgage loans, including legacy commercial mortgage loans. Treasury provides credit support for TALF as part of Treasury's Consumer and Business Lending Initiative.

How does the TALF work?

- Once each month investors can request the FRBNY to make loans secured by eligible consumer or small business ABS. Assuming that the borrower and the ABS it plans to pledge as collateral meet Federal Reserve requirements, the investor will receive the requested funding. Most borrowers use the loan, together with their own funds, to purchase the ABS that serves as collateral for the TALF loans.

- If the borrower does not repay the loan, the FRBNY will enforce its rights in the collateral and sell the collateral to a special purpose vehicle (SPV) established specifically for the purpose of purchasing and managing such assets. The SPV is funded, in part, by a $20 billion subordinated loan commitment from Treasury.

- The first TALF subscription took place on March 19, 2009 and there have been five subsequent monthly ABS subscriptions to date. A total of $53.8 billion of new TALF-eligible ABS has been brought to market. Of that amount, approximately 62% or $33.1 billion was financed using TALF loans.

- On August 17, 2009, Treasury and the FRBNY announced the extension of the TALF for newly-issued ABS and legacy commercial mortgage backed securities (CMBS) through March 31, 2010. In addition, TALF will make loans against newly issued CMBS through June 30, 2010. There were no further additions to the types of collateral eligible for the TALF.

What is the Small Business and Community Lending Initiative?

- Under the Small Business and Community Lending Initiative to ensure that credit flows to entrepreneurs and small business owners, Treasury is taking measures to complement the Administration's actions to help small businesses recover and grow, including several tax cuts under the American Recovery and Reinvestment Act of 2009 and a temporary increase in the Small Business Administration (SBA) guarantee for certain types of loans. Treasury has announced a program to purchase in the secondary market securities that are backed by the SBA-guaranteed portions of loans originated under section 7(a) of the Small Business Act.

Legacy Securities Public-Private Investment Program

What is the Legacy Securities Public-Private Investment Program (S-PPIP)?

- The Legacy Securities Public-Private Investment Program is intended to address the problem of legacy real estate-related assets, support market functioning and facilitate price discovery in the market for mortgage-backed securities (MBS), allowing banks and other financial institutions to re-deploy capital and extend new credit to households and businesses. Both residential and commercial MBS are pools of mortgages bundled together by financial institutions. Rights to receive a portion of the cash generated by the pools are sold as securities in the financial markets, in the same way a stock or bond would be sold in financial markets. The term "legacy assets" generally refers to loans, asset-backed securities and other types of assets that were originated or issued before the financial markets for these types of assets deteriorated significantly in 2008.

- The Public-Private Investment Program was announced as part of the Financial Stability Plan, which also included a program for legacy loans, to be administered by the FDIC. That program is still under development.

How does the Legacy Securities PPIP work?

- Treasury will partner with selected fund managers to purchase MBS under the S-PPIP.

- Treasury provides equity as well as debt financing to special purpose entities to be formed by the managers. Treasury will provide one-half of the equity investment; the remainder must be raised by the fund manager from private sources. Treasury also will make a loan to each special purpose entity. The loan will earn interest and must be repaid at the end of the life of the fund.

- Treasury's maximum equity obligation to a PPIF would be $1.11 billion, and Treasury's maximum debt financing obligation to a PPIF would be $2.22 billion.

- The equity investment, together with warrants to be received by Treasury, ensures that if these PPIFs perform well, the U.S. treasury will benefit from the upside of the performance alongside private investors.

- The S-PPIP is designed to help the financial system recover by enabling institutions that hold mortgage-backed securities to sell them, thereby freeing up their capital for other purposes.

- Treasury carefully designed the S-PPIP terms to protect the interests of taxpayers. Fund managers may not acquire assets from or sell assets to their affiliates or any other PPIF fund manager or private investor that has committed at least ten percent of the aggregate private capital raised by such fund manager. Fund managers must submit regular monthly reports about assets purchased, assets disposed, asset values, and profits and losses. Due to the possibility of actual or potential conflicts of interest inherent in any market-based investment program, fund managers also must agree to abide by ethical standards and conflicts of interest rules developed by Treasury. In developing these requirements, Treasury worked closely with, among others, the staff of the SIGTARP and the Federal Reserve.

S-PPIP Fund Managers

- Following a comprehensive two-month application, evaluation and selection process, during which Treasury received over 100 unique applications to participate in the Legacy Securities PPIP, in July 2009, Treasury pre-qualified the following firms to participate as fund managers in the initial round of the program: AllianceBernstein, LP and its sub-advisors Greenfield Partners, LLC and Rialto Capital Management, LLC; Angelo, Gordon & Co., L.P. and GE Capital Real Estate; BlackRock, Inc.; Invesco Ltd.; Marathon Asset Management, L.P.; Oaktree Capital Management, L.P.; RLJ Western Asset Management, LP; The TCW Group, Inc.; Wellington Management Company, LLP.

- In addition, these firms have committed to establishing partnerships with small, minority-, and women-owned businesses.

Making Home Affordable

What is the Home Affordable Modification Program?

- The Home Affordable Modification Program (HAMP) is designed to give up to 3 to 4 million homeowners an opportunity to reduce their monthly mortgage payments to more affordable levels. HAMP includes both GSE and non-GSE mortgages. GSE stands for "government sponsored enterprise" and in this report refers to Fannie Mae and Freddie Mac.

- $50 billion of TARP funds will be used primarily to encourage the modification of non-GSE mortgages that financial institutions own and hold in their portfolios (whole loans) and mortgages held in private-label securitization trusts.

How does the HAMP work?

- Homeowners participating in HAMP work with HUD-certified housing counselors and mortgage servicers to have their monthly first lien mortgage payments adjusted to no more than 31 percent of monthly gross income. In other words, HAMP is designed to enable responsible homeowners to stay in their homes by reducing mortgage payments to an affordable level.

How Treasury Exercises Its Voting Rights

The Obama Administration has stated that core principles will guide Treasury's management of financial interests in private firms. One such principle is that the United States government will not interfere with or exert control over day-to-day company operations and, in the event the government obtains ownership interests, it will vote only on key governance issues. These core principles also include Treasury's commitment to seek to dispose of its ownership interests as soon as practicable. Treasury will follow these principles in a manner consistent with the obligation to promote the liquidity and stability of the financial system.

Treasury does not participate in the day-to-day management of any company in which it has an investment nor is any Treasury employee a director of any such company. Treasury's investments have generally been in the form of non-voting securities or loans. For example, the preferred shares that Treasury holds in financial institutions under the Capital Purchase Program do not have voting rights except in certain limited circumstances, such as amendments to the charter of the company, or in the event dividends are not paid for several quarters, in which case Treasury has the right to elect two directors to the board.

Treasury holds common stock in a few companies, including the new General Motors, the new Chrysler, and Citigroup. In those cases, Treasury has announced that it will follow the following principles in exercising its voting rights:

Governance Principles for Citigroup

1) Treasury will exercise its right to vote only on certain matters consisting of:

    - The election or removal of directors
    - Certain major corporate transactions such as mergers, sales of substantially all assets, and dissolution
    - Issuances of equity securities where shareholders are entitled to vote
    - Amendments to the charter or bylaws.

2) On all other matters, Treasury will vote its shares in the same proportion (for, against or abstain) as all other shares of the company's stock are voted.

These principles are set forth in an agreement between Treasury and Citigroup.

Governance Principles for GM

Before GM's expected initial public offering (IPO), Treasury will vote its shares as it determines, provided that it will vote in favor of directors nominated by the GM Voluntary Employee Benefit Association (VEBA) or the government of Canada, each of which is also a shareholder. After the IPO, the following voting principles will apply:

1) Treasury will exercise its right to vote only on certain matters consisting of:

    - The removal of directors
    - The election of directors, provided that Treasury will vote in favor of individuals nominated through a certain pre-designated process, and individuals nominated by VEBA

- Certain major corporate transactions such as mergers, sales of substantially all assets, and dissolution
- Amendments to the charter or bylaws
- Matters in which Treasury's vote is necessary for the stockholders to take action, in which case the shares will be voted in the same proportion (for, against or abstain) as all other shares of the company's stock are voted.

2) On all other matters, Treasury will not vote its shares.

These principles are set forth in the GM Stockholders Agreement.

Governance of AIG

In the case of AIG, the U.S. Treasury is the beneficiary of a trust created by the Federal Reserve Bank of New York (FRBNY). That trust owns shares having 79.8% of the voting rights of the common stock. The FRBNY has appointed three independent trustees who have the power to vote the stock and dispose of the stock with prior approval of FRBNY and after consultation with Treasury. The trust agreement provides that the trustees cannot be employees of Treasury or the FRBNY. The trust exists for the benefit of the U.S. Treasury, and the Department of the Treasury does not control the trust and it cannot direct the trustees. Treasury owns preferred stock which does not have voting rights except in certain limited circumstances (such as amendments to the charter) or in the event dividends are not paid for four quarters, in which case Treasury has the right to elect three directors to the board.

Appendix 2 – Financial Statement

Attached as Appendix 2 is the financial statement required under Sections 105(a)(2) and (3) of EESA for the period ending September 30, 2009.

United States Department of Treasury
Office of Financial Stability
Troubled Asset Relief Program

Report of Administrative Obligations and Expenditures [Section 105(a)(2)]

			For Period Ending September 30, 2009		For Period Ending October 31, 2009	
	Budget Object Class (BOC)	Budget Object Class Title	Obligations	Expenditures	Projected Obligations	Projected Expenditures
PERSONNEL SERVICES	1100 & 1200	PERSONNEL COMPENSATION & BENEFITS	$ 14,173,433	$ 13,825,384	$ 16,383,000	$ 15,908,000
		PERSONNEL SERVICES Total:	$ 14,173,433	$ 13,825,384	$ 16,383,000	$ 15,908,000
NON-PERSONNEL SERVICES	2100	TRAVEL & TRANSPORTATION OF PERSONS	$ 268,126	$ 230,257	$ 319,000	$ 277,000
	2200	TRANSPORTATION OF THINGS	11,934	11,934	13,000	15,000
	2300	RENTS, COMMUNICATIONS, UTILITIES & MISC CHARGES	112,965	41,531	114,000	43,000
	2400	PRINTING & REPRODUCTION	395	395	1,000	1,000
	2500	OTHER SERVICES	68,060,362	36,497,220	69,066,000	42,160,000
	2600	SUPPLIES AND MATERIALS	257,418	147,418	410,000	185,000
	3100	EQUIPMENT	232,054	222,675	242,000	227,000
	3200	LAND & STRUCTURES	-	-	-	-
	4300	INTEREST & DIVIDENDS	8	8	1,000	1,000
		NON-PERSONNEL SERVICES Total:	[illegible]	[illegible]	[illegible]	[illegible]
		GRAND TOTAL:	$ 83,116,697	$ 50,776,803	$ 86,549,000	$ 58,815,000

U.S. Treasury Department
Office of Financial Stability

Troubled Asset Relief Program

Agreements Under TARP [Section 105(a)(3)(A)]

For Period Ending September 30, 2009

Date Approved or Renewed	Type of Transaction	Vendor	Purpose
10/10/2008	BPA	Simpson, Thacher & Bartlett	Legal Services
10/11/2008	BPA	EnnisKnupp	Investment and Advisory Services
10/14/2008	Financial Agent	Bank of New York Mellon	Custodian and Cash Management
10/16/2008	BPA	PricewaterhouseCoopers	Internal Control Services
10/18/2008	BPA	Ernst & Young	Accounting Services
10/23/2008	IAA	GSA - Turner Consulting*	Archiving Services
10/29/2008	BPA	Hughes Hubbard & Reed	Legal Services
10/29/2008	BPA	Squire Sanders & Dempsey	Legal Services
10/31/2008	Contract	Lindholm & Associates*	Human Resources Services
11/7/2008	BPA	Thacher Proffitt & Wood**	Legal Services
11/14/2008	IAA	Securities and Exchange Commission	Detailees
11/14/2008	Procurement	CSC Systems and Solutions	IT Services
12/3/2008	IAA	Trade and Tax Bureau - Treasury	IT Services
12/5/2008	IAA	Department of Housing and Urban Development	Detailees
12/5/2008	Procurement	Washington Post	Vacancy Announcement
12/10/2008	BPA	Thacher Proffitt & Wood**	Legal Services
12/12/2008	IAA	Pension Benefit Guaranty Corp.	Legal Services
12/15/2008	IAA	Office of Thrift Supervision	Detailees
12/24/2008	Procurement	Cushman and Wakefield of VA, Inc.	Painting
1/6/2009	IAA	Office of the Controller of the Currency	Detailees
1/6/2009	IAA	State Department	Detailees
1/7/2009	Procurement	Colonial Parking	Parking
1/9/2009	IAA	Internal Revenue Service	Detailees
1/27/2009	BPA	Cadwalader Wickersham & Taft, LLP	Legal Services
1/27/2009	Procurement	Whitaker Brothers Bus. Machines*	Office Machines
2/2/2009	IAA	Government Accountability Office	Oversight
2/9/2009	Contract	Pat Taylor and Associates, Inc*	Temporary Employee Services
2/12/2009	Contract	Locke Lord Bissell & Lidell LLP	Legal Services
2/18/2009	Financial Agent	Freddie Mac	Homeownership Program
2/18/2009	Financial Agent	Fannie Mae	Homeownership Program
2/20/2009	IAA	Congressional Oversight Panel	Oversight
2/20/2009	Contract	Simpson, Thacher & Bartlett	Legal Services
2/22/2009	Contract	Venable LLP	Legal Services
3/6/2009	Contract	Boston Consulting Group	Management Consulting Support
3/16/2009	Financial Agent	EARNEST Partners	Asset Management Services
3/23/2009	Procurement	Heery International Inc.	Architects
3/30/2009	Contract	McKee Nelson, LLP	Legal Services
3/30/2009	Contract	Sonnenschein Nath & Rosenthal	Legal Services
3/30/2009	Contract	Cadwalader Wickersham & Taft, LLP	Legal Services
3/30/2009	Contract	Haynes and Boone LLP	Legal Services
3/31/2009	BPA	FI Consulting*	Modeling and Analysis
4/3/2009	Procurement	American Furniture Rentals*	Office Furniture
4/17/2009	Procurement	Herman Miller	Office Furniture
4/17/2009	IAA	Bureau of Printing and Engraving	Detailee
4/21/2009	Financial Agent	AllianceBernstein	Asset Management Services
4/21/2009	Financial Agent	FSI Group	Asset Management Services
4/21/2009	Financial Agent	Piedmont Investment Advisors	Asset Management Services
5/4/2009	IAA	Federal Reserve	Detailee
5/14/2009	Contract	Phacil*	FOIA Services
5/14/2009	IAA	Department of Treasury - US Mint	Administrative Support
5/22/2009	IAA	Department of Justice - ATF	Detailee
5/26/2009	Contract	Anderson, McCoy & Orta, LLP*	Legal Services
5/26/2009	Contract	Simpson, Thacher & Bartlett	Legal Services
6/5/2009	Contract	Department of Treasury - Internal Revenue Service	Administrative Services
6/9/2009	IAA	Department of Treasury - Financial Management Service	IT Services
6/29/2009	IAA	Department of Interior	Website Testing
7/15/2009	Contract	Judicial Watch	Legal Advisory
7/17/2009	Contract	Korn Ferry International	Administrative Support
7/30/2009	Contract	Cadwalader Wickersham & Taft, LLP	Legal Advisory
7/30/2009	Contract	Debevoise & Plimpton, LLP	Legal Advisory
7/30/2009	Contract	Fox Hefter Swibel Levin & Carol, LLP	Legal Advisory
8/11/2009	IAA	NASA	Detailee
9/2/2009	Contract	Knowledge Mosaic Inc.*	Administrative Services
9/10/2009	Contract	Equilar, Inc.*	Administrative Services
9/14/2009	Contract	PricewaterhouseCoopers	Asset Management Services
9/30/2009	Contract	SNL Financial LC	Administrative Services

* Small or Women-, or Minority-Owned Small Business
**Contract responsibilities assumed by Sonnenschein Nath & Rosenthal via novation.

Troubled Asset Relief Program

Insurance Contracts [Section 105(a)(3)(B)]

For Period Ending September 30, 2009

Name	Amount
Citigroup	$5,000,000,000

The subsidy rate for this insurance contract is determined to be -0.25 percent. Per EESA section 102(c)(3), premiums shall be set at a level necessary to meet anticipated claims. To ensure that the guarantee remains compliant with section 102(c)(3), the Master Agreement provides for post-signing adjustments including additional Citigroup preferred stock, a reduction of the covered asset pool, and/or an increased Citigroup deductible (section 5.2 of the Master Agreement). Under this section of the agreement, the subsidy rate will be reassessed once the loan pools are finalized and details are provided to Treasury (minor changes in the composition of assets are expected). Citigroup must either transfer more preferred stock or absorb more in first losses (it is unlikely the size of the asset pool would be reduced), if it is found that the risks of the assets in the loan pool exceed those estimated today and would not meet the requirements of EESA section 102(c)(3). This "true-up" would occur over the next 2 months.

U.S. Treasury Department
Office of Financial Stability

Troubled Asset Relief Program

Transactions Report [Sections 105(a) (3)(C,D,G)]

For Period Ending September 30, 2009

CAPITAL PURCHASE PROGRAM

		Seller			Purchase Details			Capital Repayment Details		Treasury Investment Remaining		Final Disposition		
Footnote	Purchase Date	Name of Institution	City	State	Investment Description	Investment Amount	Pricing Mechanism	Capital Repayment Date	Capital Repayment Amount [6]	Remaining Capital Amount	Remaining Investment Description	Final Disposition Date	Disposition Investment Description	Final Disposition Proceeds
	10/28/2008	Bank of America Corporation	Charlotte	NC	Preferred Stock w/ Warrants	$ 15,000,000,000	Par							
	10/28/2008	The Bank of New York Mellon Corporation	New York	NY	Preferred Stock w/ Warrants	$ 3,000,000,000	Par	6/17/2009 [4]	$ 3,000,000,000	$ 0	Warrants	8/5/2009	Warrants	$ 136,000,000
11	10/28/2008	Citigroup Inc.	New York	NY	Common Stock	$ 25,000,000,000	Par							
	10/28/2008	The Goldman Sachs Group, Inc.	New York	NY	Preferred Stock w/ Warrants	$ 10,000,000,000	Par	6/17/2009 [4]	$ 10,000,000,000	$ 0	Warrants	7/22/2009	Warrants	$ 1,100,000,000
	10/28/2008	JPMorgan Chase & Co.	New York	NY	Preferred Stock w/ Warrants	$ 25,000,000,000	Par	6/17/2009 [4]	$ 25,000,000,000	$ 0	Warrants			
	10/28/2008	Morgan Stanley	New York	NY	Preferred Stock w/ Warrants	$ 10,000,000,000	Par	6/17/2009 [4]	$ 10,000,000,000	$ 0	Warrants	8/12/2009	Warrants	$ 950,000,000
	10/28/2008	State Street Corporation	Boston	MA	Preferred Stock w/ Warrants	$ 2,000,000,000	Par	6/17/2009 [5]	$ 2,000,000,000	$ 0	Warrants	7/8/2009	Warrants [7]	$ 60,000,000
	10/28/2008	Wells Fargo & Company	San Francisco	CA	Preferred Stock w/ Warrants	$ 25,000,000,000	Par							
	11/14/2008	Bank of Commerce Holdings	Redding	CA	Preferred Stock w/ Warrants	$ 17,000,000	Par							
	11/14/2008	1st FS Corporation	Hendersonville	NC	Preferred Stock w/ Warrants	$ 16,369,000	Par							
	11/14/2008	UCBH Holdings, Inc.	San Francisco	CA	Preferred Stock w/ Warrants	$ 298,737,000	Par							
	11/14/2008	Northern Trust Corporation	Chicago	IL	Preferred Stock w/ Warrants	$ 1,576,000,000	Par	6/17/2009 [4]	$ 1,576,000,000	$ 0	Warrants	8/26/2009	Warrants	$ 87,000,000
	11/14/2008	SunTrust Banks, Inc.	Atlanta	GA	Preferred Stock w/ Warrants	$ 3,500,000,000	Par							
	11/14/2008	Broadway Financial Corporation	Los Angeles	CA	Preferred Stock w/ Warrants	$ 9,000,000	Par							
	11/14/2008	Washington Federal Inc.	Seattle	WA	Preferred Stock w/ Warrants	$ 200,000,000	Par	5/27/2009 [4]	$ 200,000,000	$ 0	Warrants			
	11/14/2008	BB&T Corp.	Winston-Salem	NC	Preferred Stock w/ Warrants	$ 3,133,640,000	Par	6/17/2009 [4]	$ 3,133,640,000	$ 0	Warrants	7/22/2009	Warrants	$ 67,010,402
	11/14/2008	Provident Bancshares Corp.	Baltimore	MD	Preferred Stock w/ Warrants	$ 151,500,000	Par							
	11/14/2008	Umpqua Holdings Corp.	Portland	OR	Preferred Stock w/ Warrants	$ 214,181,000	Par							
	11/14/2008	Comerica Inc.	Dallas	TX	Preferred Stock w/ Warrants	$ 2,250,000,000	Par							
	11/14/2008	Regions Financial Corp.	Birmingham	AL	Preferred Stock w/ Warrants	$ 3,500,000,000	Par							
	11/14/2008	Capital One Financial Corporation	McLean	VA	Preferred Stock w/ Warrants	$ 3,555,199,000	Par	6/17/2009 [4]	$ 3,555,199,000	$ 0	Warrants			
	11/14/2008	First Horizon National Corporation	Memphis	TN	Preferred Stock w/ Warrants	$ 866,540,000	Par							
	11/14/2008	Huntington Bancshares	Columbus	OH	Preferred Stock w/ Warrants	$ 1,398,071,000	Par							
	11/14/2008	KeyCorp	Cleveland	OH	Preferred Stock w/ Warrants	$ 2,500,000,000	Par							
	11/14/2008	Valley National Bancorp	Wayne	NJ	Preferred Stock w/ Warrants	$ 300,000,000	Par	6/3/2009 [4]	$ 75,000,000	$ 225,000,000	Preferred Stock w/ Warrants			
								9/23/2009 [4]	$ 125,000,000	$ 100,000,000	Preferred Stock w/ Warrants			
	11/14/2008	Zions Bancorporation	Salt Lake City	UT	Preferred Stock w/ Warrants	$ 1,400,000,000	Par							
	11/14/2008	Marshall & Ilsley Corporation	Milwaukee	WI	Preferred Stock w/ Warrants	$ 1,715,000,000	Par							
	11/14/2008	U.S. Bancorp	Minneapolis	MN	Preferred Stock w/ Warrants	$ 6,599,000,000	Par	6/17/2009 [4]	$ 6,599,000,000	$ 0	Warrants	7/15/2009	Warrants	$ 139,000,000
	11/14/2008	TCF Financial Corporation	Wayzata	MN	Preferred Stock w/ Warrants	$ 361,172,000	Par	4/22/2009 [4]	$ 361,172,000	$ 0	Warrants			
	11/21/2008	First Niagara Financial Group	Lockport	NY	Preferred Stock w/ Warrants	$ 184,011,000	Par	5/27/2009 [6]	$ 184,011,000	$ 0	Warrants	6/24/2009	Warrants [7]	$ 2,700,000
	11/21/2008	HF Financial Corp.	Sioux Falls	SD	Preferred Stock w/ Warrants	$ 25,000,000	Par	6/3/2009 [4]	$ 25,000,000	$ 0	Warrants	6/30/2009	Warrants	$ 650,000
	11/21/2008	Centerstate Banks of Florida Inc.	Davenport	FL	Preferred Stock w/ Warrants	$ 27,875,000	Par	9/30/2009 [5]	$ 27,875,000	$ 0	Warrants			
	11/21/2008	City National Corporation	Beverly Hills	CA	Preferred Stock w/ Warrants	$ 400,000,000	Par							
	11/21/2008	First Community Bankshares Inc.	Bluefield	VA	Preferred Stock w/ Warrants	$ 41,500,000	Par	7/8/2009 [5]	$ 41,500,000	$ 0	Warrants			
	11/21/2008	Western Alliance Bancorporation	Las Vegas	NV	Preferred Stock w/ Warrants	$ 140,000,000	Par							
	11/21/2008	Webster Financial Corporation	Waterbury	CT	Preferred Stock w/ Warrants	$ 400,000,000	Par							
	11/21/2008	Pacific Capital Bancorp	Santa Barbara	CA	Preferred Stock w/ Warrants	$ 180,634,000	Par							
	11/21/2008	Heritage Commerce Corp.	San Jose	CA	Preferred Stock w/ Warrants	$ 40,000,000	Par							
	11/21/2008	Ameris Bancorp	Moultrie	GA	Preferred Stock w/ Warrants	$ 52,000,000	Par							
	11/21/2008	Porter Bancorp Inc.	Louisville	KY	Preferred Stock w/ Warrants	$ 35,000,000	Par							

		Seller			Purchase Details			Capital Repayment Details		Treasury Investment Remaining		Final Disposition		
Footnote	Purchase Date	Name of Institution	City	State	Investment Description	Investment Amount	Pricing Mechanism	Capital Repayment Date	Capital Repayment Amount [6]	Remaining Capital Amount	Remaining Investment Description	Final Disposition Date	Disposition Investment Description	Final Disposition Proceeds
	11/21/2008	Banner Corporation	Walla Walla	WA	Preferred Stock w/ Warrants	$ 124,000,000	Par							
	11/21/2008	Cascade Financial Corporation	Everett	WA	Preferred Stock w/ Warrants	$ 38,970,000	Par							
	11/21/2008	Columbia Banking System, Inc.	Tacoma	WA	Preferred Stock w/ Warrants	$ 76,898,000	Par							
	11/21/2008	Heritage Financial Corporation	Olympia	WA	Preferred Stock w/ Warrants	$ 24,000,000	Par							
	11/21/2008	First PacTrust Bancorp, Inc.	Chula Vista	CA	Preferred Stock w/ Warrants	$ 19,300,000	Par							
	11/21/2008	Severn Bancorp, Inc.	Annapolis	MD	Preferred Stock w/ Warrants	$ 23,393,000	Par							
	11/21/2008	Boston Private Financial Holdings, Inc.	Boston	MA	Preferred Stock w/ Warrants	$ 154,000,000	Par							
	11/21/2008	Associated Banc-Corp	Green Bay	WI	Preferred Stock w/ Warrants	$ 525,000,000	Par							
	11/21/2008	Trustmark Corporation	Jackson	MS	Preferred Stock w/ Warrants	$ 215,000,000	Par							
	11/21/2008	First Community Corporation	Lexington	SC	Preferred Stock w/ Warrants	$ 11,350,000	Par							
	11/21/2008	Taylor Capital Group	Rosemont	IL	Preferred Stock w/ Warrants	$ 104,823,000	Par							
	11/21/2008	Nara Bancorp, Inc.	Los Angeles	CA	Preferred Stock w/ Warrants	$ 67,000,000	Par							
	12/5/2008	Midwest Banc Holdings, Inc.	Melrose Park	IL	Preferred Stock w/ Warrants	$ 84,784,000	Par							
	12/5/2008	MB Financial Inc.	Chicago	IL	Preferred Stock w/ Warrants	$ 196,000,000	Par							
	12/5/2008	First Midwest Bancorp, Inc.	Itasca	IL	Preferred Stock w/ Warrants	$ 193,000,000	Par							
	12/5/2008	United Community Banks, Inc.	Blairsville	GA	Preferred Stock w/ Warrants	$ 180,000,000	Par							
	12/5/2008	Wesbanco Bank Inc.	Wheeling	WV	Preferred Stock w/ Warrants	$ 75,000,000	Par	9/9/2009 [4]	$ 75,000,000	$ 0	Warrants			
	12/5/2008	Encore Bancshares Inc.	Houston	TX	Preferred Stock w/ Warrants	$ 34,000,000	Par							
	12/5/2008	Manhattan Bancorp	El Segundo	CA	Preferred Stock w/ Warrants	$ 1,700,000	Par	9/16/2009 [4]	$ 1,700,000	$ 0	Warrants			
	12/5/2008	Iberiabank Corporation	Lafayette	LA	Preferred Stock w/ Warrants	$ 90,000,000	Par	3/31/2009 [4]	$ 90,000,000	$ 0	Warrants	5/20/2009	Warrants [7]	$ 1,200,000
	12/5/2008	Eagle Bancorp, Inc.	Bethesda	MD	Preferred Stock w/ Warrants	$ 38,235,000	Par							
	12/5/2008	Sandy Spring Bancorp, Inc.	Olney	MD	Preferred Stock w/ Warrants	$ 83,094,000	Par							
	12/5/2008	Coastal Banking Company, Inc.	Fernandina Beach	FL	Preferred Stock w/ Warrants	$ 9,950,000	Par							
	12/5/2008	East West Bancorp	Pasadena	CA	Preferred Stock w/ Warrants	$ 306,546,000	Par							
	12/5/2008	South Financial Group, Inc.	Greenville	SC	Preferred Stock w/ Warrants	$ 347,000,000	Par							
	12/5/2008	Great Southern Bancorp	Springfield	MO	Preferred Stock w/ Warrants	$ 58,000,000	Par							
	12/5/2008	Cathay General Bancorp	Los Angeles	CA	Preferred Stock w/ Warrants	$ 258,000,000	Par							
	12/5/2008	Southern Community Financial Corp.	Winston-Salem	NC	Preferred Stock w/ Warrants	$ 42,750,000	Par							
	12/5/2008	CVB Financial Corp	Ontario	CA	Preferred Stock w/ Warrants	$ 130,000,000	Par	8/26/2009 [4]	$ 97,500,000	$ 32,500,000	Preferred Stock w/ Warrants			
								9/2/2009 [4]	$ 32,500,000	$ 0	Warrants			
	12/5/2008	First Defiance Financial Corp.	Defiance	OH	Preferred Stock w/ Warrants	$ 37,000,000	Par							
	12/5/2008	First Financial Holdings Inc.	Charleston	SC	Preferred Stock w/ Warrants	$ 65,000,000	Par							
	12/5/2008	Superior Bancorp Inc.	Birmingham	AL	Preferred Stock w/ Warrants	$ 69,000,000	Par							
	12/5/2008	Southwest Bancorp, Inc.	Stillwater	OK	Preferred Stock w/ Warrants	$ 70,000,000	Par							
12	12/5/2008	Popular, Inc.	San Juan	PR	Preferred Stock w/ Warrants	$ 935,000,000	Par							
	12/5/2008	Blue Valley Ban Corp	Overland Park	KS	Preferred Stock w/ Warrants	$ 21,750,000	Par							
	12/5/2008	Central Federal Corporation	Fairlawn	OH	Preferred Stock w/ Warrants	$ 7,225,000	Par							
	12/5/2008	Bank of Marin Bancorp	Novato	CA	Preferred Stock w/ Warrants	$ 28,000,000	Par	3/31/2009 [4]	$ 28,000,000	$ 0	Warrants			
	12/5/2008	Bank of North Carolina	Thomasville	NC	Preferred Stock w/ Warrants	$ 31,260,000	Par							
	12/5/2008	Central Bancorp, Inc.	Somerville	MA	Preferred Stock w/ Warrants	$ 10,000,000	Par							
	12/5/2008	Southern Missouri Bancorp, Inc.	Poplar Bluff	MO	Preferred Stock w/ Warrants	$ 9,550,000	Par							
	12/5/2008	State Bancorp, Inc.	Jericho	NY	Preferred Stock w/ Warrants	$ 36,842,000	Par							
	12/5/2008	TIB Financial Corp	Naples	FL	Preferred Stock w/ Warrants	$ 37,000,000	Par							
	12/5/2008	Unity Bancorp, Inc.	Clinton	NJ	Preferred Stock w/ Warrants	$ 20,649,000	Par							
	12/5/2008	Old Line Bancshares, Inc.	Bowie	MD	Preferred Stock w/ Warrants	$ 7,000,000	Par	7/15/2009	$ 7,000,000	$ 0	Warrants	9/2/2009	Warrants	$ 225,000
	12/5/2008	FPB Bancorp, Inc.	Port St. Lucie	FL	Preferred Stock w/ Warrants	$ 5,800,000	Par							
	12/5/2008	Sterling Financial Corporation	Spokane	WA	Preferred Stock w/ Warrants	$ 303,000,000	Par							
	12/5/2008	Oak Valley Bancorp	Oakdale	CA	Preferred Stock w/ Warrants	$ 13,500,000	Par							
	12/12/2008	Old National Bancorp	Evansville	IN	Preferred Stock w/ Warrants	$ 100,000,000	Par	3/31/2009 [4]	$ 100,000,000	$ 0	Warrants	5/8/2009	Warrants	$ 1,200,000
	12/12/2008	Capital Bank Corporation	Raleigh	NC	Preferred Stock w/ Warrants	$ 41,279,000	Par							
	12/12/2008	Pacific International Bancorp	Seattle	WA	Preferred Stock w/ Warrants	$ 6,500,000	Par							

		Seller			Purchase Details			Capital Repayment Details		Treasury Investment Remaining		Final Disposition		
Footnote	Purchase Date	Name of Institution	City	State	Investment Description	Investment Amount	Pricing Mechanism	Capital Repayment Date	Capital Repayment Amount [6]	Remaining Capital Amount	Remaining Investment Description	Final Disposition Date	Disposition Investment Description	Final Disposition Proceeds
	12/12/2008	SVB Financial Group	Santa Clara	CA	Preferred Stock w/ Warrants	$ 235,000,000	Par							
	12/12/2008	LNB Bancorp Inc.	Lorain	OH	Preferred Stock w/ Warrants	$ 25,223,000	Par							
	12/12/2008	Wilmington Trust Corporation	Wilmington	DE	Preferred Stock w/ Warrants	$ 330,000,000	Par							
	12/12/2008	Susquehanna Bancshares, Inc	Lititz	PA	Preferred Stock w/ Warrants	$ 300,000,000	Par							
	12/12/2008	Signature Bank	New York	NY	Preferred Stock w/ Warrants	$ 120,000,000	Par	3/31/2009 [4]	$ 120,000,000	$ 0	Warrants			
	12/12/2008	HopFed Bancorp	Hopkinsville	KY	Preferred Stock w/ Warrants	$ 18,400,000	Par							
	12/12/2008	Citizens Republic Bancorp, Inc.	Flint	MI	Preferred Stock w/ Warrants	$ 300,000,000	Par							
	12/12/2008	Indiana Community Bancorp	Columbus	IN	Preferred Stock w/ Warrants	$ 21,500,000	Par							
	12/12/2008	Bank of the Ozarks, Inc.	Little Rock	AR	Preferred Stock w/ Warrants	$ 75,000,000	Par							
	12/12/2008	Center Financial Corporation	Los Angeles	CA	Preferred Stock w/ Warrants	$ 55,000,000	Par							
	12/12/2008	NewBridge Bancorp	Greensboro	NC	Preferred Stock w/ Warrants	$ 52,372,000	Par							
	12/12/2008	Sterling Bancshares, Inc.	Houston	TX	Preferred Stock w/ Warrants	$ 125,198,000	Par	5/6/2009 [4]	$ 125,198,000	$ 0	Warrants			
	12/12/2008	The Bancorp, Inc.	Wilmington	DE	Preferred Stock w/ Warrants	$ 45,220,000	Par							
	12/12/2008	TowneBank	Portsmouth	VA	Preferred Stock w/ Warrants	$ 76,458,000	Par							
	12/12/2008	Wilshire Bancorp, Inc.	Los Angeles	CA	Preferred Stock w/ Warrants	$ 62,158,000	Par							
	12/12/2008	Valley Financial Corporation	Roanoke	VA	Preferred Stock w/ Warrants	$ 16,019,000	Par							
	12/12/2008	Independent Bank Corporation	Ionia	MI	Preferred Stock w/ Warrants	$ 72,000,000	Par							
	12/12/2008	Pinnacle Financial Partners, Inc.	Nashville	TN	Preferred Stock w/ Warrants	$ 95,000,000	Par							
	12/12/2008	First Litchfield Financial Corporation	Litchfield	CT	Preferred Stock w/ Warrants	$ 10,000,000	Par							
	12/12/2008	National Penn Bancshares, Inc.	Boyertown	PA	Preferred Stock w/ Warrants	$ 150,000,000	Par							
	12/12/2008	Northeast Bancorp	Lewiston	ME	Preferred Stock w/ Warrants	$ 4,227,000	Par							
	12/12/2008	Citizens South Banking Corporation	Gastonia	NC	Preferred Stock w/ Warrants	$ 20,500,000	Par							
	12/12/2008	Virginia Commerce Bancorp	Arlington	VA	Preferred Stock w/ Warrants	$ 71,000,000	Par							
	12/12/2008	Fidelity Bancorp, Inc.	Pittsburgh	PA	Preferred Stock w/ Warrants	$ 7,000,000	Par							
	12/12/2008	LSB Corporation	North Andover	MA	Preferred Stock w/ Warrants	$ 15,000,000	Par							
	12/19/2008	Intermountain Community Bancorp	Sandpoint	ID	Preferred Stock w/ Warrants	$ 27,000,000	Par							
	12/19/2008	Community West Bancshares	Goleta	CA	Preferred Stock w/ Warrants	$ 15,600,000	Par							
	12/19/2008	Synovus Financial Corp.	Columbus	GA	Preferred Stock w/ Warrants	$ 967,870,000	Par							
	12/19/2008	Tennessee Commerce Bancorp, Inc.	Franklin	TN	Preferred Stock w/ Warrants	$ 30,000,000	Par							
	12/19/2008	Community Bankers Trust Corporation	Glen Allen	VA	Preferred Stock w/ Warrants	$ 17,680,000	Par							
	12/19/2008	BancTrust Financial Group, Inc.	Mobile	AL	Preferred Stock w/ Warrants	$ 50,000,000	Par							
	12/19/2008	Enterprise Financial Services Corp.	St. Louis	MO	Preferred Stock w/ Warrants	$ 35,000,000	Par							
	12/19/2008	Mid Penn Bancorp, Inc.	Millersburg	PA	Preferred Stock w/ Warrants	$ 10,000,000	Par							
	12/19/2008	Summit State Bank	Santa Rosa	CA	Preferred Stock w/ Warrants	$ 8,500,000	Par							
	12/19/2008	VIST Financial Corp.	Wyomissing	PA	Preferred Stock w/ Warrants	$ 25,000,000	Par							
	12/19/2008	Wainwright Bank & Trust Company	Boston	MA	Preferred Stock w/ Warrants	$ 22,000,000	Par							
	12/19/2008	Whitney Holding Corporation	New Orleans	LA	Preferred Stock w/ Warrants	$ 300,000,000	Par							
	12/19/2008	The Connecticut Bank and Trust Company	Hartford	CT	Preferred Stock w/ Warrants	$ 5,448,000	Par							
	12/19/2008	CoBiz Financial Inc.	Denver	CO	Preferred Stock w/ Warrants	$ 64,450,000	Par							
	12/19/2008	Santa Lucia Bancorp	Atascadero	CA	Preferred Stock w/ Warrants	$ 4,000,000	Par							
	12/19/2008	Seacoast Banking Corporation of Florida	Stuart	FL	Preferred Stock w/ Warrants	$ 50,000,000	Par							
	12/19/2008	Horizon Bancorp	Michigan City	IN	Preferred Stock w/ Warrants	$ 25,000,000	Par							
	12/19/2008	Fidelity Southern Corporation	Atlanta	GA	Preferred Stock w/ Warrants	$ 48,200,000	Par							
	12/19/2008	Community Financial Corporation	Staunton	VA	Preferred Stock w/ Warrants	$ 12,643,000	Par							
	12/19/2008	Berkshire Hills Bancorp, Inc.	Pittsfield	MA	Preferred Stock w/ Warrants	$ 40,000,000	Par	5/27/2009 [4]	$ 40,000,000	$ 0	Warrants	6/24/2009	Warrants	$ 1,040,000
	12/19/2008	First California Financial Group, Inc	Westlake Village	CA	Preferred Stock w/ Warrants	$ 25,000,000	Par							
	12/19/2008	AmeriServ Financial, Inc	Johnstown	PA	Preferred Stock w/ Warrants	$ 21,000,000	Par							
	12/19/2008	Security Federal Corporation	Aiken	SC	Preferred Stock w/ Warrants	$ 18,000,000	Par							
	12/19/2008	Wintrust Financial Corporation	Lake Forest	IL	Preferred Stock w/ Warrants	$ 250,000,000	Par							
	12/19/2008	Flushing Financial Corporation	Lake Success	NY	Preferred Stock w/ Warrants	$ 70,000,000	Par							
	12/19/2008	Monarch Financial Holdings, Inc.	Chesapeake	VA	Preferred Stock w/ Warrants	$ 14,700,000	Par							
	12/19/2008	StellarOne Corporation	Charlottesville	VA	Preferred Stock w/ Warrants	$ 30,000,000	Par							

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	12/19/2008	Union Bankshares Corporation	Bowling Green	VA	Preferred Stock w/ Warrants	$ 59,000,000	Par							
	12/19/2008	Tidelands Bancshares, Inc	Mt. Pleasant	SC	Preferred Stock w/ Warrants	$ 14,448,000	Par							
	12/19/2008	Bancorp Rhode Island, Inc.	Providence	RI	Preferred Stock w/ Warrants	$ 30,000,000	Par	8/5/2009 [4]	$ 30,000,000	$ 0	Warrants	9/30/2009	Warrants	$ 1,400,000
	12/19/2008	Hawthorn Bancshares, Inc.	Lees Summit	MO	Preferred Stock w/ Warrants	$ 30,255,000	Par							
	12/19/2008	The Elmira Savings Bank, FSB	Elmira	NY	Preferred Stock w/ Warrants	$ 9,090,000	Par							
	12/19/2008	Alliance Financial Corporation	Syracuse	NY	Preferred Stock w/ Warrants	$ 26,918,000	Par	5/13/2009 [4]	$ 26,918,000	$ 0	Warrants	6/17/2009	Warrants	$ 900,000
	12/19/2008	Heartland Financial USA, Inc.	Dubuque	IA	Preferred Stock w/ Warrants	$ 81,698,000	Par							
	12/19/2008	Citizens First Corporation	Bowling Green	KY	Preferred Stock w/ Warrants	$ 8,779,000	Par							
2	12/19/2008	FFW Corporation	Wabash	IN	Preferred Stock w/ Exercised Warrants	$ 7,289,000	Par							
2	12/19/2008	Plains Capital Corporation	Dallas	TX	Preferred Stock w/ Exercised Warrants	$ 87,631,000	Par							
2	12/19/2008	Tri-County Financial Corporation	Waldorf	MD	Preferred Stock w/ Exercised Warrants	$ 15,540,000	Par							
3	12/19/2008	OneUnited Bank	Boston	MA	Preferred Stock	$ 12,063,000	Par							
2	12/19/2008	Patriot Bancshares, Inc.	Houston	TX	Preferred Stock w/ Exercised Warrants	$ 26,038,000	Par							
2	12/19/2008	Pacific City Financial Corporation	Los Angeles	CA	Preferred Stock w/ Exercised Warrants	$ 16,200,000	Par							
2	12/19/2008	Marquette National Corporation	Chicago	IL	Preferred Stock w/ Exercised Warrants	$ 35,500,000	Par							
2	12/19/2008	Exchange Bank	Santa Rosa	CA	Preferred Stock w/ Exercised Warrants	$ 43,000,000	Par							
2	12/19/2008	Monadnock Bancorp, Inc.	Peterborough	NH	Preferred Stock w/ Exercised Warrants	$ 1,834,000	Par							
2	12/19/2008	Bridgeview Bancorp, Inc.	Bridgeview	IL	Preferred Stock w/ Exercised Warrants	$ 38,000,000	Par							
2	12/19/2008	Fidelity Financial Corporation	Wichita	KS	Preferred Stock w/ Exercised Warrants	$ 36,282,000	Par							
2	12/19/2008	Patapsco Bancorp, Inc.	Dundalk	MD	Preferred Stock w/ Exercised Warrants	$ 6,000,000	Par							
2	12/19/2008	NCAL Bancorp	Los Angeles	CA	Preferred Stock w/ Exercised Warrants	$ 10,000,000	Par							
2	12/19/2008	FCB Bancorp, Inc.	Louisville	KY	Preferred Stock w/ Exercised Warrants	$ 9,294,000	Par							
	12/23/2008	First Financial Bancorp	Cincinnati	OH	Preferred Stock w/ Warrants	$ 80,000,000	Par							
	12/23/2008	Bridge Capital Holdings	San Jose	CA	Preferred Stock w/ Warrants	$ 23,864,000	Par							
	12/23/2008	International Bancshares Corporation	Laredo	TX	Preferred Stock w/ Warrants	$ 216,000,000	Par							
	12/23/2008	First Sound Bank	Seattle	WA	Preferred Stock w/ Warrants	$ 7,400,000	Par							
	12/23/2008	M&T Bank Corporation	Buffalo	NY	Preferred Stock w/ Warrants	$ 600,000,000	Par							
	12/23/2008	Emclaire Financial Corp.	Emlenton	PA	Preferred Stock w/ Warrants	$ 7,500,000	Par							
	12/23/2008	Park National Corporation	Newark	OH	Preferred Stock w/ Warrants	$ 100,000,000	Par							
	12/23/2008	Green Bankshares, Inc.	Greeneville	TN	Preferred Stock w/ Warrants	$ 72,278,000	Par							
	12/23/2008	Cecil Bancorp, Inc.	Elkton	MD	Preferred Stock w/ Warrants	$ 11,560,000	Par							
	12/23/2008	Financial Institutions, Inc.	Warsaw	NY	Preferred Stock w/ Warrants	$ 37,515,000	Par							
	12/23/2008	Fulton Financial Corporation	Lancaster	PA	Preferred Stock w/ Warrants	$ 376,500,000	Par							
	12/23/2008	United Bancorporation of Alabama, Inc.	Atmore	AL	Preferred Stock w/ Warrants	$ 10,300,000	Par							
	12/23/2008	MutualFirst Financial, Inc.	Muncie	IN	Preferred Stock w/ Warrants	$ 32,382,000	Par							
	12/23/2008	BCSB Bancorp, Inc.	Baltimore	MD	Preferred Stock w/ Warrants	$ 10,800,000	Par							
	12/23/2008	HMN Financial, Inc.	Rochester	MN	Preferred Stock w/ Warrants	$ 26,000,000	Par							
	12/23/2008	First Community Bank Corporation of America	Pinellas Park	FL	Preferred Stock w/ Warrants	$ 10,685,000	Par							
	12/23/2008	Sterling Bancorp	New York	NY	Preferred Stock w/ Warrants	$ 42,000,000	Par							
	12/23/2008	Intervest Bancshares Corporation	New York	NY	Preferred Stock w/ Warrants	$ 25,000,000	Par							
	12/23/2008	Peoples Bancorp of North Carolina, Inc.	Newton	NC	Preferred Stock w/ Warrants	$ 25,054,000	Par							
	12/23/2008	Parkvale Financial Corporation	Monroeville	PA	Preferred Stock w/ Warrants	$ 31,762,000	Par							
	12/23/2008	Timberland Bancorp, Inc.	Hoquiam	WA	Preferred Stock w/ Warrants	$ 16,641,000	Par							
	12/23/2008	1st Constitution Bancorp	Cranbury	NJ	Preferred Stock w/ Warrants	$ 12,000,000	Par							
	12/23/2008	Central Jersey Bancorp	Oakhurst	NJ	Preferred Stock w/ Warrants	$ 11,300,000	Par							
2	12/23/2008	Western Illinois Bancshares Inc.	Monmouth	IL	Preferred Stock w/ Exercised Warrants	$ 6,855,000	Par							
2	12/23/2008	Saigon National Bank	Westminster	CA	Preferred Stock w/ Exercised Warrants	$ 1,549,000	Par							
2	12/23/2008	Capital Pacific Bancorp	Portland	OR	Preferred Stock w/ Exercised Warrants	$ 4,000,000	Par							
2	12/23/2008	Uwharrie Capital Corp	Albemarle	NC	Preferred Stock w/ Exercised Warrants	$ 10,000,000	Par							
3	12/23/2008	Mission Valley Bancorp	Sun Valley	CA	Preferred Stock	$ 5,500,000	Par							
2	12/23/2008	The Little Bank, Incorporated	Kinston	NC	Preferred Stock w/ Exercised Warrants	$ 7,500,000	Par							
2	12/23/2008	Pacific Commerce Bank	Los Angeles	CA	Preferred Stock w/ Exercised Warrants	$ 4,060,000	Par							

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2	12/23/2008	Citizens Community Bank	South Hill	VA	Preferred Stock w/ Exercised Warrants	$ 3,000,000	Par							
2	12/23/2008	Seacoast Commerce Bank	Chula Vista	CA	Preferred Stock w/ Exercised Warrants	$ 1,800,000	Par							
2	12/23/2008	TCNB Financial Corp.	Dayton	OH	Preferred Stock w/ Exercised Warrants	$ 2,000,000	Par							
2	12/23/2008	Leader Bancorp, Inc.	Arlington	MA	Preferred Stock w/ Exercised Warrants	$ 5,830,000	Par							
2	12/23/2008	Nicolet Bankshares, Inc.	Green Bay	WI	Preferred Stock w/ Exercised Warrants	$ 14,964,000	Par							
2	12/23/2008	Magna Bank	Memphis	TN	Preferred Stock w/ Exercised Warrants	$ 13,795,000	Par							
2	12/23/2008	Western Community Bancshares, Inc.	Palm Desert	CA	Preferred Stock w/ Exercised Warrants	$ 7,290,000	Par							
2	12/23/2008	Community Investors Bancorp, Inc.	Bucyrus	OH	Preferred Stock w/ Exercised Warrants	$ 2,600,000	Par							
2	12/23/2008	Capital Bancorp, Inc.	Rockville	MD	Preferred Stock w/ Exercised Warrants	$ 4,700,000	Par							
2	12/23/2008	Cache Valley Banking Company	Logan	UT	Preferred Stock w/ Exercised Warrants	$ 4,767,000	Par							
2	12/23/2008	Citizens Bancorp	Nevada City	CA	Preferred Stock w/ Exercised Warrants	$ 10,400,000	Par							
2	12/23/2008	Tennessee Valley Financial Holdings, Inc.	Oak Ridge	TN	Preferred Stock w/ Exercised Warrants	$ 3,000,000	Par							
2	12/23/2008	Pacific Coast Bankers' Bancshares	San Francisco	CA	Preferred Stock w/ Exercised Warrants	$ 11,600,000	Par							
	12/31/2008	SunTrust Banks, Inc.	Atlanta	GA	Preferred Stock w/ Warrants	$ 1,350,000,000	Par							
	12/31/2008	The PNC Financial Services Group Inc.	Pittsburgh	PA	Preferred Stock w/ Warrants	$ 7,579,200,000	Par							
	12/31/2008	Fifth Third Bancorp	Cincinnati	OH	Preferred Stock w/ Warrants	$ 3,408,000,000	Par							
	12/31/2008	Hampton Roads Bankshares, Inc.	Norfolk	VA	Preferred Stock w/ Warrants	$ 80,347,000	Par							
	12/31/2008	CIT Group Inc.	New York	NY	Preferred Stock w/ Warrants	$ 2,330,000,000	Par							
	12/31/2008	West Bancorporation, Inc.	West Des Moines	IA	Preferred Stock w/ Warrants	$ 36,000,000	Par							
2	12/31/2008	First Banks, Inc.	Clayton	MO	Preferred Stock w/ Exercised Warrants	$ 295,400,000	Par							
1	1/9/2009	Bank of America Corporation	Charlotte	NC	Preferred Stock w/ Warrants	$ 15,000,000,000	Par							
	1/9/2009	FirstMerit Corporation	Akron	OH	Preferred Stock w/ Warrants	$ 125,000,000	Par	4/22/2009 [4]	$ 125,000,000	$ 0	Warrants	5/27/2009	Warrants	$ 5,025,000
	1/9/2009	Farmers Capital Bank Corporation	Frankfort	KY	Preferred Stock w/ Warrants	$ 30,000,000	Par							
	1/9/2009	Peapack-Gladstone Financial Corporation	Gladstone	NJ	Preferred Stock w/ Warrants	$ 28,685,000	Par							
	1/9/2009	Commerce National Bank	Newport Beach	CA	Preferred Stock w/ Warrants	$ 5,000,000	Par							
	1/9/2009	The First Bancorp, Inc.	Damariscotta	ME	Preferred Stock w/ Warrants	$ 25,000,000	Par							
	1/9/2009	Sun Bancorp, Inc.	Vineland	NJ	Preferred Stock w/ Warrants	$ 89,310,000	Par	4/8/2009 [4]	$ 89,310,000	$ 0	Warrants	5/27/2009	Warrants	$ 2,100,000
	1/9/2009	Crescent Financial Corporation	Cary	NC	Preferred Stock w/ Warrants	$ 24,900,000	Par							
	1/9/2009	American Express Company	New York	NY	Preferred Stock w/ Warrants	$ 3,388,890,000	Par	6/17/2009 [4]	$ 3,388,890,000	$ 0	Warrants	7/29/2009	Warrants	$ 340,000,000
	1/9/2009	Central Pacific Financial Corp.	Honolulu	HI	Preferred Stock w/ Warrants	$ 135,000,000	Par							
	1/9/2009	Centrue Financial Corporation	St. Louis	MO	Preferred Stock w/ Warrants	$ 32,668,000	Par							
	1/9/2009	Eastern Virginia Bankshares, Inc.	Tappahannock	VA	Preferred Stock w/ Warrants	$ 24,000,000	Par							
	1/9/2009	Colony Bankcorp, Inc.	Fitzgerald	GA	Preferred Stock w/ Warrants	$ 28,000,000	Par							
	1/9/2009	Independent Bank Corp.	Rockland	MA	Preferred Stock w/ Warrants	$ 78,158,000	Par	4/22/2009 [4]	$ 78,158,000	$ 0	Warrants	5/27/2009	Warrants	$ 2,200,000
	1/9/2009	Cadence Financial Corporation	Starkville	MS	Preferred Stock w/ Warrants	$ 44,000,000	Par							
	1/9/2009	LCNB Corp.	Lebanon	OH	Preferred Stock w/ Warrants	$ 13,400,000	Par							
	1/9/2009	Center Bancorp, Inc.	Union	NJ	Preferred Stock w/ Warrants	$ 10,000,000	Par							
	1/9/2009	F.N.B. Corporation	Hermitage	PA	Preferred Stock w/ Warrants	$ 100,000,000	Par	9/9/2009 [4]	$ 100,000,000	$ 0	Warrants			
	1/9/2009	C&F Financial Corporation	West Point	VA	Preferred Stock w/ Warrants	$ 20,000,000	Par							
	1/9/2009	North Central Bancshares, Inc.	Fort Dodge	IA	Preferred Stock w/ Warrants	$ 10,200,000	Par							
	1/9/2009	Carolina Bank Holdings, Inc.	Greensboro	NC	Preferred Stock w/ Warrants	$ 16,000,000	Par							
	1/9/2009	First Bancorp	Troy	NC	Preferred Stock w/ Warrants	$ 65,000,000	Par							
	1/9/2009	First Financial Service Corporation	Elizabethtown	KY	Preferred Stock w/ Warrants	$ 20,000,000	Par							
	1/9/2009	Codorus Valley Bancorp, Inc	York	PA	Preferred Stock w/ Warrants	$ 16,500,000	Par							
	1/9/2009	MidSouth Bancorp, Inc.	Lafayette	LA	Preferred Stock w/ Warrants	$ 20,000,000	Par							
	1/9/2009	First Security Group, Inc.	Chattanooga	TN	Preferred Stock w/ Warrants	$ 33,000,000	Par							
	1/9/2009	Shore Bankshares, Inc.	Easton	MD	Preferred Stock w/ Warrants	$ 25,000,000	Par	4/15/2009 [4]	$ 25,000,000	$ 0	Warrants			
2	1/9/2009	The Queensborough Company	Louisville	GA	Preferred Stock w/ Exercised Warrants	$ 12,000,000	Par							
2	1/9/2009	American State Bancshares, Inc.	Great Bend	KS	Preferred Stock w/ Exercised Warrants	$ 6,000,000	Par							
2	1/9/2009	Security California Bancorp	Riverside	CA	Preferred Stock w/ Exercised Warrants	$ 6,815,000	Par							
2	1/9/2009	Security Business Bancorp	San Diego	CA	Preferred Stock w/ Exercised Warrants	$ 5,803,000	Par							
2	1/9/2009	Sound Banking Company	Morehead City	NC	Preferred Stock w/ Exercised Warrants	$ 3,070,000	Par							

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3	1/9/2009	Mission Community Bancorp	San Luis Obispo	CA	Preferred Stock	$ 5,116,000	Par							
2	1/9/2009	Redwood Financial Inc.	Redwood Falls	MN	Preferred Stock w/ Exercised Warrants	$ 2,995,000	Par							
2	1/9/2009	Surrey Bancorp	Mount Airy	NC	Preferred Stock w/ Exercised Warrants	$ 2,000,000	Par							
2	1/9/2009	Independence Bank	East Greenwich	RI	Preferred Stock w/ Exercised Warrants	$ 1,065,000	Par							
2	1/9/2009	Valley Community Bank	Pleasanton	CA	Preferred Stock w/ Exercised Warrants	$ 5,500,000	Par							
2	1/9/2009	Rising Sun Bancorp	Rising Sun	MD	Preferred Stock w/ Exercised Warrants	$ 5,983,000	Par							
2	1/9/2009	Community Trust Financial Corporation	Ruston	LA	Preferred Stock w/ Exercised Warrants	$ 24,000,000	Par							
2	1/9/2009	GrandSouth Bancorporation	Greenville	SC	Preferred Stock w/ Exercised Warrants	$ 9,000,000	Par							
2	1/9/2009	Texas National Bancorporation	Jacksonville	TX	Preferred Stock w/ Exercised Warrants	$ 3,981,000	Par							
2	1/9/2009	Congaree Bancshares, Inc.	Cayce	SC	Preferred Stock w/ Exercised Warrants	$ 3,285,000	Par							
2	1/9/2009	New York Private Bank & Trust Corporation	New York	NY	Preferred Stock w/ Exercised Warrants	$ 267,274,000	Par							
	1/16/2009	Home Bancshares, Inc.	Conway	AR	Preferred Stock w/ Warrants	$ 50,000,000	Par							
	1/16/2009	Washington Banking Company	Oak Harbor	WA	Preferred Stock w/ Warrants	$ 26,380,000	Par							
	1/16/2009	New Hampshire Thrift Bancshares, Inc.	Newport	NH	Preferred Stock w/ Warrants	$ 10,000,000	Par							
	1/16/2009	Bar Harbor Bankshares	Bar Harbor	ME	Preferred Stock w/ Warrants	$ 18,751,000	Par							
	1/16/2009	Somerset Hills Bancorp	Bernardsville	NJ	Preferred Stock w/ Warrants	$ 7,414,000	Par	5/20/2009 [4]	$ 7,414,000	$ 0	Warrants	6/24/2009	Warrants	$ 275,000
	1/16/2009	SCBT Financial Corporation	Columbia	SC	Preferred Stock w/ Warrants	$ 64,779,000	Par	5/20/2009 [4]	$ 64,779,000	$ 0	Warrants	6/24/2009	Warrants	$ 1,400,000
	1/16/2009	S&T Bancorp	Indiana	PA	Preferred Stock w/ Warrants	$ 108,676,000	Par							
	1/16/2009	ECB Bancorp, Inc.	Engelhard	NC	Preferred Stock w/ Warrants	$ 17,949,000	Par							
	1/16/2009	First BanCorp	San Juan	PR	Preferred Stock w/ Warrants	$ 400,000,000	Par							
	1/16/2009	Texas Capital Bancshares, Inc.	Dallas	TX	Preferred Stock w/ Warrants	$ 75,000,000	Par	5/13/2009 [4]	$ 75,000,000	$ 0	Warrants			
	1/16/2009	Yadkin Valley Financial Corporation	Elkin	NC	Preferred Stock w/ Warrants	$ 36,000,000	Par							
3	1/16/2009	Carver Bancorp, Inc	New York	NY	Preferred Stock	$ 18,980,000	Par							
	1/16/2009	Citizens & Northern Corporation	Wellsboro	PA	Preferred Stock w/ Warrants	$ 26,440,000	Par							
	1/16/2009	MainSource Financial Group, Inc.	Greensburg	IN	Preferred Stock w/ Warrants	$ 57,000,000	Par							
	1/16/2009	MetroCorp Bancshares, Inc.	Houston	TX	Preferred Stock w/ Warrants	$ 45,000,000	Par							
	1/16/2009	United Bancorp, Inc.	Tecumseh	MI	Preferred Stock w/ Warrants	$ 20,600,000	Par							
	1/16/2009	Old Second Bancorp, Inc.	Aurora	IL	Preferred Stock w/ Warrants	$ 73,000,000	Par							
	1/16/2009	Pulaski Financial Corp	Creve Coeur	MO	Preferred Stock w/ Warrants	$ 32,538,000	Par							
	1/16/2009	OceanFirst Financial Corp.	Toms River	NJ	Preferred Stock w/ Warrants	$ 38,263,000	Par							
2	1/16/2009	Community 1st Bank	Roseville	CA	Preferred Stock w/ Exercised Warrants	$ 2,550,000	Par							
2	1/16/2009	TCB Holding Company, Texas Community Bank	The Woodlands	TX	Preferred Stock w/ Exercised Warrants	$ 11,730,000	Par							
2	1/16/2009	Centra Financial Holdings, Inc.	Morgantown	WV	Preferred Stock w/ Exercised Warrants	$ 15,000,000	Par	3/31/2009 [4]	$ 15,000,000	$ 0	Preferred Stock [2]	4/15/2009	Preferred Stock [2, 7]	$ 750,000
2	1/16/2009	First Bankers Trustshares, Inc.	Quincy	IL	Preferred Stock w/ Exercised Warrants	$ 10,000,000	Par							
2	1/16/2009	Pacific Coast National Bancorp	San Clemente	CA	Preferred Stock w/ Exercised Warrants	$ 4,120,000	Par							
3	1/16/2009	Community Bank of the Bay	Oakland	CA	Preferred Stock	$ 1,747,000	Par							
2	1/16/2009	Redwood Capital Bancorp	Eureka	CA	Preferred Stock w/ Exercised Warrants	$ 3,800,000	Par							
2	1/16/2009	Syringa Bancorp	Boise	ID	Preferred Stock w/ Exercised Warrants	$ 8,000,000	Par							
2	1/16/2009	Idaho Bancorp	Boise	ID	Preferred Stock w/ Exercised Warrants	$ 6,900,000	Par							
2	1/16/2009	Puget Sound Bank	Bellevue	WA	Preferred Stock w/ Exercised Warrants	$ 4,500,000	Par							
2	1/16/2009	United Financial Banking Companies, Inc.	Vienna	VA	Preferred Stock w/ Exercised Warrants	$ 5,658,000	Par							
2	1/16/2009	Dickinson Financial Corporation II	Kansas City	MO	Preferred Stock w/ Exercised Warrants	$ 146,053,000	Par							
2	1/16/2009	The Baraboo Bancorporation	Baraboo	WI	Preferred Stock w/ Exercised Warrants	$ 20,749,000	Par							
2	1/16/2009	Bank of Commerce	Charlotte	NC	Preferred Stock w/ Exercised Warrants	$ 3,000,000	Par							
2	1/16/2009	State Bankshares, Inc.	Fargo	ND	Preferred Stock w/ Exercised Warrants	$ 50,000,000	Par	8/12/2009 [4]	$ 12,500,000	$ 37,500,000	Preferred Stock [2]			
2	1/16/2009	BNCCORP, Inc.	Bismarck	ND	Preferred Stock w/ Exercised Warrants	$ 20,093,000	Par							
2	1/16/2009	First Manitowoc Bancorp, Inc.	Manitowoc	WI	Preferred Stock w/ Exercised Warrants	$ 12,000,000	Par	5/27/2009 [5]	$ 12,000,000	$ 0	Preferred Stock [2]	5/27/2009	Preferred Stock [2, 7]	$ 600,000
3	1/16/2009	Southern Bancorp, Inc.	Arkadelphia	AR	Preferred Stock	$ 11,000,000	Par							
2	1/16/2009	Morrill Bancshares, Inc.	Merriam	KS	Preferred Stock w/ Exercised Warrants	$ 13,000,000	Par							
2	1/16/2009	Treaty Oak Bancorp, Inc.	Austin	TX	Preferred Stock w/ Exercised Warrants	$ 3,268,000	Par							

		Seller			Purchase Details			Capital Repayment Details		Treasury Investment Remaining		Final Disposition		
Footnote	Purchase Date	Name of Institution	City	State	Investment Description	Investment Amount	Pricing Mechanism	Capital Repayment Date	Capital Repayment Amount [6]	Remaining Capital Amount	Remaining Investment Description	Final Disposition Date	Disposition Investment Description	Final Disposition Proceeds
	1/23/2009	1st Source Corporation	South Bend	IN	Preferred Stock w/ Warrants	$ 111,000,000	Par							
	1/23/2009	Princeton National Bancorp, Inc.	Princeton	IL	Preferred Stock w/ Warrants	$ 25,083,000	Par							
	1/23/2009	AB&T Financial Corporation	Gastonia	NC	Preferred Stock w/ Warrants	$ 3,500,000	Par							
	1/23/2009	First Citizens Banc Corp	Sandusky	OH	Preferred Stock w/ Warrants	$ 23,184,000	Par							
	1/23/2009	WSFS Financial Corporation	Wilmington	DE	Preferred Stock w/ Warrants	$ 52,625,000	Par							
2	1/23/2009	Commonwealth Business Bank	Los Angeles	CA	Preferred Stock w/ Exercised Warrants	$ 7,701,000	Par							
2	1/23/2009	Seaside National Bank & Trust	Orlando	FL	Preferred Stock w/ Exercised Warrants	$ 5,677,000	Par							
2	1/23/2009	CalWest Bancorp	Rancho Santa Margarita	CA	Preferred Stock w/ Exercised Warrants	$ 4,656,000	Par							
2	1/23/2009	Fresno First Bank	Fresno	CA	Preferred Stock w/ Exercised Warrants	$ 1,968,000	Par							
2	1/23/2009	First ULB Corp.	Oakland	CA	Preferred Stock w/ Exercised Warrants	$ 4,900,000	Par	4/22/2009 [4]	$ 4,900,000	$ 0	Preferred Stock [2]	4/22/2009	Preferred Stock [2, 7]	$ 245,000
2	1/23/2009	Alarion Financial Services, Inc.	Ocala	FL	Preferred Stock w/ Exercised Warrants	$ 6,514,000	Par							
2	1/23/2009	Midland States Bancorp, Inc.	Effingham	IL	Preferred Stock w/ Exercised Warrants	$ 10,189,000	Par							
2	1/23/2009	Moscow Bancshares, Inc.	Moscow	TN	Preferred Stock w/ Exercised Warrants	$ 6,216,000	Par							
2	1/23/2009	Farmers Bank	Windsor	VA	Preferred Stock w/ Exercised Warrants	$ 8,752,000	Par							
2	1/23/2009	California Oaks State Bank	Thousand Oaks	CA	Preferred Stock w/ Exercised Warrants	$ 3,300,000	Par							
2	1/23/2009	Pierce County Bancorp	Tacoma	WA	Preferred Stock w/ Exercised Warrants	$ 6,800,000	Par							
2	1/23/2009	Calvert Financial Corporation	Ashland	MO	Preferred Stock w/ Exercised Warrants	$ 1,037,000	Par							
2	1/23/2009	Liberty Bancshares, Inc.	Jonesboro	AR	Preferred Stock w/ Exercised Warrants	$ 57,500,000	Par							
2	1/23/2009	Crosstown Holding Company	Blaine	MN	Preferred Stock w/ Exercised Warrants	$ 10,650,000	Par							
2	1/23/2009	BankFirst Capital Corporation	Macon	MS	Preferred Stock w/ Exercised Warrants	$ 15,500,000	Par							
2	1/23/2009	Southern Illinois Bancorp, Inc.	Carmi	IL	Preferred Stock w/ Exercised Warrants	$ 5,000,000	Par							
2	1/23/2009	FPB Financial Corp.	Hammond	LA	Preferred Stock w/ Exercised Warrants	$ 3,240,000	Par							
2	1/23/2009	Stonebridge Financial Corp.	West Chester	PA	Preferred Stock w/ Exercised Warrants	$ 10,973,000	Par							
	1/30/2009	Peoples Bancorp Inc.	Marietta	OH	Preferred Stock w/ Warrants	$ 39,000,000	Par							
	1/30/2009	Anchor BanCorp Wisconsin Inc.	Madison	WI	Preferred Stock w/ Warrants	$ 110,000,000	Par							
	1/30/2009	Parke Bancorp, Inc.	Sewell	NJ	Preferred Stock w/ Warrants	$ 16,288,000	Par							
	1/30/2009	Central Virginia Bankshares, Inc.	Powhatan	VA	Preferred Stock w/ Warrants	$ 11,385,000	Par							
	1/30/2009	Flagstar Bancorp, Inc.	Troy	MI	Preferred Stock w/ Warrants	$ 266,657,000	Par							
	1/30/2009	Middleburg Financial Corporation	Middleburg	VA	Preferred Stock w/ Warrants	$ 22,000,000	Par							
	1/30/2009	Peninsula Bank Holding Co.	Palo Alto	CA	Preferred Stock w/ Warrants	$ 6,000,000	Par							
	1/30/2009	PrivateBancorp, Inc.	Chicago	IL	Preferred Stock w/ Warrants	$ 243,815,000	Par							
	1/30/2009	Central Valley Community Bancorp	Fresno	CA	Preferred Stock w/ Warrants	$ 7,000,000	Par							
	1/30/2009	Plumas Bancorp	Quincy	CA	Preferred Stock w/ Warrants	$ 11,949,000	Par							
	1/30/2009	Stewardship Financial Corporation	Midland Park	NJ	Preferred Stock w/ Warrants	$ 10,000,000	Par							
	1/30/2009	Oak Ridge Financial Services, Inc.	Oak Ridge	NC	Preferred Stock w/ Warrants	$ 7,700,000	Par							
	1/30/2009	First United Corporation	Oakland	MD	Preferred Stock w/ Warrants	$ 30,000,000	Par							
	1/30/2009	Community Partners Bancorp	Middletown	NJ	Preferred Stock w/ Warrants	$ 9,000,000	Par							
	1/30/2009	Guaranty Federal Bancshares, Inc.	Springfield	MO	Preferred Stock w/ Warrants	$ 17,000,000	Par							
	1/30/2009	Annapolis Bancorp, Inc.	Annapolis	MD	Preferred Stock w/ Warrants	$ 8,152,000	Par							
	1/30/2009	DNB Financial Corporation	Downingtown	PA	Preferred Stock w/ Warrants	$ 11,750,000	Par							
	1/30/2009	Firstbank Corporation	Alma	MI	Preferred Stock w/ Warrants	$ 33,000,000	Par							
2	1/30/2009	Valley Commerce Bancorp	Visalia	CA	Preferred Stock w/ Exercised Warrants	$ 7,700,000	Par							
2	1/30/2009	Greer Bancshares Incorporated	Greer	SC	Preferred Stock w/ Exercised Warrants	$ 9,993,000	Par							
2	1/30/2009	Ojai Community Bank	Ojai	CA	Preferred Stock w/ Exercised Warrants	$ 2,080,000	Par							
2	1/30/2009	Adbanc, Inc	Ogallala	NE	Preferred Stock w/ Exercised Warrants	$ 12,720,000	Par							
2	1/30/2009	Beach Business Bank	Manhattan Beach	CA	Preferred Stock w/ Exercised Warrants	$ 6,000,000	Par							
3	1/30/2009	Legacy Bancorp, Inc.	Milwaukee	WI	Preferred Stock	$ 5,498,000	Par							
2	1/30/2009	First Southern Bancorp, Inc.	Boca Raton	FL	Preferred Stock w/ Exercised Warrants	$ 10,900,000	Par							
2	1/30/2009	Country Bank Shares, Inc.	Milford	NE	Preferred Stock w/ Exercised Warrants	$ 7,525,000	Par							
2	1/30/2009	Katahdin Bankshares Corp.	Houlton	ME	Preferred Stock w/ Exercised Warrants	$ 10,449,000	Par							

		Seller			Purchase Details			Capital Repayment Details		Treasury Investment Remaining		Final Disposition		
Footnote	Purchase Date	Name of Institution	City	State	Investment Description	Investment Amount	Pricing Mechanism	Capital Repayment Date	Capital Repayment Amount [6]	Remaining Capital Amount	Remaining Investment Description	Final Disposition Date	Disposition Investment Description	Final Disposition Proceeds
2	1/30/2009	Rogers Bancshares, Inc.	Little Rock	AR	Preferred Stock w/ Exercised Warrants	$ 25,000,000	Par							
2	1/30/2009	UBT Bancshares, Inc.	Marysville	KS	Preferred Stock w/ Exercised Warrants	$ 8,950,000	Par							
2	1/30/2009	Bankers' Bank of the West Bancorp, Inc.	Denver	CO	Preferred Stock w/ Exercised Warrants	$ 12,639,000	Par							
2	1/30/2009	W.T.B. Financial Corporation	Spokane	WA	Preferred Stock w/ Exercised Warrants	$ 110,000,000	Par							
2	1/30/2009	AMB Financial Corp.	Munster	IN	Preferred Stock w/ Exercised Warrants	$ 3,674,000	Par							
2	1/30/2009	Goldwater Bank, N.A.	Scottsdale	AZ	Preferred Stock w/ Exercised Warrants	$ 2,568,000	Par							
2	1/30/2009	Equity Bancshares, Inc.	Wichita	KS	Preferred Stock w/ Exercised Warrants	$ 8,750,000	Par							
2	1/30/2009	WashingtonFirst Bank	Reston	VA	Preferred Stock w/ Exercised Warrants	$ 6,633,000	Par							
2	1/30/2009	Central Bancshares, Inc.	Houston	TX	Preferred Stock w/ Exercised Warrants	$ 5,800,000	Par							
2	1/30/2009	Hilltop Community Bancorp, Inc.	Summit	NJ	Preferred Stock w/ Exercised Warrants	$ 4,000,000	Par							
2	1/30/2009	Northway Financial, Inc.	Berlin	NH	Preferred Stock w/ Exercised Warrants	$ 10,000,000	Par							
2	1/30/2009	Monument Bank	Bethesda	MD	Preferred Stock w/ Exercised Warrants	$ 4,734,000	Par							
2	1/30/2009	Metro City Bank	Doraville	GA	Preferred Stock w/ Exercised Warrants	$ 7,700,000	Par							
2	1/30/2009	F & M Bancshares, Inc.	Trezevant	TN	Preferred Stock w/ Exercised Warrants	$ 4,609,000	Par							
2	1/30/2009	First Resource Bank	Exton	PA	Preferred Stock w/ Exercised Warrants	$ 2,600,000	Par							
	2/6/2009	MidWestOne Financial Group, Inc.	Iowa City	IA	Preferred Stock w/ Warrants	$ 16,000,000	Par							
	2/6/2009	Lakeland Bancorp, Inc.	Oak Ridge	NJ	Preferred Stock w/ Warrants	$ 59,000,000	Par							
	2/6/2009	Monarch Community Bancorp, Inc.	Coldwater	MI	Preferred Stock w/ Warrants	$ 6,785,000	Par							
	2/6/2009	The First Bancshares, Inc.	Hattiesburg	MS	Preferred Stock w/ Warrants	$ 5,000,000	Par							
	2/6/2009	Carolina Trust Bank	Lincolnton	NC	Preferred Stock w/ Warrants	$ 4,000,000	Par							
	2/6/2009	Alaska Pacific Bancshares, Inc.	Juneau	AK	Preferred Stock w/ Warrants	$ 4,781,000	Par							
3	2/6/2009	PGB Holdings, Inc.	Chicago	IL	Preferred Stock	$ 3,000,000	Par							
2	2/6/2009	The Freeport State Bank	Harper	KS	Preferred Stock w/ Exercised Warrants	$ 301,000	Par							
2	2/6/2009	Stockmens Financial Corporation	Rapid City	SD	Preferred Stock w/ Exercised Warrants	$ 15,568,000	Par							
2	2/6/2009	US Metro Bank	Garden Grove	CA	Preferred Stock w/ Exercised Warrants	$ 2,861,000	Par							
2	2/6/2009	First Express of Nebraska, Inc.	Gering	NE	Preferred Stock w/ Exercised Warrants	$ 5,000,000	Par							
2	2/6/2009	Mercantile Capital Corp.	Boston	MA	Preferred Stock w/ Exercised Warrants	$ 3,500,000	Par							
2	2/6/2009	Citizens Commerce Bancshares, Inc.	Versailles	KY	Preferred Stock w/ Exercised Warrants	$ 6,300,000	Par							
3	2/6/2009	Liberty Financial Services, Inc.	New Orleans	LA	Preferred Stock	$ 5,645,000	Par							
2	2/6/2009	Lone Star Bank	Houston	TX	Preferred Stock w/ Exercised Warrants	$ 3,072,000	Par							
2	2/6/2009	First Market Bank, FSB	Richmond	VA	Preferred Stock w/ Exercised Warrants	$ 33,900,000	Par							
2	2/6/2009	Banner County Ban Corporation	Harrisburg	NE	Preferred Stock w/ Exercised Warrants	$ 795,000	Par							
2	2/6/2009	Centrix Bank & Trust	Bedford	NH	Preferred Stock w/ Exercised Warrants	$ 7,500,000	Par							
2	2/6/2009	Todd Bancshares, Inc.	Hopkinsville	KY	Preferred Stock w/ Exercised Warrants	$ 4,000,000	Par							
2	2/6/2009	Georgia Commerce Bancshares, Inc.	Atlanta	GA	Preferred Stock w/ Exercised Warrants	$ 8,700,000	Par							
2	2/6/2009	First Bank of Charleston, Inc.	Charleston	WV	Preferred Stock w/ Exercised Warrants	$ 3,345,000	Par							
2	2/6/2009	F & M Financial Corporation	Salisbury	NC	Preferred Stock w/ Exercised Warrants	$ 17,000,000	Par							
2	2/6/2009	The Bank of Currituck	Moyock	NC	Preferred Stock w/ Exercised Warrants	$ 4,021,000	Par							
2	2/6/2009	CedarStone Bank	Lebanon	TN	Preferred Stock w/ Exercised Warrants	$ 3,564,000	Par							
2	2/6/2009	Community Holding Company of Florida, Inc.	Miramar Beach	FL	Preferred Stock w/ Exercised Warrants	$ 1,050,000	Par							
2	2/6/2009	Hyperion Bank	Philadelphia	PA	Preferred Stock w/ Exercised Warrants	$ 1,552,000	Par							
2	2/6/2009	Pascack Community Bank	Westwood	NJ	Preferred Stock w/ Exercised Warrants	$ 3,756,000	Par							
2	2/6/2009	First Western Financial, Inc.	Denver	CO	Preferred Stock w/ Exercised Warrants	$ 8,559,000	Par							
	2/13/2009	QCR Holdings, Inc.	Moline	IL	Preferred Stock w/ Warrants	$ 38,237,000	Par							
	2/13/2009	Westamerica Bancorporation	San Rafael	CA	Preferred Stock w/ Warrants	$ 83,726,000	Par	9/2/2009	$ 41,863,000	$ 41,863,000	Preferred Stock w/ Warrants			
	2/13/2009	The Bank of Kentucky Financial Corporation	Crestview Hills	KY	Preferred Stock w/ Warrants	$ 34,000,000	Par							
	2/13/2009	PremierWest Bancorp	Medford	OR	Preferred Stock w/ Warrants	$ 41,400,000	Par							
	2/13/2009	Carrollton Bancorp	Baltimore	MD	Preferred Stock w/ Warrants	$ 9,201,000	Par							
	2/13/2009	FNB United Corp.	Asheboro	NC	Preferred Stock w/ Warrants	$ 51,500,000	Par							
2	2/13/2009	First Menasha Bancshares, Inc.	Neenah	WI	Preferred Stock w/ Exercised Warrants	$ 4,797,000	Par							
2	2/13/2009	1st Enterprise Bank	Los Angeles	CA	Preferred Stock w/ Exercised Warrants	$ 4,400,000	Par							

Footnote	Purchase Date	Seller: Name of Institution	Seller: City	Seller: State	Purchase Details: Investment Description	Purchase Details: Investment Amount	Purchase Details: Pricing Mechanism	Capital Repayment Details: Capital Repayment Date	Capital Repayment Details: Capital Repayment Amount[6]	Treasury Investment Remaining: Remaining Capital Amount	Treasury Investment Remaining: Remaining Investment Description	Final Disposition: Final Disposition Date	Final Disposition: Disposition Investment Description	Final Disposition: Final Disposition Proceeds
2	2/13/2009	DeSoto County Bank	Horn Lake	MS	Preferred Stock w/ Exercised Warrants	$ 1,173,000	Par							
2	2/13/2009	Security Bancshares of Pulaski County, Inc.	Waynesville	MO	Preferred Stock w/ Exercised Warrants	$ 2,152,000	Par							
2	2/13/2009	State Capital Corporation	Greenwood	MS	Preferred Stock w/ Exercised Warrants	$ 15,000,000	Par							
2	2/13/2009	BankGreenville	Greenville	SC	Preferred Stock w/ Exercised Warrants	$ 1,000,000	Par							
2	2/13/2009	Corning Savings and Loan Association	Corning	AR	Preferred Stock w/ Exercised Warrants	$ 638,000	Par							
2	2/13/2009	Financial Security Corporation	Basin	WY	Preferred Stock w/ Exercised Warrants	$ 5,000,000	Par							
2	2/13/2009	ColoEast Bankshares, Inc.	Lamar	CO	Preferred Stock w/ Exercised Warrants	$ 10,000,000	Par							
2	2/13/2009	Santa Clara Valley Bank, N.A.	Santa Paula	CA	Preferred Stock w/ Exercised Warrants	$ 2,900,000	Par							
2	2/13/2009	Reliance Bancshares, Inc.	Frontenac	MO	Preferred Stock w/ Exercised Warrants	$ 40,000,000	Par							
2	2/13/2009	Regional Bankshares, Inc.	Hartsville	SC	Preferred Stock w/ Exercised Warrants	$ 1,500,000	Par							
2	2/13/2009	Peoples Bancorp	Lynden	WA	Preferred Stock w/ Exercised Warrants	$ 18,000,000	Par							
2	2/13/2009	First Choice Bank	Cerritos	CA	Preferred Stock w/ Exercised Warrants	$ 2,200,000	Par							
2	2/13/2009	Gregg Bancshares, Inc.	Ozark	MO	Preferred Stock w/ Exercised Warrants	$ 825,000	Par							
2	2/13/2009	Hometown Bancshares, Inc.	Corbin	KY	Preferred Stock w/ Exercised Warrants	$ 1,900,000	Par							
2	2/13/2009	Midwest Regional Bancorp, Inc.	Festus	MO	Preferred Stock w/ Exercised Warrants	$ 700,000	Par							
2	2/13/2009	Bern Bancshares, Inc.	Bern	KS	Preferred Stock w/ Exercised Warrants	$ 985,000	Par							
2	2/13/2009	Northwest Bancorporation, Inc.	Spokane	WA	Preferred Stock w/ Exercised Warrants	$ 10,500,000	Par							
2	2/13/2009	Liberty Bancshares, Inc.	Springfield	MO	Preferred Stock w/ Exercised Warrants	$ 21,900,000	Par							
2	2/13/2009	F&M Financial Corporation	Clarksville	TN	Preferred Stock w/ Exercised Warrants	$ 17,243,000	Par							
2	2/13/2009	Meridian Bank	Devon	PA	Preferred Stock w/ Exercised Warrants	$ 6,200,000	Par							
2	2/13/2009	Northwest Commercial Bank	Lakewood	WA	Preferred Stock w/ Exercised Warrants	$ 1,992,000	Par							
	2/20/2009	Royal Bancshares of Pennsylvania, Inc.	Narberth	PA	Preferred Stock w/ Warrants	$ 30,407,000	Par							
	2/20/2009	First Merchants Corporation	Muncie	IN	Preferred Stock w/ Warrants	$ 116,000,000	Par							
	2/20/2009	Northern States Financial Corporation	Waukegan	IL	Preferred Stock w/ Warrants	$ 17,211,000	Par							
2	2/20/2009	Sonoma Valley Bancorp	Sonoma	CA	Preferred Stock w/ Exercised Warrants	$ 8,653,000	Par							
2	2/20/2009	Guaranty Bancorp, Inc.	Woodsville	NH	Preferred Stock w/ Exercised Warrants	$ 6,920,000	Par							
2	2/20/2009	The Private Bank of California	Los Angeles	CA	Preferred Stock w/ Exercised Warrants	$ 5,450,000	Par							
2	2/20/2009	Lafayette Bancorp, Inc.	Oxford	MS	Preferred Stock w/ Exercised Warrants	$ 1,998,000	Par							
2	2/20/2009	Liberty Shares, Inc.	Hinesville	GA	Preferred Stock w/ Exercised Warrants	$ 17,280,000	Par							
2	2/20/2009	White River Bancshares Company	Fayetteville	AR	Preferred Stock w/ Exercised Warrants	$ 16,800,000	Par							
2	2/20/2009	United American Bank	San Mateo	CA	Preferred Stock w/ Exercised Warrants	$ 8,700,000	Par							
2	2/20/2009	Crazy Woman Creek Bancorp, Inc.	Buffalo	WY	Preferred Stock w/ Exercised Warrants	$ 3,100,000	Par							
2	2/20/2009	First Priority Financial Corp.	Malvern	PA	Preferred Stock w/ Exercised Warrants	$ 4,579,000	Par							
2	2/20/2009	Mid-Wisconsin Financial Services, Inc.	Medford	WI	Preferred Stock w/ Exercised Warrants	$ 10,000,000	Par							
2	2/20/2009	Market Bancorporation, Inc.	New Market	MN	Preferred Stock w/ Exercised Warrants	$ 2,060,000	Par							
2	2/20/2009	Hometown Bancorp of Alabama, Inc.	Oneonta	AL	Preferred Stock w/ Exercised Warrants	$ 3,250,000	Par							
2	2/20/2009	Security State Bancshares, Inc.	Charleston	MO	Preferred Stock w/ Exercised Warrants	$ 12,500,000	Par							
2	2/20/2009	CBB Bancorp	Cartersville	GA	Preferred Stock w/ Exercised Warrants	$ 2,644,000	Par							
2	2/20/2009	BancPlus Corporation	Ridgeland	MS	Preferred Stock w/ Exercised Warrants	$ 48,000,000	Par							
2	2/20/2009	Central Community Corporation	Temple	TX	Preferred Stock w/ Exercised Warrants	$ 22,000,000	Par							
2	2/20/2009	First BancTrust Corporation	Paris	IL	Preferred Stock w/ Exercised Warrants	$ 7,350,000	Par							
2	2/20/2009	Premier Service Bank	Riverside	CA	Preferred Stock w/ Exercised Warrants	$ 4,000,000	Par							
2	2/20/2009	Florida Business BancGroup, Inc.	Tampa	FL	Preferred Stock w/ Exercised Warrants	$ 9,495,000	Par							
2	2/20/2009	Hamilton State Bancshares	Hoschton	GA	Preferred Stock w/ Exercised Warrants	$ 7,000,000	Par							
	2/27/2009	Lakeland Financial Corporation	Warsaw	IN	Preferred Stock w/ Warrants	$ 56,044,000	Par							
	2/27/2009	First M&F Corporation	Kosciusko	MS	Preferred Stock w/ Warrants	$ 30,000,000	Par							
	2/27/2009	Southern First Bancshares, Inc.	Greenville	SC	Preferred Stock w/ Warrants	$ 17,299,000	Par							
	2/27/2009	Integra Bank Corporation	Evansville	IN	Preferred Stock w/ Warrants	$ 83,586,000	Par							
2	2/27/2009	Community First Inc.	Columbia	TN	Preferred Stock w/ Exercised Warrants	$ 17,806,000	Par							
2	2/27/2009	BNC Financial Group, Inc.	New Canaan	CT	Preferred Stock w/ Exercised Warrants	$ 4,797,000	Par							
2	2/27/2009	California Bank of Commerce	Lafayette	CA	Preferred Stock w/ Exercised Warrants	$ 4,000,000	Par							
2	2/27/2009	Columbine Capital Corp.	Buena Vista	CO	Preferred Stock w/ Exercised Warrants	$ 2,260,000	Par							

		Seller			Purchase Details			Capital Repayment Details		Treasury Investment Remaining		Final Disposition		
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2	2/27/2009	National Bancshares, Inc.	Bettendorf	IA	Preferred Stock w/ Exercised Warrants	$ 24,664,000	Par							
2	2/27/2009	First State Bank of Mobeetie	Mobeetie	TX	Preferred Stock w/ Exercised Warrants	$ 731,000	Par							
2	2/27/2009	Ridgestone Financial Services, Inc.	Brookfield	WI	Preferred Stock w/ Exercised Warrants	$ 10,900,000	Par							
2	2/27/2009	Community Business Bank	West Sacramento	CA	Preferred Stock w/ Exercised Warrants	$ 3,976,000	Par							
2	2/27/2009	D.L. Evans Bancorp	Burley	ID	Preferred Stock w/ Exercised Warrants	$ 19,891,000	Par							
2	2/27/2009	TriState Capital Holdings, Inc.	Pittsburgh	PA	Preferred Stock w/ Exercised Warrants	$ 23,000,000	Par							
2	2/27/2009	Green City Bancshares, Inc.	Green City	MO	Preferred Stock w/ Exercised Warrants	$ 651,000	Par							
2	2/27/2009	First Gothenburg Bancshares, Inc.	Gothenburg	NE	Preferred Stock w/ Exercised Warrants	$ 7,570,000	Par							
2	2/27/2009	Green Circle Investments, Inc.	Clive	IA	Preferred Stock w/ Exercised Warrants	$ 2,400,000	Par							
2	2/27/2009	Private Bancorporation, Inc.	Minneapolis	MN	Preferred Stock w/ Exercised Warrants	$ 4,960,000	Par							
2	2/27/2009	Regent Capital Corporation	Nowata	OK	Preferred Stock w/ Exercised Warrants	$ 2,655,000	Par							
2	2/27/2009	Central Bancorp, Inc.	Garland	TX	Preferred Stock w/ Exercised Warrants	$ 22,500,000	Par							
2	2/27/2009	Medallion Bank	Salt Lake City	UT	Preferred Stock w/ Exercised Warrants	$ 11,800,000	Par							
2	2/27/2009	PSB Financial Corporation	Many	LA	Preferred Stock w/ Exercised Warrants	$ 9,270,000	Par							
2	2/27/2009	Avenue Financial Holdings, Inc.	Nashville	TN	Preferred Stock w/ Exercised Warrants	$ 7,400,000	Par							
2	2/27/2009	Howard Bancorp, Inc.	Ellicott City	MD	Preferred Stock w/ Exercised Warrants	$ 5,983,000	Par							
2	2/27/2009	FNB Bancorp	South San Francisco	CA	Preferred Stock w/ Exercised Warrants	$ 12,000,000	Par							
2	2/27/2009	The Victory Bank	Limerick	PA	Preferred Stock w/ Exercised Warrants	$ 541,000	Par							
2	2/27/2009	Catskill Hudson Bancorp, Inc	Rock Hill	NY	Preferred Stock w/ Exercised Warrants	$ 3,000,000	Par							
2	2/27/2009	Midtown Bank & Trust Company	Atlanta	GA	Preferred Stock w/ Exercised Warrants	$ 5,222,000	Par							
	3/6/2009	HCSB Financial Corporation	Loris	SC	Preferred Stock w/ Warrants	$ 12,895,000	Par							
	3/6/2009	First Busey Corporation	Urbana	IL	Preferred Stock w/ Warrants	$ 100,000,000	Par							
	3/6/2009	First Federal Bancshares of Arkansas, Inc.	Harrison	AR	Preferred Stock w/ Warrants	$ 16,500,000	Par							
3	3/6/2009	Citizens Bancshares Corporation	Atlanta	GA	Preferred Stock	$ 7,462,000	Par							
2	3/6/2009	ICB Financial	Ontario	CA	Preferred Stock w/ Exercised Warrants	$ 6,000,000	Par							
2	3/6/2009	First Texas BHC, Inc.	Fort Worth	TX	Preferred Stock w/ Exercised Warrants	$ 13,533,000	Par							
2	3/6/2009	Farmers & Merchants Bancshares, Inc.	Houston	TX	Preferred Stock w/ Exercised Warrants	$ 11,000,000	Par							
2	3/6/2009	Blue Ridge Bancshares, Inc.	Independence	MO	Preferred Stock w/ Exercised Warrants	$ 12,000,000	Par							
2	3/6/2009	First Reliance Bancshares, Inc.	Florence	SC	Preferred Stock w/ Exercised Warrants	$ 15,349,000	Par							
2	3/6/2009	Merchants and Planters Bancshares, Inc.	Toone	TN	Preferred Stock w/ Exercised Warrants	$ 1,881,000	Par							
2	3/6/2009	First Southwest Bancorporation, Inc.	Alamosa	CO	Preferred Stock w/ Exercised Warrants	$ 5,500,000	Par							
2	3/6/2009	Germantown Capital Corporation, Inc.	Germantown	TN	Preferred Stock w/ Exercised Warrants	$ 4,967,000	Par							
2	3/6/2009	BOH Holdings, Inc.	Houston	TX	Preferred Stock w/ Exercised Warrants	$ 10,000,000	Par							
2	3/6/2009	AmeriBank Holding Company	Collinsville	OK	Preferred Stock w/ Exercised Warrants	$ 2,492,000	Par							
2	3/6/2009	Highlands Independent Bancshares, Inc.	Sebring	FL	Preferred Stock w/ Exercised Warrants	$ 6,700,000	Par							
2	3/6/2009	Pinnacle Bank Holding Company, Inc.	Orange City	FL	Preferred Stock w/ Exercised Warrants	$ 4,389,000	Par							
2	3/6/2009	Blue River Bancshares, Inc.	Shelbyville	IN	Preferred Stock w/ Exercised Warrants	$ 5,000,000	Par							
2	3/6/2009	Marine Bank & Trust Company	Vero Beach	FL	Preferred Stock w/ Exercised Warrants	$ 3,000,000	Par							
2	3/6/2009	Community Bancshares of Kansas, Inc.	Goff	KS	Preferred Stock w/ Exercised Warrants	$ 500,000	Par							
2	3/6/2009	Regent Bancorp, Inc.	Davie	FL	Preferred Stock w/ Exercised Warrants	$ 9,982,000	Par							
2	3/6/2009	Park Bancorporation, Inc.	Madison	WI	Preferred Stock w/ Exercised Warrants	$ 23,200,000	Par							
2	3/6/2009	PeoplesSouth Bancshares, Inc.	Colquitt	GA	Preferred Stock w/ Exercised Warrants	$ 12,325,000	Par							
	3/13/2009	First Place Financial Corp.	Warren	OH	Preferred Stock w/ Warrants	$ 72,927,000	Par							
	3/13/2009	Salisbury Bancorp, Inc.	Lakeville	CT	Preferred Stock w/ Warrants	$ 8,816,000	Par							
	3/13/2009	First Northern Community Bancorp	Dixon	CA	Preferred Stock w/ Warrants	$ 17,390,000	Par							
	3/13/2009	Discover Financial Services	Riverwoods	IL	Preferred Stock w/ Warrants	$ 1,224,558,000	Par							
	3/13/2009	Provident Community Bancshares, Inc.	Rock Hill	SC	Preferred Stock w/ Warrants	$ 9,266,000	Par							
3	3/13/2009	First American International Corp.	Brooklyn	NY	Preferred Stock	$ 17,000,000	Par							
2	3/13/2009	BancIndependent, Inc.	Sheffield	AL	Preferred Stock w/ Exercised Warrants	$ 21,100,000	Par							
2	3/13/2009	Haviland Bancshares, Inc.	Haviland	KS	Preferred Stock w/ Exercised Warrants	$ 425,000	Par							
2	3/13/2009	1st United Bancorp, Inc.	Boca Raton	FL	Preferred Stock w/ Exercised Warrants	$ 10,000,000	Par							

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2	3/13/2009	Madison Financial Corporation	Richmond	KY	Preferred Stock w/ Exercised Warrants	$ 3,370,000	Par							
2	3/13/2009	First National Corporation	Strasburg	VA	Preferred Stock w/ Exercised Warrants	$ 13,900,000	Par							
2	3/13/2009	St. Johns Bancshares, Inc.	St. Louis	MO	Preferred Stock w/ Exercised Warrants	$ 3,000,000	Par							
2	3/13/2009	Blackhawk Bancorp, Inc.	Beloit	WI	Preferred Stock w/ Exercised Warrants	$ 10,000,000	Par							
2	3/13/2009	IBW Financial Corporation	Washington	DC	Preferred Stock w/ Exercised Warrants	$ 6,000,000	Par							
2	3/13/2009	Butler Point, Inc.	Catlin	IL	Preferred Stock w/ Exercised Warrants	$ 607,000	Par							
2	3/13/2009	Bank of George	Las Vegas	NV	Preferred Stock w/ Exercised Warrants	$ 2,672,000	Par							
2	3/13/2009	Moneytree Corporation	Lenoir City	TN	Preferred Stock w/ Exercised Warrants	$ 9,516,000	Par							
2	3/13/2009	Sovereign Bancshares, Inc.	Dallas	TX	Preferred Stock w/ Exercised Warrants	$ 18,215,000	Par							
2	3/13/2009	First Intercontinental Bank	Doraville	GA	Preferred Stock w/ Exercised Warrants	$ 6,398,000	Par							
	3/20/2009	Heritage Oaks Bancorp	Paso Robles	CA	Preferred Stock w/ Warrants	$ 21,000,000	Par							
2	3/20/2009	Community First Bancshares Inc.	Union City	TN	Preferred Stock w/ Exercised Warrants	$ 20,000,000	Par							
2	3/20/2009	First NBC Bank Holding Company	New Orleans	LA	Preferred Stock w/ Exercised Warrants	$ 17,836,000	Par							
2	3/20/2009	First Colebrook Bancorp, Inc.	Colebrook	NH	Preferred Stock w/ Exercised Warrants	$ 4,500,000	Par							
2	3/20/2009	Kirksville Bancorp, Inc.	Kirksville	MO	Preferred Stock w/ Exercised Warrants	$ 470,000	Par							
2	3/20/2009	Peoples Bancshares of TN, Inc	Madisonville	TN	Preferred Stock w/ Exercised Warrants	$ 3,900,000	Par							
2	3/20/2009	Premier Bank Holding Company	Tallahassee	FL	Preferred Stock w/ Exercised Warrants	$ 9,500,000	Par							
2	3/20/2009	Citizens Bank & Trust Company	Covington	LA	Preferred Stock w/ Exercised Warrants	$ 2,400,000	Par							
2	3/20/2009	Farmers & Merchants Financial Corporation	Argonia	KS	Preferred Stock w/ Exercised Warrants	$ 442,000	Par							
2	3/20/2009	Farmers State Bankshares, Inc.	Holton	KS	Preferred Stock w/ Exercised Warrants	$ 700,000	Par							
2	3/27/2009	SBT Bancorp, Inc.	Simsbury	CT	Preferred Stock w/ Exercised Warrants	$ 4,000,000	Par							
2	3/27/2009	CSRA Bank Corp.	Wrens	GA	Preferred Stock w/ Exercised Warrants	$ 2,400,000	Par							
2	3/27/2009	Trinity Capital Corporation	Los Alamos	NM	Preferred Stock w/ Exercised Warrants	$ 35,539,000	Par							
2	3/27/2009	Clover Community Bankshares, Inc.	Clover	SC	Preferred Stock w/ Exercised Warrants	$ 3,000,000	Par							
2	3/27/2009	Pathway Bancorp	Cairo	NE	Preferred Stock w/ Exercised Warrants	$ 3,727,000	Par							
2	3/27/2009	Colonial American Bank	West Conshohocken	PA	Preferred Stock w/ Exercised Warrants	$ 574,000	Par							
2	3/27/2009	MS Financial, Inc.	Kingwood	TX	Preferred Stock w/ Exercised Warrants	$ 7,723,000	Par							
2	3/27/2009	Triad Bancorp, Inc	Frontenac	MO	Preferred Stock w/ Exercised Warrants	$ 3,700,000	Par							
2	3/27/2009	Alpine Banks of Colorado	Glenwood Springs	CO	Preferred Stock w/ Exercised Warrants	$ 70,000,000	Par							
2	3/27/2009	Naples Bancorp, Inc.	Naples	FL	Preferred Stock w/ Exercised Warrants	$ 4,000,000	Par							
2	3/27/2009	CBS Banc-Corp.	Russellville	AL	Preferred Stock w/ Exercised Warrants	$ 24,300,000	Par							
2	3/27/2009	IBT Bancorp, Inc.	Irving	TX	Preferred Stock w/ Exercised Warrants	$ 2,295,000	Par							
2	3/27/2009	Spirit BankCorp, Inc.	Bristow	OK	Preferred Stock w/ Exercised Warrants	$ 30,000,000	Par							
2	3/27/2009	Maryland Financial Bank	Towson	MD	Preferred Stock w/ Exercised Warrants	$ 1,700,000	Par							
	4/3/2009	First Capital Bancorp, Inc.	Glen Allen	VA	Preferred Stock w/ Warrants	$ 10,958,000	Par							
2, 3	4/3/2009	Tri-State Bank of Memphis	Memphis	TN	Preferred Stock	$ 2,795,000	Par							
2	4/3/2009	Fortune Financial Corporation	Arnold	MO	Preferred Stock w/ Exercised Warrants	$ 3,100,000	Par							
2	4/3/2009	BancStar, Inc.	Festus	MO	Preferred Stock w/ Exercised Warrants	$ 8,600,000	Par							
2	4/3/2009	Titonka Bancshares, Inc	Titonka	IA	Preferred Stock w/ Exercised Warrants	$ 2,117,000	Par							
2	4/3/2009	Millennium Bancorp, Inc.	Edwards	CO	Preferred Stock w/ Exercised Warrants	$ 7,260,000	Par							
2	4/3/2009	TriSummit Bank	Kingsport	TN	Preferred Stock w/ Exercised Warrants	$ 2,765,000	Par							
2	4/3/2009	Prairie Star Bancshares, Inc.	Olathe	KS	Preferred Stock w/ Exercised Warrants	$ 2,800,000	Par							
2	4/3/2009	Community First Bancshares, Inc.	Harrison	AR	Preferred Stock w/ Exercised Warrants	$ 12,725,000	Par							
2	4/3/2009	BCB Holding Company, Inc.	Theodore	AL	Preferred Stock w/ Exercised Warrants	$ 1,706,000	Par							
3	4/10/2009	City National Bancshares Corporation	Newark	NJ	Preferred Stock	$ 9,439,000	Par							
2	4/10/2009	First Business Bank, N.A.	San Diego	CA	Preferred Stock w/ Exercised Warrants	$ 2,211,000	Par							
2	4/10/2009	SV Financial, Inc.	Sterling	IL	Preferred Stock w/ Exercised Warrants	$ 4,000,000	Par							
2	4/10/2009	Capital Commerce Bancorp, Inc.	Milwaukee	WI	Preferred Stock w/ Exercised Warrants	$ 5,100,000	Par							
2	4/10/2009	Metropolitan Capital Bancorp, Inc.	Chicago	IL	Preferred Stock w/ Exercised Warrants	$ 2,040,000	Par							
	4/17/2009	Bank of the Carolinas Corporation	Mocksville	NC	Preferred Stock w/ Warrants	$ 13,179,000	Par							
2	4/17/2009	Penn Liberty Financial Corp.	Wayne	PA	Preferred Stock w/ Exercised Warrants	$ 9,960,000	Par							

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2	4/17/2009	Tifton Banking Company	Tifton	GA	Preferred Stock w/ Exercised Warrants	$ 3,800,000	Par							
2	4/17/2009	Patterson Bancshares, Inc	Patterson	LA	Preferred Stock w/ Exercised Warrants	$ 3,690,000	Par							
2	4/17/2009	BNB Financial Services Corporation	New York	NY	Preferred Stock w/ Exercised Warrants	$ 7,500,000	Par							
2	4/17/2009	Omega Capital Corp.	Lakewood	CO	Preferred Stock w/ Exercised Warrants	$ 2,816,000	Par							
	4/24/2009	Mackinac Financial Corporation	Manistique	MI	Preferred Stock w/ Warrants	$ 11,000,000	Par							
2	4/24/2009	Birmingham Bloomfield Bancshares, Inc	Birmingham	MI	Preferred Stock w/ Exercised Warrants	$ 1,635,000	Par							
2	4/24/2009	Vision Bank - Texas	Richardson	TX	Preferred Stock w/ Exercised Warrants	$ 1,500,000	Par							
2	4/24/2009	Oregon Bancorp, Inc.	Salem	OR	Preferred Stock w/ Exercised Warrants	$ 3,216,000	Par							
2	4/24/2009	Peoples Bancorporation, Inc.	Easley	SC	Preferred Stock w/ Exercised Warrants	$ 12,660,000	Par							
2	4/24/2009	Indiana Bank Corp.	Dana	IN	Preferred Stock w/ Exercised Warrants	$ 1,312,000	Par							
2	4/24/2009	Business Bancshares, Inc.	Clayton	MO	Preferred Stock w/ Exercised Warrants	$ 15,000,000	Par							
2	4/24/2009	Standard Bancshares, Inc.	Hickory Hills	IL	Preferred Stock w/ Exercised Warrants	$ 60,000,000	Par							
2	4/24/2009	York Traditions Bank	York	PA	Preferred Stock w/ Exercised Warrants	$ 4,871,000	Par							
2	4/24/2009	Grand Capital Corporation	Tulsa	OK	Preferred Stock w/ Exercised Warrants	$ 4,000,000	Par							
2	4/24/2009	Allied First Bancorp, Inc.	Oswego	IL	Preferred Stock w/ Exercised Warrants	$ 3,652,000	Par							
8	4/24/2009	Frontier Bancshares, Inc.	Austin	TX	Subordinated Debentures w/ Exercised Warrants	$ 3,000,000	Par							
	5/1/2009	Village Bank and Trust Financial Corp	Midlothian	VA	Preferred Stock w/ Warrants	$ 14,738,000	Par							
2	5/1/2009	CenterBank	Milford	OH	Preferred Stock w/ Exercised Warrants	$ 2,250,000	Par							
2	5/1/2009	Georgia Primary Bank	Atlanta	GA	Preferred Stock w/ Exercised Warrants	$ 4,500,000	Par							
2	5/1/2009	Union Bank & Trust Company	Oxford	NC	Preferred Stock w/ Exercised Warrants	$ 3,194,000	Par							
2	5/1/2009	HPK Financial Corporation	Chicago	IL	Preferred Stock w/ Exercised Warrants	$ 4,000,000	Par							
8	5/1/2009	OSB Financial Services, Inc.	Orange	TX	Subordinated Debentures w/ Exercised Warrants	$ 6,100,000	Par							
8	5/1/2009	Security State Bank Holding-Company	Jamestown	ND	Subordinated Debentures w/ Exercised Warrants	$ 10,750,000	Par							
2	5/8/2009	Highlands State Bank	Vernon	NJ	Preferred Stock w/ Exercised Warrants	$ 3,091,000	Par							
2	5/8/2009	One Georgia Bank	Atlanta	GA	Preferred Stock w/ Exercised Warrants	$ 5,500,000	Par							
2	5/8/2009	Gateway Bancshares, Inc.	Ringgold	GA	Preferred Stock w/ Exercised Warrants	$ 6,000,000	Par							
8	5/8/2009	Freeport Bancshares, Inc.	Freeport	IL	Subordinated Debentures w/ Exercised Warrants	$ 3,000,000	Par							
8	5/8/2009	Investors Financial Corporation of Pettis County, Inc.	Sedalia	MO	Subordinated Debentures w/ Exercised Warrants	$ 4,000,000	Par							
8	5/8/2009	Sword Financial Corporation	Horicon	WI	Subordinated Debentures w/ Exercised Warrants	$ 13,644,000	Par							
3, 8	5/8/2009	Premier Bancorp, Inc.	Wilmette	IL	Subordinated Debentures	$ 6,784,000	Par							
	5/15/2009	Mercantile Bank Corporation	Grand Rapids	MI	Preferred Stock w/ Warrants	$ 21,000,000	Par							
2	5/15/2009	Northern State Bank	Closter	NJ	Preferred Stock w/ Exercised Warrants	$ 1,341,000	Par							
2	5/15/2009	Western Reserve Bancorp, Inc	Medina	OH	Preferred Stock w/ Exercised Warrants	$ 4,700,000	Par							
2	5/15/2009	Community Financial Shares, Inc.	Glen Ellyn	IL	Preferred Stock w/ Exercised Warrants	$ 6,970,000	Par							
2	5/15/2009	Worthington Financial Holdings, Inc.	Huntsville	AL	Preferred Stock w/ Exercised Warrants	$ 2,720,000	Par							
2	5/15/2009	First Community Bancshares, Inc	Overland Park	KS	Preferred Stock w/ Exercised Warrants	$ 14,800,000	Par							
2	5/15/2009	Southern Heritage Bancshares, Inc.	Cleveland	TN	Preferred Stock w/ Exercised Warrants	$ 4,862,000	Par							
2	5/15/2009	Foresight Financial Group, Inc.	Rockford	IL	Preferred Stock w/ Exercised Warrants	$ 15,000,000	Par							
3, 8	5/15/2009	IBC Bancorp, Inc.	Chicago	IL	Subordinated Debentures	$ 4,205,000	Par							
8	5/15/2009	Boscobel Bancorp, Inc	Boscobel	WI	Subordinated Debentures w/ Exercised Warrants	$ 5,586,000	Par							
8	5/15/2009	Brogan Bankshares, Inc.	Kaukauna	WI	Subordinated Debentures w/ Exercised Warrants	$ 2,400,000	Par							
8	5/15/2009	Riverside Bancshares, Inc.	Little Rock	AR	Subordinated Debentures w/ Exercised Warrants	$ 1,100,000	Par							
8	5/15/2009	Deerfield Financial Corporation	Deerfield	WI	Subordinated Debentures w/ Exercised Warrants	$ 2,639,000	Par							
8	5/15/2009	Market Street Bancshares, Inc.	Mt. Vernon	IL	Subordinated Debentures w/ Exercised Warrants	$ 20,300,000	Par							

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2	5/22/2009	The Landrum Company	Columbia	MO	Preferred Stock w/ Exercised Warrants	$ 15,000,000	Par							
2	5/22/2009	First Advantage Bancshares Inc.	Coon Rapids	MN	Preferred Stock w/ Exercised Warrants	$ 1,177,000	Par							
2	5/22/2009	Fort Lee Federal Savings Bank	Fort Lee	NJ	Preferred Stock w/ Exercised Warrants	$ 1,300,000	Par							
2	5/22/2009	Blackridge Financial, Inc.	Fargo	ND	Preferred Stock w/ Exercised Warrants	$ 5,000,000	Par							
2	5/22/2009	Illinois State Bancorp, Inc.	Chicago	IL	Preferred Stock w/ Exercised Warrants	$ 6,272,000	Par							
2	5/22/2009	Universal Bancorp	Bloomfield	IN	Preferred Stock w/ Exercised Warrants	$ 9,900,000	Par							
2	5/22/2009	Franklin Bancorp, Inc.	Washington	MO	Preferred Stock w/ Exercised Warrants	$ 5,097,000	Par							
8	5/22/2009	Commonwealth Bancshares, Inc.	Louisville	KY	Subordinated Debentures w/ Exercised Warrants	$ 20,400,000	Par							
8	5/22/2009	Premier Financial Corp	Dubuque	IA	Subordinated Debentures w/ Exercised Warrants	$ 6,349,000	Par							
8	5/22/2009	F & C Bancorp, Inc.	Holden	MO	Subordinated Debentures w/ Exercised Warrants	$ 2,993,000	Par							
8	5/22/2009	Diamond Bancorp, Inc.	Washington	MO	Subordinated Debentures w/ Exercised Warrants	$ 20,445,000	Par							
8	5/22/2009	United Bank Corporation	Barnesville	GA	Subordinated Debentures w/ Exercised Warrants	$ 14,400,000	Par							
	5/29/2009	Community Bank Shares of Indiana, Inc.	New Albany	IN	Preferred Stock w/ Warrants	$ 19,468,000	Par							
2	5/29/2009	American Premier Bancorp	Arcadia	CA	Preferred Stock w/ Exercised Warrants	$ 1,800,000	Par							
2	5/29/2009	CB Holding Corp.	Aledo	IL	Preferred Stock w/ Exercised Warrants	$ 4,114,000	Par							
2	5/29/2009	Citizens Bancshares Co.	Chillicothe	MO	Preferred Stock w/ Exercised Warrants	$ 24,990,000	Par							
2	5/29/2009	Grand Mountain Bancshares, Inc.	Granby	CO	Preferred Stock w/ Exercised Warrants	$ 3,076,000	Par							
2	5/29/2009	Two Rivers Financial Group	Burlington	IA	Preferred Stock w/ Exercised Warrants	$ 12,000,000	Par							
8	5/29/2009	Fidelity Bancorp, Inc	Baton Rouge	LA	Subordinated Debentures w/ Exercised Warrants	$ 3,942,000	Par							
8	5/29/2009	Chambers Bancshares, Inc.	Danville	AR	Subordinated Debentures w/ Exercised Warrants	$ 19,817,000	Par							
2	6/5/2009	Covenant Financial Corporation	Clarksdale	MS	Preferred Stock w/ Exercised Warrants	$ 5,000,000	Par							
8	6/5/2009	First Trust Corporation	New Orleans	LA	Subordinated Debentures w/ Exercised Warrants	$ 17,969,000	Par							
8, 10	6/5/2009	OneFinancial Corporation	Little Rock	AR	Subordinated Debentures w/ Exercised Warrants	$ 17,300,000	Par							
2	6/12/2009	Berkshire Bancorp, Inc.	Wyomissing	PA	Preferred Stock w/ Exercised Warrants	$ 2,892,000	Par							
2, 10	6/12/2009	First Vernon Bancshares, Inc.	Vernon	AL	Preferred Stock w/ Exercised Warrants	$ 6,000,000	Par							
2	6/12/2009	SouthFirst Bancshares, Inc.	Sylacauga	AL	Preferred Stock w/ Exercised Warrants	$ 2,760,000	Par							
2, 10	6/12/2009	Virginia Company Bank	Newport News	VA	Preferred Stock w/ Exercised Warrants	$ 4,700,000	Par							
2	6/12/2009	Enterprise Financial Services Group, Inc.	Allison Park	PA	Preferred Stock w/ Exercised Warrants	$ 4,000,000	Par							
8, 10	6/12/2009	First Financial Bancshares, Inc.	Lawrence	KS	Subordinated Debentures w/ Exercised Warrants	$ 3,756,000	Par							
8	6/12/2009	River Valley Bancorporation, Inc.	Wausau	WI	Subordinated Debentures w/ Exercised Warrants	$ 15,000,000	Par							
2	6/19/2009	Merchants and Manufacturers Bank Corporation	Joliet	IL	Preferred Stock w/ Exercised Warrants	$ 3,510,000	Par							
2, 10	6/19/2009	RCB Financial Corporation	Rome	GA	Preferred Stock w/ Exercised Warrants	$ 8,900,000	Par							
8	6/19/2009	Manhattan Bancshares, Inc.	Manhattan	IL	Subordinated Debentures w/ Exercised Warrants	$ 2,639,000	Par							
8, 10	6/19/2009	Biscayne Bancshares, Inc.	Coconut Grove	FL	Subordinated Debentures w/ Exercised Warrants	$ 6,400,000	Par							
8	6/19/2009	Duke Financial Group, Inc.	Minneapolis	MN	Subordinated Debentures w/ Exercised Warrants	$ 12,000,000	Par							
8	6/19/2009	Farmers Enterprises, Inc.	Great Bend	KS	Subordinated Debentures w/ Exercised Warrants	$ 12,000,000	Par							
8	6/19/2009	Century Financial Services Corporation	Santa Fe	NM	Subordinated Debentures w/ Exercised Warrants	$ 10,000,000	Par							
8	6/19/2009	NEMO Bancshares Inc.	Madison	MO	Subordinated Debentures w/ Exercised Warrants	$ 2,330,000	Par							
3, 8	6/19/2009	University Financial Corp, Inc.	St. Paul	MN	Subordinated Debentures	$ 11,926,000	Par							
8	6/19/2009	Suburban Illinois Bancorp, Inc.	Elmhurst	IL	Subordinated Debentures w/ Exercised Warrants	$ 15,000,000	Par							

Footnote	Purchase Date	Seller: Name of Institution	Seller: City	Seller: State	Purchase Details: Investment Description	Purchase Details: Investment Amount	Purchase Details: Pricing Mechanism	Capital Repayment Details: Capital Repayment Date	Capital Repayment Details: Capital Repayment Amount [6]	Treasury Investment Remaining: Remaining Capital Amount	Treasury Investment Remaining: Remaining Investment Description	Final Disposition: Final Disposition Date	Final Disposition: Disposition Investment Description	Final Disposition: Final Disposition Proceeds
	6/26/2009	Hartford Financial Services Group, Inc.	Hartford	CT	Preferred Stock w/ Warrants	$ 3,400,000,000	Par							
2	6/26/2009	Fidelity Resources Company	Plano	TX	Preferred Stock w/ Exercised Warrants	$ 3,000,000	Par							
2, 10	6/26/2009	Waukesha Bankshares, Inc.	Waukesha	WI	Preferred Stock w/ Exercised Warrants	$ 5,625,000	Par							
2	6/26/2009	FC Holdings, Inc.	Houston	TX	Preferred Stock w/ Exercised Warrants	$ 21,042,000	Par							
2, 10	6/26/2009	Security Capital Corporation	Batesville	MS	Preferred Stock w/ Exercised Warrants	$ 17,388,000	Par							
2	6/26/2009	First Alliance Bancshares, Inc.	Cordova	TN	Preferred Stock w/ Exercised Warrants	$ 3,422,000	Par							
2	6/26/2009	Gulfstream Bancshares, Inc.	Stuart	FL	Preferred Stock w/ Exercised Warrants	$ 7,500,000	Par							
2, 10	6/26/2009	Gold Canyon Bank	Gold Canyon	AZ	Preferred Stock w/ Exercised Warrants	$ 1,607,000	Par							
2, 3, 10	6/26/2009	M&F Bancorp, Inc.	Durham	NC	Preferred Stock	$ 11,735,000	Par							
2	6/26/2009	Metropolitan Bank Group, Inc.	Chicago	IL	Preferred Stock w/ Exercised Warrants	$ 71,526,000	Par							
2	6/26/2009	NC Bancorp, Inc.	Chicago	IL	Preferred Stock w/ Exercised Warrants	$ 6,880,000	Par							
2	6/26/2009	Alliance Bancshares, Inc.	Dalton	GA	Preferred Stock w/ Exercised Warrants	$ 2,986,000	Par							
8	6/26/2009	Stearns Financial Services, Inc.	St. Cloud	MN	Subordinated Debentures w/ Exercised Warrants	$ 24,900,000	Par							
8	6/26/2009	Signature Bancshares, Inc.	Dallas	TX	Subordinated Debentures w/ Exercised Warrants	$ 1,700,000	Par							
8	6/26/2009	Fremont Bancorporation	Fremont	CA	Subordinated Debentures w/ Exercised Warrants	$ 35,000,000	Par							
8	6/26/2009	Alliance Financial Services Inc.	Saint Paul	MN	Subordinated Debentures w/ Exercised Warrants	$ 12,000,000	Par							
	7/10/2009	Lincoln National Corporation	Radnor	PA	Preferred Stock w/ Warrants	$ 950,000,000	Par							
2, 10	7/10/2009	Bancorp Financial, Inc.	Oak Brook	IL	Preferred Stock w/ Exercised Warrants	$ 13,669,000	Par							
2	7/17/2009	Brotherhood Bancshares, Inc.	Kansas City	KS	Preferred Stock w/ Exercised Warrants	$ 11,000,000	Par							
2	7/17/2009	SouthCrest Financial Group, Inc.	Fayetteville	GA	Preferred Stock w/ Exercised Warrants	$ 12,900,000	Par							
2, 3	7/17/2009	Harbor Bankshares Corporation	Baltimore	MD	Preferred Stock	$ 6,800,000	Par							
8	7/17/2009	First South Bancorp, Inc.	Lexington	TN	Subordinated Debentures w/ Exercised Warrants	$ 50,000,000	Par							
8	7/17/2009	Great River Holding Company	Baxter	MN	Subordinated Debentures w/ Exercised Warrants	$ 8,400,000	Par							
8, 10	7/17/2009	Plato Holdings Inc.	Saint Paul	MN	Subordinated Debentures w/ Exercised Warrants	$ 2,500,000	Par							
	7/24/2009	Yadkin Valley Financial Corporation	Elkin	NC	Preferred Stock w/ Warrants	$ 13,312,000	Par							
2, 10	7/24/2009	Community Bancshares, Inc.	Kingman	AZ	Preferred Stock w/ Exercised Warrants	$ 3,872,000	Par							
2	7/24/2009	Florida Bank Group, Inc.	Tampa	FL	Preferred Stock w/ Exercised Warrants	$ 20,471,000	Par							
8	7/24/2009	First American Bank Corporation	Elk Grove Village	IL	Subordinated Debentures w/ Exercised Warrants	$ 50,000,000	Par							
2	7/31/2009	Chicago Shore Corporation	Chicago	IL	Preferred Stock w/ Exercised Warrants	$ 7,000,000	Par							
8, 10	7/31/2009	Financial Services of Winger, Inc.	Winger	MN	Subordinated Debentures w/ Exercised Warrants	$ 3,742,000	Par							
2	8/7/2009	The ANB Corporation	Terrell	TX	Preferred Stock w/ Exercised Warrants	$ 20,000,000	Par							
2	8/7/2009	U.S. Century Bank	Miami	FL	Preferred Stock w/ Exercised Warrants	$ 50,236,000	Par							
2	8/14/2009	Bank Financial Services, Inc.	Eden Prairie	MN	Preferred Stock w/ Exercised Warrants	$ 1,004,000	Par							
2	8/21/2009	KS Bancorp, Inc.	Smithfield	NC	Preferred Stock w/ Exercised Warrants	$ 4,000,000	Par							
8	8/21/2009	AmFirst Financial Services, Inc.	McCook	NE	Subordinated Debentures w/ Exercised Warrants	$ 5,000,000	Par							
2, 3	8/28/2009	First Independence Corporation	Detroit	MI	Preferred Stock	$ 3,223,000	Par							
2	8/28/2009	First Guaranty Bancshares, Inc.	Hammond	LA	Preferred Stock w/ Exercised Warrants	$ 20,699,000	Par							
2, 10	8/28/2009	CoastalSouth Bancshares, Inc.	Hilton Head Island	SC	Preferred Stock w/ Exercised Warrants	$ 16,015,000	Par							
8, 10	8/28/2009	TCB Corporation	Greenwood	SC	Subordinated Debentures w/ Exercised Warrants	$ 9,720,000	Par							
8, 10	9/4/2009	The State Bank of Bartley	Bartley	NE	Subordinated Debentures w/ Exercised Warrants	$ 1,697,000	Par							
	9/11/2009	Pathfinder Bancorp, Inc.	Oswego	NY	Preferred Stock w/ Warrants	$ 6,771,000	Par							
2	9/11/2009	Community Bancshares of Mississippi, Inc.	Brandon	MS	Preferred Stock w/ Exercised Warrants	$52,000,000	Par							
2, 10	9/11/2009	Heartland Bancshares, Inc.	Franklin	IN	Preferred Stock w/ Exercised Warrants	$7,000,000	Par							

		Seller			Purchase Details			Capital Repayment Details		Treasury Investment Remaining		Final Disposition		
Footnote	Purchase Date	Name of Institution	City	State	Investment Description	Investment Amount	Pricing Mechanism	Capital Repayment Date	Capital Repayment Amount [6]	Remaining Capital Amount	Remaining Investment Description	Final Disposition Date	Disposition Investment Description	Final Disposition Proceeds
2, 10	9/11/2009	PFSB Bancorporation, Inc.	Pigeon Falls	WI	Preferred Stock w/ Exercised Warrants	$1,500,000	Par							
8	9/11/2009	First Eagle Bancshares, Inc.	Hanover Park	IL	Subordinated Debentures w/ Exercised Warrants	$7,500,000	Par							
2, 10	9/18/2009	IA Bancorp, Inc.	Iselin	NJ	Preferred Stock w/ Exercised Warrants	$5,976,000	Par							
2, 10	9/18/2009	HomeTown Bankshares Corporation	Roanoke	VA	Preferred Stock w/ Exercised Warrants	$10,000,000	Par							
2, 10	9/25/2009	Heritage Bankshares, Inc.	Norfolk	VA	Preferred Stock w/ Exercised Warrants	$10,103,000	Par							
2	9/25/2009	Mountain Valley Bancshares, Inc.	Cleveland	GA	Preferred Stock w/ Exercised Warrants	$3,300,000	Par							
8	9/25/2009	Grand Financial Corporation	Hattiesburg	MS	Subordinated Debentures w/ Exercised Warrants	$2,443,320	Par							
3, 8	9/25/2009	Guaranty Capital Corporation	Belzoni	MS	Subordinated Debentures	$14,000,000	Par							
8, 10	9/25/2009	GulfSouth Private Bank	Destin	FL	Subordinated Debentures w/ Exercised Warrants	$7,500,000	Par							
8, 10	9/25/2009	Steele Street Bank Corporation	Denver	CO	Subordinated Debentures w/ Exercised Warrants	$11,019,000	Par							

Total Purchase Amount $ 204,617,673,320

Total Capital Repayment Amount $ 70,717,027,005

TOTAL TREASURY CPP INVESTMENT AMOUNT $ 133,900,646,320

1/ This transaction was included in previous Transaction Reports with Merrill Lynch & Co., Inc. listed as the qualifying institution and a 10/28/2008 transaction date, footnoted to indicate that settlement was deferred pending merger. The purchase of Merrill Lynch by Bank of America was completed on 1/1/2009, and this transaction under the CPP was funded on 1/9/2009.
2/ Privately-held qualified financial institution. Treasury received a warrant to purchase additional shares of preferred stock (unless the institution is a CDFI), which it exercised immediately.
3/ To promote community development financial institutions (CDFIs), Treasury does not require warrants as part of its investment in certified CDFIs when the size of the investment is $50 million or less.
4/ Repayment pursuant to Title VII, Section 7001(g) of the American Recovery and Reinvestment Act of 2009.
5/ Redemption pursuant to a qualified equity offering.
6/ This amount does not include accrued and unpaid dividends, which must be paid at the time of capital repayment.
7/ The proceeds associated with the disposition of this investment do not include accrued and unpaid dividends.
8/ Subchapter S corporation. Treasury received a warrant to purchase additional subordinated debentures (unless the institution is a CDFI), which it exercised immediately.
9/ In its qualified equity offering, this institution raised more capital than Treasury's original investment, therefore, the number of Treasury's shares underlying the warrant was reduced by half.
10/ This institution participated in the expansion of CPP for small banks.
11/ Treasury has three separate investments in Citigroup Inc. ("Citigroup") under CPP, TIP, and AGP for a total of $49 billion. On 6/9/2009, Treasury entered into an agreement with Citigroup to exchange up to $25 billion of Treasury's investment in Fixed Rate Cumulative Perpetual Preferred Stock, Series H (CPP Shares) "dollar for dollar" in Citigroup's Private and Public Exchange Offerings. On 7/23/2009 and 7/30/2009, Treasury exchanged a total of $25 billion of the CPP shares for Series M Common Stock Equivalent ("Series M") and a warrant to purchase shares of common stock. On 9/11/2009, Series M automatically converted to 7,692,307,692 shares of common stock and the associated warrant terminated on receipt of certain shareholder approvals.
12/ On 8/24/2009, Treasury exchanged its Series C Preferred Stock issued by Popular, Inc. for a like amount of non tax-deductible Trust Preferred Securities issued by Popular Capital Trust III, administrative trustee for Popular, Inc. Popular, Inc. paid a $13 million exchange fee in connection with this transaction.

AUTOMOTIVE INDUSTRY FINANCING PROGRAM

		Seller			Purchase Details				Exchange Details					Principal Repayment Details		Treasury Investment Remaining After Principal Repayment	
Footnote	Date	Name of Institution	City	State	Transaction Type	Investment Description	Investment Amount	Pricing Mechanism	Date	Transaction Type	Investment Description	Investment Amount	Pricing Mechanism	Repayment Date	Principal Repayment Amount [7]	Remaining Principal Amount	Remaining Investment Description
16	12/29/2008	GMAC LLC	Detroit	MI	Purchase	Preferred Stock w/ Exercised Warrants	$ 5,000,000,000	Par									
1, 20	12/29/2008	General Motors Corporation	Detroit	MI	Purchase	Debt Obligation	$ 884,024,131	N/A	5/29/2009	Exchange	Equity Interest in GMAC	$ 884,024,131	Par				
20	12/31/2008	General Motors Corporation	Detroit	MI	Purchase	Debt Obligation w/ Warrants and Additional Note	$ 13,400,000,000	N/A	7/10/2009	Exchange	Preferred and common stock in General Motors Company	$ 13,400,000,000	Par				
14, 21	1/2/2009	Chrysler Holding LLC	Auburn Hills	MI	Purchase	Debt Obligation w/ Additional Note	$ 4,000,000,000	N/A									
2	1/16/2009	Chrysler Financial Services Americas LLC	Farmington Hills	MI	Purchase	Debt Obligation w/ Additional Note	$ 1,500,000,000	N/A						3/17/2009	$ 3,499,054.95	$ 1,496,500,945	Debt Obligation w/ Additional Note
														4/17/2009	$ 31,810,122.11	$ 1,464,690,823	Debt Obligation w/ Additional Note
														5/18/2009	$ 51,136,083.87	$ 1,413,554,739	Debt Obligation w/ Additional Note
														6/17/2009	$ 44,357,709.98	$ 1,369,197,029	Debt Obligation w/ Additional Note
														7/14/2009	$ 1,369,197,029.15	$ 0	N/A
3, 20	4/22/2009	General Motors Corporation	Detroit	MI	Purchase	Debt Obligation w/ Additional Note	$ 2,000,000,000	N/A	7/10/2009	Exchange	Preferred and common stock in General Motors Company	$ 2,000,000,000	Par				
4, 5, 21	4/29/2009	Chrysler Holding LLC	Auburn Hills	MI	Purchase	Debt Obligation w/ Additional Note	$ 500,000,000	N/A									
4, 5, 21	4/29/2009	Chrysler Holding LLC	Auburn Hills	MI	Purchase	Debt Obligation w/ Additional Note	$ 280,130,642	N/A						7/10/2009	$ 280,130,642	$ 0	N/A
7	5/1/2009	Chrysler LLC	Wilmington	DE	Purchase	Debt Obligation w/ Additional Note	$ 3,043,143,000	N/A									
8	5/20/2009	Chrysler LLC	Wilmington	DE	Purchase	Debt Obligation w/ Additional Note	$ 756,857,000	N/A									
9, 20	5/20/2009	General Motors Corporation	Detroit	MI	Purchase	Debt Obligation w/ Additional Note	$ 4,000,000,000	N/A	7/10/2009	Exchange	Preferred and common stock in General Motors Company	$ 4,000,000,000	Par				
15	5/21/2009	GMAC LLC	Detroit	MI	Purchase	Preferred Stock w/ Exercised Warrants	$ 7,500,000,000	Par									
10	5/27/2009	New CarCo Acquisition LLC	Wilmington	DE	Purchase	Debt Obligation w/ Additional Note, Equity Interest	$ 6,642,000,000	N/A									
11, 20	5/27/2009	General Motors Corporation	Detroit	MI	Purchase	Debt Obligation w/ Additional Note	$ 360,624,198	N/A	7/10/2009	Exchange	Preferred and common stock in General Motors Company	$ 360,624,198	Par				
13, 20	6/3/2009	General Motors Corporation	Detroit	MI	Purchase	Debt Obligation w/ Additional Note	$ 30,100,000,000	N/A	7/10/2009	Exchange	Preferred and common stock in General Motors Company	$ 22,041,706,310	Par				
18	7/10/2009	General Motors Company	Detroit	MI	Purchase	Debt Obligation w/ Additional Note, Equity Interest	$ 7,072,488,605	N/A						7/10/2009	$ 360,624,198	$ 6,711,864,407	Debt Obligation w/ Additional Note, Equity Interest

Total Initial Investment Amount $ 79,956,776,871

Total Principal Repayment Amount $ 2,140,754,640

TOTAL TREASURY INVESTMENT AMOUNT $ 77,826,024,131

1/ Treasury committed to lend General Motors Corporation up to $1,000,000,000. The ultimate level of funding was dependent upon the level of investor participation in GMAC LLC's rights offering. The amount has been updated to reflect the final level of funding.
2/ The loan was funded through Chrysler LB Receivables Trust, a special purpose vehicle created by Chrysler Financial. The amount of $1,500,000,000 represents the maximum loan amount. The loan was incrementally funded until it reached the maximum amount of $1.5 billion on 4/9/2009.
3/ This transaction is an amendment to Treasury's 12/31/2008 agreement with General Motors Corporation, which brought the total loan amount to $15,400,000,000.
4/ This transaction is an amendment to Treasury's 1/2/2009 agreement with Chrysler Holding LLC, increasing the total loan amount to $4,780,130,642.
5/ The loan may be incrementally funded.
6/ The loan will be used to capitalize Chrysler Warranty SPV LLC, a special purpose vehicle created by Chrysler LLC.
7/ The terms of this transaction, first reported based on a binding term sheet fully executed on 5/1/2009, but made effective as of 4/30/2009, are now finalized and reflected in a credit agreement fully executed on 5/5/2009. Under the terms of the credit agreement, all commitment amounts were adjusted as follows: Treasury's commitment amount is $3.04 billion of the total $4.1 billion debtor-in-possession (DIP) credit facility. The amount of $1.4 billion, of which Treasury's share is $1.04 billion, is available in weekly disbursements under the terms of the Bankruptcy Court's interim order approving the DIP credit facility; the balance will be available in weekly disbursements after certain Bankruptcy Court milestones are met.
8/ This transaction is an amendment to Treasury's DIP credit agreement with Chrysler LLC dated 5/5/2009 and increases Treasury's commitment to $3,800,000,000. The amendment was fully executed on 5/20/2009, but was made effective as of 5/15/2009.
9/ This transaction is an amendment to Treasury's 12/31/2008 agreement with General Motors Corporation, which brought the total loan amount to $19,400,000,000, including the 4/22/2009 amendment.
10/ The terms of this transaction, first reported based on a term sheet fully executed on 5/27/2009 for an amount up to $6.943 billion, are now finalized and reflected in a credit agreement fully executed on 6/10/2009. Under the terms of the credit agreement, Treasury made a new commitment to New CarCo Acquisition LLC (renamed Chrysler Group LLC on or about 6/10/2009) of up to $6.642 billion. The total loan amount is up to $7.142 billion including $500 million of debt assumed from Treasury's 1/2/2009 credit agreement with Chrysler Holding LLC. The debt obligations will be secured by a first priority lien on the assets of New CarCo Acquisition LLC (the company that purchased Chrysler LLC's assets in a sale pursuant to section 363 of the Bankruptcy Code).
11/ This transaction is an amendment to Treasury's 12/31/2008 agreement with General Motors Corporation, which brings the total loan amount to $19,760,624,198, including the 4/22/2009 and 5/20/2009 amendments. The $360 million loan will be used to capitalize GM Warranty LLC, a special purpose vehicle created by General Motors Corporation. On 7/10/2009, the principal amount was included in
12/ Pursuant to its rights under the loan agreement with General Motors Corporation (GM) reported on 12/29/2008, Treasury exchanged its $884 million loan to GM for a portion of GM's common equity interest in GMAC LLC. As a result of the exchange, Treasury holds a 35.4% common equity interest in GMAC LLC.
13/ Under the terms of the $33.3 billion debtor-in-possession (DIP) credit agreement, Treasury's commitment amount is $30.1 billion. Up to $15 billion is available pursuant to the interim order the Bankruptcy Court entered approving the DIP credit facility, of which Treasury's share is $12.8 billion; the balance will be available shortly after the Bankruptcy Court's final and non-appealable order approving the

14/ Pursuant to the agreement originally reported on 5/27/2009 and fully executed on 6/10/2009 (explained in Footnote 13), $400 million of this deal's debt will be assumed under that fully executed agreement.
15/ GMAC LLC is now known as GMAC Inc. effective 6/30/2009.
16/ This investment amount was funded as a prepayment of the new General Motors Company's assumed note described in footnote 17.

17/ On 7/10/2009, Treasury and Motors Liquidation Company (formerly known as General Motors Corporation) amended the 6/3/2009 DIP credit agreement for $30.1 billion between Treasury and General Motors Corporation. Under the terms of the amendment, the DIP loan and interest accruing thereunder were extinguished and exchanged for privately placed preferred and common equity in General Motors Company (the new GM) except for $986 million, which remained for the benefit of Motors Liquidation Company, and $7.07 billion, which was assumed by General Motors Company as a new obligation under the terms of a separate agreement (see footnote 18). In total, Treasury received $2.1 billion in preferred shares and 60.8% of the common shares of General Motors Company.
18/ On 7/10/2009, Treasury and General Motors Company entered into an agreement under which General Motors Company assumed $7.07 billion of General Motors Corporation's (now known as Motors Liquidation Company) obligation under its 6/3/2009 agreement with Treasury.
19/ This amount does not include accrued and unpaid interest, which must be paid at the time of principal repayment.
20/ General Motors Corporation is now known as Motors Liquidation Company.
21/ Chrysler Holding LLC is now known as CGI Holding LLC.

AUTOMOTIVE SUPPLIER SUPPORT PROGRAM

Footnote	Date	Seller			Transaction Type	Investment Description	Investment Amount	Pricing Mechanism	Adjustment Details		
		Name of Institution	City	State					Adjustment Date	Adjustment Amount	Adjusted Investment Amount
1	4/9/2009	GM Supplier Receivables LLC	Wilmington	DE	Purchase	Debt Obligation w/ Additional Note	$ 3,500,000,000	N/A	7/8/2009 [3]	$ (1,000,000,000)	$ 2,500,000,000
2	4/9/2009	Chrysler Receivables SPV LLC	Wilmington	DE	Purchase	Debt Obligation w/ Additional Note	$ 1,500,000,000	N/A	7/8/2009 [3]	$ (500,000,000)	$ 1,000,000,000
						INITIAL TOTAL	$ 5,000,000,000		ADJUSTED TOTAL		$ 3,500,000,000

1/ The loan was funded through GM Supplier Receivables LLC, a special purpose vehicle created by General Motors Corporation. The amount of $3,500,000,000 represents the maximum loan amount. The loan will be incrementally funded. The credit agreement was fully executed on 4/9/2009, but was made effective as of 4/3/2009. General Motors Company assumed GM Supplier Receivables LLC on 7/10/2009.

2/ The loan was funded through Chrysler Receivables SPV LLC, a special purpose vehicle created by Chrysler LLC. The amount of $1,500,000,000 represents the maximum loan amount. The loan will be incrementally funded. The credit agreement was fully executed on 4/9/2009, but was made effective as of 4/7/2009. Chrysler Group LLC assumed Chrysler Receivables SPV LLC on 6/10/2009.
3/ Treasury issued notice to the institution of the permanent reduced commitment on 7/8/2009; the reduction was effective on 7/1/2009.

TARGETED INVESTMENT PROGRAM

Footnote	Date	Seller: Name of Institution	Seller: City	Seller: State	Transaction Type	Investment Description	Investment Amount	Pricing Mechanism
1	12/31/2008	Citigroup Inc.	New York	NY	Purchase	Trust Preferred Securities	$ 20,000,000,000	Par
	1/16/2009	Bank of America Corporation	Charlotte	NC	Purchase	Preferred Stock w/ Warrants	$ 20,000,000,000	Par
						TOTAL	$ 40,000,000,000	

1/ Treasury has three separate investments in Citigroup Inc. ("Citigroup") under CPP, TIP, and AGP for a total of $45 billion. On 6/9/2009, Treasury entered into an agreement with Citigroup to exchange all of Treasury's investments. On 7/30/2009, Treasury exchanged all of its Fixed Rate Cumulative Perpetual Preferred Stock, Series I (TIP Shares) "dollar for dollar" for Trust Preferred Securities.

ASSET GUARANTEE PROGRAM

Footnote	Date	Seller: Name of Institution	Seller: City	Seller: State	Transaction Type	Investment Description	Guarantee Limit	Premium Received
1, 2	1/16/2009	Citigroup Inc.	New York	NY	Guarantee	Trust Preferred Securities	$ 5,000,000,000	Preferred Stock and Warrants
						TOTAL	$ 5,000,000,000	

1/ In consideration for the guarantee, Treasury received $4.03 billion of preferred stock, which pays 8% interest.
2/ Treasury has three separate investments in Citigroup Inc. ("Citigroup") under CPP, TIP, and AGP for a total of $49 billion. On 6/9/2009, Treasury entered into an agreement with Citigroup to exchange all of Treasury's investments. On 7/30/2009, Treasury exchanged all of its Fixed Rate Cumulative Perpetual Preferred Stock Series G (AGP Shares), received as premium with the AGP agreement, "dollar

CONSUMER AND BUSINESS LENDING INITIATIVE INVESTMENT PROGRAM

Footnote	Date	Seller: Name of Institution	Seller: City	Seller: State	Transaction Type	Investment Description	Investment Amount	Pricing Mechanism
1	3/3/2009	TALF LLC	Wilmington	DE	Purchase	Debt Obligation w/ Additional Note	$ 20,000,000,000	N/A
						TOTAL	$ 20,000,000,000	

1/ The loan was funded through TALF LLC, a special purpose vehicle created by The Federal Reserve Bank of New York. The amount of $20,000,000,000 represents the maximum loan amount. The loan will be incrementally funded.

SYSTEMICALLY SIGNIFICANT FAILING INSTITUTIONS

Footnote	Date	Seller: Name of Institution	Seller: City	Seller: State	Purchase Details: Transaction Type	Purchase Details: Investment Description	Purchase Details: Investment Amount	Purchase Details: Pricing Mechanism	Exchange Details: Date	Exchange Details: Transaction Type	Exchange Details: Investment Description	Exchange Details: Investment Amount	Exchange Details: Pricing Mechanism
	11/25/2008	AIG	New York	NY	Purchase	Preferred Stock w/ Warrants	$ 40,000,000,000	Par	4/17/2009	Exchange	Preferred Stock w/ Warrants 1	$ 40,000,000,000	Par
2	4/17/2009	AIG	New York	NY	Purchase	Preferred Stock w/ Warrants	$ 29,835,000,000	Par 3					
						TOTAL	$ 69,835,000,000						

1/ On 4/17/2009, Treasury exchanged its Series D Fixed Rate Cumulative Preferred Shares for Series E Fixed Rate Non-Cumulative Preferred Shares with no change to Treasury's initial investment amount. In addition, in order for AIG to fully redeem the Series E Preferred Shares, it has an additional obligation to Treasury of $1,604,576,000 to reflect the cumulative unpaid dividends for the Series D Preferred Shares due to Treasury through and including the exchange date.
2/ The investment price reflects Treasury's commitment to invest up to $30 billion less a reduction of $165 million representing retention payments AIG Financial Products made to its employees in March 2009.
3/ This transaction does not include AIG's commitment fee of an additional $165 million scheduled to be paid from its operating income in three equal installments over the five-year life of the facility.

LEGACY SECURITIES PUBLIC-PRIVATE INVESTMENT PROGRAM (S-PPIP)

Footnote	Date	Seller: Name of Institution	City	State	Transaction Type	Investment Description	Investment Amount	Pricing Mechanism
1	9/30/2009	UST/TCW Senior Mortgage Securities Fund, L.P.	Wilmington	DE	Purchase	Membership Interest	$1,111,111,111	Par
2	9/30/2009	UST/TCW Senior Mortgage Securities Fund, L.P.	Wilmington	DE	Purchase	Debt Obligation w/ Contingent Proceeds	$2,222,222,222	Par
1	9/30/2009	Invesco Legacy Securities Master Fund, L.P.	Wilmington	DE	Purchase	Membership Interest	$1,111,111,111	Par
2	9/30/2009	Invesco Legacy Securities Master Fund, L.P.	Wilmington	DE	Purchase	Debt Obligation w/ Contingent Proceeds	$2,222,222,222	Par
					TOTAL		$6,666,666,666	

1/ The equity amount may be incrementally funded. Investment amount represents Treasury's maximum obligation if the limited partners other than Treasury fund their maximum equity capital obligations.
2/ The loan may be incrementally funded. Investment amount represents Treasury's maximum obligation if Treasury and the limited partners other than Treasury fund 100% of their maximum equity obligations.

HOME AFFORDABLE MODIFICATION PROGRAM

Date	Servicer Modifying Borrowers' Loans: Name of Institution	City	State	Transaction Type	Investment Description	Cap of Incentive Payments on Behalf of Borrowers and to Servicers &	Pricing Mechanism	Adjustment Details: Adjustment Date	Cap Adjustment Amount	Adjusted Cap	Reason for Adjustment
4/13/2009	Select Portfolio Servicing	Salt Lake City	UT	Purchase	Financial Instrument for Home Loan Modifications	$ 376,000,000	N/A	6/12/2009	$ 284,590,000	$ 660,590,000	Updated portfolio data from servicer
								9/30/2009	$ 121,910,000	$ 782,500,000	Updated portfolio data from servicer & HPDP initial cap
4/13/2009	CitiMortgage, Inc.	O'Fallon	MO	Purchase	Financial Instrument for Home Loan Modifications	$ 2,071,000,000	N/A	6/12/2009	$ (991,580,000)	$ 1,079,420,000	Updated portfolio data from servicer
								9/30/2009	$ 1,010,180,000	$ 2,089,600,000	Updated portfolio data from servicer & HPDP initial cap
4/13/2009	Wells Fargo Bank, NA	Des Moines	IA	Purchase	Financial Instrument for Home Loan Modifications	$ 2,873,000,000	N/A	6/17/2009	$ (462,990,000)	$ 2,410,010,000	Updated portfolio data from servicer
								9/30/2009	$ 65,070,000	$ 2,475,080,000	Updated portfolio data from servicer & HPDP initial cap
4/13/2009	GMAC Mortgage, Inc.	Ft. Washington	PA	Purchase	Financial Instrument for Home Loan Modifications	$ 633,000,000	N/A	6/12/2009	$ 384,650,000	$ 1,017,650,000	Updated portfolio data from servicer
								9/30/2009	$ 2,537,240,000	$ 3,554,890,000	Updated portfolio data from servicer & HPDP initial cap
4/13/2009	Saxon Mortgage Services, Inc	Irving	TX	Purchase	Financial Instrument for Home Loan Modifications	$ 407,000,000	N/A	6/17/2009	$ 225,040,000	$ 632,040,000	Updated portfolio data from servicer
								9/30/2009	$ 254,380,000	$ 886,420,000	Updated portfolio data from servicer & HPDP initial cap
4/13/2009	Chase Home Finance, LLC	Iselin	NJ	Purchase	Financial Instrument for Home Loan Modifications	$ 3,552,000,000	N/A	7/31/2009	$ (3,552,000,000)	$ -	Termination of SPA
4/16/2009	Ocwen Financial Corporation, Inc.	West Palm Beach	FL	Purchase	Financial Instrument for Home Loan Modifications	$ 659,000,000	N/A	6/12/2009	$ (105,620,000)	$ 553,380,000	Updated portfolio data from servicer
								9/30/2009	$ 102,580,000	$ 655,960,000	Updated portfolio data from servicer & HPDP initial cap
4/17/2009	Bank of America, N.A.	Simi Valley	CA	Purchase	Financial Instrument for Home Loan Modifications	$ 798,900,000	N/A	6/12/2009	$ 5,540,000	$ 804,440,000	Updated portfolio data from servicer
								9/30/2009	$ 162,680,000	$ 967,120,000	Updated portfolio data from servicer & HPDP initial cap
4/17/2009	Countrywide Home Loans Servicing LP	Simi Valley	CA	Purchase	Financial Instrument for Home Loan Modifications	$ 1,864,000,000	N/A	6/12/2009	$ 3,318,840,000	$ 5,182,840,000	Updated portfolio data from servicer
								9/30/2009	$ (717,420,000)	$ 4,465,420,000	Updated portfolio data from servicer & HPDP initial cap
4/20/2009	Home Loan Services, Inc.	Pittsburgh	PA	Purchase	Financial Instrument for Home Loan Modifications	$ 319,000,000	N/A	6/12/2009	$ 128,300,000	$ 447,300,000	Updated portfolio data from servicer
								9/30/2009	$ 46,730,000	$ 494,030,000	Updated portfolio data from servicer & HPDP initial cap
4/20/2009	Wilshire Credit Corporation	Beaverton	OR	Purchase	Financial Instrument for Home Loan Modifications	$ 366,000,000	N/A	6/12/2009	$ 87,130,000	$ 453,130,000	Updated portfolio data from servicer
								9/30/2009	$ (249,670,000)	$ 203,460,000	Updated portfolio data from servicer & HPDP initial cap
4/24/2009	Green Tree Servicing LLC	Saint Paul	MN	Purchase	Financial Instrument for Home Loan Modifications	$ 156,000,000	N/A	6/17/2009	$ (64,990,000)	$ 91,010,000	Updated portfolio data from servicer
								9/30/2009	$ 130,780,000	$ 221,790,000	Updated portfolio data from servicer & HPDP initial cap
4/27/2009	Carrington Mortgage Services, LLC	Santa Ana	CA	Purchase	Financial Instrument for Home Loan Modifications	$ 195,000,000	N/A	6/17/2009	$ (63,980,000)	$ 131,020,000	Updated portfolio data from servicer
								9/30/2009	$ 90,990,000	$ 222,010,000	Updated portfolio data from servicer & HPDP initial cap
5/1/2009	Aurora Loan Services, LLC	Littleton	CO	Purchase	Financial Instrument for Home Loan Modifications	$ 798,000,000	N/A	6/17/2009	$ (338,450,000)	$ 459,550,000	Updated portfolio data from servicer
								9/30/2009	$ (11,860,000)	$ 447,690,000	Updated portfolio data from servicer & HPDP initial cap
5/28/2009	Nationstar Mortgage LLC	Lewisville	TX	Purchase	Financial Instrument for Home Loan Modifications	$ 101,000,000	N/A	6/12/2009	$ 16,140,000	$ 117,140,000	Updated portfolio data from servicer
								9/30/2009	$ 134,560,000	$ 251,700,000	Updated portfolio data from servicer & HPDP initial cap
6/12/2009	Residential Credit Solutions	Fort Worth	TX	Purchase	Financial Instrument for Home Loan Modifications	$ 19,400,000	N/A	9/30/2009	$ (1,860,000)	$ 17,540,000	Updated portfolio data from servicer & HPDP initial cap

Date	Servicer Modifying Borrowers' Loans: Name of Institution	City	State	Transaction Type	Investment Description	Cap of Incentive Payments on Behalf of Borrowers and to Servicers &	Pricing Mechanism	Adjustment Details: Adjustment Date	Cap Adjustment Amount	Adjusted Cap	Reason for Adjustment
6/17/2009	CCO Mortgage	Glen Allen	VA	Purchase	Financial Instrument for Home Loan Modifications	$ 16,520,000	N/A	9/30/2009	$ 13,070,000	$ 29,590,000	Updated portfolio data from servicer & HPDP initial cap
6/17/2009	RG Mortgage Corporation	San Juan	PR	Purchase	Financial Instrument for Home Loan Modifications	$ 57,000,000	N/A	9/30/2009	$ (11,300,000)	$ 45,700,000	Updated portfolio data from servicer & HPDP initial cap
6/19/2009	First Federal Savings and Loan	Port Angeles	WA	Purchase	Financial Instrument for Home Loan Modifications	$ 770,000	N/A				
6/19/2009	Wescom Central Credit Union	Anaheim	CA	Purchase	Financial Instrument for Home Loan Modifications	$ 540,000	N/A	9/30/2009	$ 330,000	$ 870,000	Updated portfolio data from servicer & HPDP initial cap
6/26/2009	Citizens First Wholesale Mortgage Company	The Villages	FL	Purchase	Financial Instrument for Home Loan Modifications	$ 30,000	N/A	9/30/2009	$ (10,000)	$ 20,000	Updated portfolio data from servicer & HPDP initial cap
6/26/2009	Technology Credit Union	San Jose	CA	Purchase	Financial Instrument for Home Loan Modifications	$ 70,000	N/A				
6/26/2009	National City Bank	Miamisburg	OH	Purchase	Financial Instrument for Home Loan Modifications	$ 294,980,000	N/A	9/30/2009	$ 315,170,000	$ 610,150,000	Updated portfolio data from servicer & HPDP initial cap
7/1/2009	Wachovia Mortgage, FSB	Des Moines	IA	Purchase	Financial Instrument for Home Loan Modifications	$ 634,010,000	N/A	9/30/2009	$ 723,880,000	$ 1,357,890,000	Updated portfolio data from servicer & HPDP initial cap
7/1/2009	Bayview Loan Servicing, LLC	Coral Gables	FL	Purchase	Financial Instrument for Home Loan Modifications	$ 44,260,000	N/A	9/30/2009	$ 23,850,000	$ 68,110,000	Updated portfolio data from servicer & HPDP initial cap
7/10/2009	Lake National Bank	Mentor	OH	Purchase	Financial Instrument for Home Loan Modifications	$ 100,000	N/A	9/30/2009	$ 150,000	$ 250,000	Updated portfolio data from servicer & HPDP initial cap
7/10/2009	IBM Southeast Employees' Federal Credit Union	Delray Beach	FL	Purchase	Financial Instrument for Home Loan Modifications	$ 870,000	N/A	9/30/2009	$ (10,000)	$ 860,000	Updated portfolio data from servicer & HPDP initial cap
7/17/2009	MorEquity, Inc.	Evansville	IN	Purchase	Financial Instrument for Home Loan Modifications	$ 23,480,000	N/A	9/30/2009	$ 18,530,000	$ 42,010,000	Updated portfolio data from servicer & HPDP initial cap
7/17/2009	PNC Bank, National Association	Pittsburgh	PA	Purchase	Financial Instrument for Home Loan Modifications	$ 54,470,000	N/A	9/30/2009	$ (36,240,000)	$ 18,230,000	Updated portfolio data from servicer & HPDP initial cap
7/17/2009	Farmers State Bank	West Salem	OH	Purchase	Financial Instrument for Home Loan Modifications	$ 170,000	N/A	9/30/2009	$ (90,000)	$ 80,000	Updated portfolio data from servicer & HPDP initial cap
7/17/2009	ShoreBank	Chicago	IL	Purchase	Financial Instrument for Home Loan Modifications	$ 1,410,000	N/A	9/30/2009	$ 890,000	$ 2,300,000	Updated portfolio data from servicer & HPDP initial cap
7/22/2009	American Home Mortgage Servicing, Inc	Coppell	TX	Purchase	Financial Instrument for Home Loan Modifications	$ 1,272,490,000	N/A	9/30/2009	$ (53,670,000)	$ 1,218,820,000	Updated portfolio data from servicer & HPDP initial cap
7/22/2009	Mortgage Center, LLC	Southfield	MI	Purchase	Financial Instrument for Home Loan Modifications	$ 4,210,000	N/A	9/30/2009	$ 1,780,000	$ 5,990,000	Updated portfolio data from servicer & HPDP initial cap
7/22/2009	Mission Federal Credit Union	San Diego	CA	Purchase	Financial Instrument for Home Loan Modifications	$ 860,000	N/A	9/30/2009	$ (490,000)	$ 370,000	Updated portfolio data from servicer & HPDP initial cap
7/29/2009	First Bank	St. Louis	MO	Purchase	Financial Instrument for Home Loan Modifications	$ 6,460,000	N/A	9/30/2009	$ (1,530,000)	$ 4,930,000	Updated portfolio data from servicer & HPDP initial cap
7/29/2009	Purdue Employees Federal Credit Union	West Lafayette	IN	Purchase	Financial Instrument for Home Loan Modifications	$ 1,090,000	N/A	9/30/2009	$ (60,000)	$ 1,030,000	Updated portfolio data from servicer & HPDP initial cap
7/29/2009	Wachovia Bank, N.A.	Charlotte	NC	Purchase	Financial Instrument for Home Loan Modifications	$ 85,020,000	N/A	9/30/2009	$ (37,700,000)	$ 47,320,000	Updated portfolio data from servicer & HPDP initial cap
7/31/2009	J.P.Morgan Chase Bank, NA	Lewisville	TX	Purchase	Financial Instrument for Home Loan Modifications	$ 2,699,720,000	N/A	9/30/2009	$ (14,850,000)	$ 2,684,870,000	Updated portfolio data from servicer & HPDP initial cap
7/31/2009	EMC Mortgage Corporation	Lewisville	TX	Purchase	Financial Instrument for Home Loan Modifications	$ 707,380,000	N/A	9/30/2009	$ (10,000)	$ 707,370,000	Updated portfolio data from servicer & HPDP initial cap
8/5/2009	Lake City Bank	Warsaw	IN	Purchase	Financial Instrument for Home Loan Modifications	$ 420,000	N/A	9/30/2009	$ 180,000	$ 600,000	Updated portfolio data from servicer & HPDP initial cap
8/5/2009	Oakland Municipal Credit Union	Oakland	CA	Purchase	Financial Instrument for Home Loan Modifications	$ 140,000	N/A	9/30/2009	$ 290,000	$ 430,000	Updated portfolio data from servicer & HPDP initial cap
8/5/2009	HomEq Servicing	North Highlands	CA	Purchase	Financial Instrument for Home Loan Modifications	$ 674,000,000	N/A	9/30/2009	$ (121,190,000)	$ 552,810,000	Updated portfolio data from servicer & HPDP initial cap
8/12/2009	Litton Loan Servicing LP	Houston	TX	Purchase	Financial Instrument for Home Loan Modifications	$ 774,900,000	N/A	9/30/2009	$ 313,050,000	$ 1,087,950,000	Updated portfolio data from servicer & HPDP initial cap
8/12/2009	PennyMac Loan Services, LLC	Calasbasas	CA	Purchase	Financial Instrument for Home Loan Modifications	$ 6,210,000	N/A	9/30/2009	$ (1,200,000)	$ 5,010,000	Updated portfolio data from servicer & HPDP initial cap
8/12/2009	Servis One, Inc.	Titusville	PA	Purchase	Financial Instrument for Home Loan Modifications	$ 29,730,000	N/A	9/30/2009	$ (25,510,000)	$ 4,220,000	Updated portfolio data from servicer & HPDP initial cap
8/28/2009	OneWest Bank	Pasadena	CA	Purchase	Financial Instrument for Home Loan Modifications	$ 668,440,000	N/A				
8/28/2009	Stanford Federal Credit Union	Palo Alto	CA	Purchase	Financial Instrument for Home Loan Modifications	$ 300,000	N/A				
8/28/2009	RoundPoint Mortgage Servicing Corporation	Charlotte	NC	Purchase	Financial Instrument for Home Loan Modifications	$ 570,000	N/A				
9/2/2009	Horicon Bank	Horicon	WI	Purchase	Financial Instrument for Home Loan Modifications	$ 560,000	N/A				
9/2/2009	Vantium Capital, Inc.	Plano	TX	Purchase	Financial Instrument for Home Loan Modifications	$ 6,000,000	N/A				
9/9/2009	Central Florida Educators Federal Credit Union	Lake Mary	FL	Purchase	Financial Instrument for Home Loan Modifications	$ 1,250,000	N/A				
9/9/2009	U.S. Bank National Association	Owensboro	KY	Purchase	Financial Instrument for Home Loan Modifications	$ 114,220,000	N/A				

Date	Servicer Modifying Borrowers' Loans			Transaction Type	Investment Description	Cap of Incentive Payments on Behalf of Borrowers and to Servicers &	Pricing Mechanism	Adjustment Details			
	Name of Institution	City	State					Adjustment Date	Cap Adjustment Amount	Adjusted Cap	Reason for Adjustment
9/9/2009	CUC Mortgage Corporation	Albany	NY	Purchase	Financial Instrument for Home Loan Modifications	$ 4,350,000	N/A				
9/11/2009	ORNL Federal Credit Union	Oak Ridge	TN	Purchase	Financial Instrument for Home Loan Modifications	$ 2,070,000	N/A				
9/11/2009	Allstate Mortgage Loans & Investments, Inc.	Ocala	FL	Purchase	Financial Instrument for Home Loan Modifications	$ 250,000	N/A				
9/11/2009	Metropolitan National Bank	Little Rock	AR	Purchase	Financial Instrument for Home Loan Modifications	$ 280,000	N/A				
9/11/2009	Franklin Credit Management Corporation	Jersey City	NJ	Purchase	Financial Instrument for Home Loan Modifications	$ 27,510,000	N/A				
9/16/2009	Bay Federal Credit Union	Capitola	CA	Purchase	Financial Instrument for Home Loan Modifications	$ 410,000	N/A				
9/23/2009	AMS Servicing, LLC	Buffalo	NY	Purchase	Financial Instrument for Home Loan Modifications	$ 4,390,000	N/A				
9/23/2009	Schools Financial Credit Union	Sacramento	CA	Purchase	Financial Instrument for Home Loan Modifications	$ 390,000	N/A				
9/23/2009	Glass City Federal Credit Union	Maumee	OH	Purchase	Financial Instrument for Home Loan Modifications	$ 230,000	N/A				
9/23/2009	Central Jersey Federal Credit Union	Woodbridge	NJ	Purchase	Financial Instrument for Home Loan Modifications	$ 30,000	N/A				
9/23/2009	Yadkin Valley Bank	Elkin	NC	Purchase	Financial Instrument for Home Loan Modifications	$ 240,000	N/A				
9/25/2009	SEFCU	Albany	NY	Purchase	Financial Instrument for Home Loan Modifications	$ 440,000	N/A				

Total Initial Cap $ 23,411,540,000 Total Cap Adjustments $ 3,654,220,000

TOTAL CAP $ 27,065,760,000

1/ The Cap of Incentive Payments represents the potential total amount allocated to each servicer and includes the maximum amount allotted for all payments on behalf of borrowers and payments to servicers and lenders/investors. The Cap is subject to adjustment based on the total amount allocated to the program and individual servicer usage for borrower modifications. Each adjustment to the Cap is reflected under Adjustment Details.

2/ On July 31, 2009, the SPA with Chase Home Finance, LLC was terminated and superseded by new SPAs with J.P. Morgan Chase Bank, NA and EMC Mortgage Corporation.

U.S. Treasury Department
Office of Financial Stability

Troubled Asset Relief Program

Projected Costs and Liabilities [Section 105(a)(3)(E)]

For Period Ending September 30, 2009

Type of Expense/Liability	Amount
None	

Note: Treasury interprets this reporting requirement as applicable to costs and liabilities related to insurance contracts entered into under the provisions of section 102 of the EESA; and the single insurance contract with Citigroup is structured such that no costs are anticipated, i.e. the currently anticipated cash inflows of the contract slightly exceed anticipated cash outflows.

U.S. Treasury Department
Office of Financial Stability

Troubled Asset Relief Program

Programmatic Operating Expenses [Section 105(a)(3)(F)]

For Period Ending September 30, 2009

Type of Expense	Amount
Compensation for financial agents and legal firms	$115,607,203

U.S. Treasury Department
Office of Financial Stability

Troubled Asset Relief Program

Description of Vehicles Established [Section 105(a)(3)(H)]

For Period Ending September 30, 2009

Date	Vehicle	Description
	None	

Standard for Applying Resolution Authority

In combination, Sections 1203 (b) and 1203(d) set forth the standard for applying the enhanced resolution authority process.

Section 1203 (b)

(b) DETERMINATION BY THE SECRETARY.—Notwithstanding any other provision of Federal law or the law of any State, if, upon the written recommendation of the Federal Reserve Board and the board of directors or commission of the Appropriate Federal Regulatory Agency as provided for in subsection (a)(1), the Secretary (in consultation with the President) determines that—

(1) the bank holding company is in default or is in danger of default;

(2) the failure of the bank holding company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability or economic conditions in the United States; and

(3) any action or assistance under section 1204 would avoid or mitigate such adverse effects, taking into consideration the effectiveness of action or assistance in mitigating potential adverse effects on the financial system or economic conditions, the cost to the general fund of the Treasury, and the potential to increase moral hazard on the part of creditors, counterparties, and shareholders in the bank holding company,

the Secretary may take action under section 1204(b) and the Corporation may take one or more actions specified in section 1204.

Section 1203 (d)

(d) DEFAULT OR IN DANGER OF DEFAULT.—For purposes of subsection (b), a bank holding company shall be considered to be in default or in danger of default if any of the following conditions exist, as determined in accordance with that subsection:

(1) a case has been, or likely will promptly be, commenced with respect to the bank holding company under title 11, United States Code;

(2) the bank holding company is critically undercapitalized, as such term has been or may be defined by the Federal Reserve Board;

(3) the bank holding company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion without assistance under section 1204;

(4) the bank holding company's assets are, or are likely to be, less than its obligations to creditors and others; or

(5) the bank holding company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.

MATERIAL SUBMITTED BY CHRISTOPHER SAGERS, CLEVELAND-MARSHALL COLLEGE OF LAW

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SUPPLEMENTAL STATEMENT OF CHRISTOPHER L. SAGERS
Associate Professor of Law, Cleveland State University

Before the
SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

of the
COMMITTEE ON THE JUDICIARY,
UNITED STATES HOUSE OF REPRESENTATIVES

Concerning
"TOO BIG TO FAIL: THE ROLE OF ANTITRUST AND BANKRUPTCY LAW IN CRAFTING A SOLUTION"

November 2, 2009

At Subcommittee counsel's request, this statement supplements my written testimony of October 22, 2009, and specifically addresses a question raised at the hearing of that date.[1] The question was whether the bill at issue, the Administration's proposed Resolution Authority for Large, Interconnected Financial Companies Act of 2009 ("Resolution Bill"), would modify existing antitrust law. The answer is, unequivocally, yes. The Resolution Bill would modify existing antitrust law, and it would do so in a way that is potentially *breathtaking*.

[1] To reiterate, I do not represent any party with any interest in this matter. I have received no compensation in connection with my testimony and I appeared at the October 22 hearing at my own expense. The views expressed are my own.

Specifically, the bill would make two changes:

(1) Where the company put into federal conservator/receivership owns both bank and non-bank assets—as will usually be the case—sales of its non-bank assets would be forced into a super-fast period of review with the benefit of only very limited information (whereas under current law those sales would be subject to the familiar Hart-Scott-Rodino (HSR) process); and

(2) Where particular exigencies are found to exist, those transactions could be exempted from any antitrust review whatsoever.

At the hearing, Administration witnesses[2] were asked whether there would be any modification. I believe they answered in perfectly good faith,[3] but their replies were in one major respect legally incorrect, and, overall, seriously misleading. In both their written and in-person testimony, both witnesses implied that the Resolution Bill would simply preserve "existing bank failure law" in most respects. In effect, they said that the special, idiosyncratic regime of bank merger review that currently exists would just be extended a bit to cover resolution of failing bank holding companies, which might happen to own some non-bank assets.[4]

[2] Michael S. Barr, Assistant Secretary of the Treasury for Financial Institutions, and Michael Krimminger, Special Advisor for Policy of the Federal Deposit Insurance Corporation.

[3] Neither Secretary Barr nor Mr. Krimminger purported to be an antitrust specialist, and, in their defense, the law in this respect is extremely complex.

[4] In reply to questions, both witnesses said that the Resolution Bill would not modify the antitrust review regime that currently applies in "bank failure" situations, though they apparently acknowledged that the bill would extend it to transactions to which it does not currently apply. *See* Hearing Transcript at 2:38:00 (testimony of Michael S. Barr) ("In our judgment the proposal mirrors the proceedings that are used with respect to bank failure law. So in the event of the need for merger and acquisition there's a process for appropriate Department of Justice review. As under existing bank failure law there are emergency exceptions . . . . Those would apply also in this case . . . . In our judgment . . . they are the same as currently provided under bank failure law. We're extending the exact type of regime that exists today with respect to antitrust review to this narrow context and in our judgment that's appropriate."); Hearing Transcript at 2:39:12 (testimony of Michael Krimminger) ("With regard to antitrust protections . . . there typically is a requirement to go through Department of Justice review on bank failures, but there can be exceptions . . . . In a systemic context there can be cases in which there is an override of the anticompetitive consequences.").

The witnesses' written statements did not specifically address antitrust, a fact perhaps reflecting the Administration's lack of concern for competition issues in this overall reform effort. But in both statements they implied that the Resolution Bill would simply follow (with some possible, unspecified modifications) existing law. *See* Statement of Michael S. Barr, at 4 (Oct. 22, 2009) (not specifically addressing antitrust, This is incorrect. On the one hand, it is true that the Resolution Bill in many cases merely incorporates existing bank merger law, which in many respects is idiosyncratic and under emergency conditions can be made to go rather fast.[5] However, the bill would exempt transfers of *non-bank* financial entities from the ordinary HSR process that currently governs them, and subject them to a new, hybrid HSR process would be very fast and very limited. The bill would do this notwithstanding that the transfers at stake might involve some of the largest mergers of financial institutions in U.S. history.

While this end result can be generalized simply enough, the legal details driving it turn out to be exceedingly complex. For the sake of clarity I explain every bit of the complexity in the footnotes. It is complex in part because the "BHCs" to which the bill's resolution authority would apply would include so-called "financial holding companies" (FHCs), which can own both bank and non-bank financial entities.[6] It is also complex

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but noting that the overall resolution process would simply follow "the approach long taken for bank failures."); Statement of Michael Krimminger, at 2 (Oct. 22, 2009) (noting only that "our antitrust and bankruptcy laws will continue to play a key role in ensuring robust competition in our free economy").

[5] That law differs from the more familiar HSR review in four main respects. First, bank mergers are one of only four situations in U.S. law in which the antitrust agencies share their merger review duties with an industry specific regulator. (The other three are railroad mergers, certain electricity mergers, and telecommunications.) *See* ANTITRUST MODERNIZATION COMMISSION, REPORT AND RECOMMENDATIONS 363-64 (2007) [hereinafter "AMC REPORT"]. Second, bank merger law is virtually unique in that an otherwise anticompetitive merger can be approved if it is found to be in the "public interest." Next, if DOJ decides to formally challenge a bank merger, it must file a lawsuit within 30 days of receipt of the parties' application. Its lawsuit during that period forces an absolute and automatic stay on the proposed transaction for the pendency of litigation, but if DOJ fails to sue within 30 days, then neither DOJ nor any other party can *ever* challenge the merger itself on antitrust grounds. Finally, bank merger law allows the responsible bank regulator to determine that one of the banks might imminently fail, in which case the regulator can speed the process up, or, in some cases, do away with antitrust review entirely. *See generally* SECTION OF ANTITRUST LAW, AM. BAR ASS'N, BANK MERGERS AND ACQUISITIONS HANDBOOK 5-33 (2006) [hereinafter "ABA BANK MERGER HANDBOOK"].

[6] Nominally, the resolution authority under the Administration bill applies only to "bank holding companies." However, that term is defined to include "financial holding companies" (FHCs) within the meaning of the Bank Holding Company Act, 12 U.S.C. §§ 1841-50. The FHC in turn was a creation of the Gramm-Leach-Bliley Act of 1999, Pub. L. 106-102, 113 Stat. 1338 (Nov. 12, 1999), now codified at scattered provisions of U.S. Code (GLB). Prior to GLB, no bank or BHC was permitted to own any non-banking asset except those engaged in a handful of activities specified by the Federal Reserve Board (FRB) as "closely related to banking," like trust services, data processing, or the operation of an ATM network. *See* 12 U.S.C. § 1843(c)(8); 12 C.F.R. § 225.28(b). But following GLB, an FHC can own both banking entities and non-bank affiliates, which can engage in a whole series of financial activities, like insurance,

because knowing when HSR applies and when it does not—especially in the banking context—is extremely thorny.[7] But the bottom line remains that under this bill, transfers

securities underwriting, and merchant banking. To qualify as an FHC, a firm must first be approved by the FRB as a BHC, and then file a declaration of intent to act as an FHC with the FRB. FHCs must maintain certain minimum capitalization and managerial standards to retain their FHC status, but there is no requirement they first receive FRB approval. *See* 12 U.S.C. 1843(*l*)(1). That last fact is relevant to the antitrust treatment of mergers and acquisitions involving FHCs. *See infra* note 7.

With one limited exception, no other business in the United States may own both banking and non-banking businesses. The exception is that national banks may own operating subsidiaries that engage in a more limited schedule of the same non-banking financial activities open to FHCs. *See* CARL FELSENFELD, BANKING REGULATION IN THE UNITED STATES 106.9 – 106.15 (2004).

[7] The best simple summary that can be given is that, again, most bank mergers and acquisitions are exempt from HSR, *see* 15 U.S.C. § 18a(c)(7), but most transfers of non-banking financial institutions are subject to HSR, regardless of whether the acquiror or seller happens to be a bank or BHC.

But to be clear, a conservator/receiver attempting to resolve a failing BHC could cause any of a complicated set of different transactions that might in one way or another trigger an HSR filing. Where a resolution involves transfer of an entire FHC to one buyer, the DOJ or FTC would review the non-banking parts of the transaction under the normal HSR process. *See* 16 C.F.R. § 802.6(b) (rule of the FTC's Premerger Notification Office providing that in all "mixed" transactions involving some assets exempt from HSR and some not, the non-exempt portions will be reviewed under the normal HSR process); Premerger Not. Off., FTC, Formal Interpretation 17, 65 FED. REG. 17,880 (Apr. 5, 2000) (clarifying that this rule would apply to mixed acquisitions by FHCs). In other cases, the failing FHC will be broken up and sold to different buyers. The banking pieces of the FHC would have to be sold to entities legally permitted to own banks; most such transfers would be exempt from HSR and would be reviewed under the existing bank merger review process (though not all of them, because occasionally acquisitions of bank stock or assets are subject to HSR; see below). The non-banking pieces could be bought by all different sorts of buyers, and the merger review rules that would apply will depend on who the buyer is. The possibilities are:

(1) Any transfer of a non-banking asset to any buyer that is not itself a bank or a BHC would trigger HSR. For example, an FHC that owns securities underwriting business might sell it to a competing firm that is not itself owned by an FHC. Under current law, such a transfer would be simply a garden variety HSR transaction.

(2) The situation is more complex where the acquiror is either a bank or another FHC. (Strictly speaking, the only bank that could purchase non-banking assets would be a national bank that makes the purchase through a subsidiary. *See supra* note 6.) Sometimes HSR applies to such acquisitions and sometimes it does not, as follows:
   (a) Under current law, if the acquiring entity is an FHC, then its acquisition of non-bank entities is fully subject to HSR. *See* 12 U.S.C. § 1843(k)(6) (providing that an FHC may commence non-banking "financial" activities without prior FRB approval); 15 U.S.C. § 18a(c)(8) (providing the HSR applies to FHC acquisitions of non-banking financial entities that are exempted from FRB prior approval).
   (b) However, if an FHC, a BHC that is not permitted to act as an FHC, or a national bank acquires a non-banking entity, *and* that acquired entity engages in activities "closely related to banking or managing or controlling banks" as defined in Federal Reserve Board regulations, then the acquiror may elect *either* to make an HSR filing or apply for FRB approval. *See* 12 U.S.C. § 1843(c)(8); 12 C.F.R. § 225.28(b). "Closely related" activities include such things as trust services, data processing, and ATM network operation.

(3) Finally, there will be cases in which transfers of *banking* assets will be subject to HSR review. Bank acquisitions are exempt from HSR only where they are subject to pre-merger review by a banking regulator. *See* 15 U.S.C. § 18a(c)(7), (c)(8). But they are reviewed by banking regulators only where the acquisition of control is itself large enough to trigger the bank

of very big financial companies would be subjected only to a hybrid HSR process so fast and so constrained as to constitute no meaningful antitrust review at all.

The Act reaches this result in two identical provisions. They first provide the following as to any transfers made by a federal conservator/receiver under the Act:

> If a filing is required under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 with the Department of Justice or the Federal Trade Commission, the waiting period shall expire not later than the 30th day following such filing notwithstanding any other provision of Federal law or any attempt by any Federal agency to extend such waiting period, and no further request for information by any Federal agency shall be permitted.

Resolution Bill at § 1209(a)(1)(G)(ii)(I); § 1209(h)(10)(A). Both of the identical provisions then continue with the following, separate rule:

> If the Secretary, in consultation with the Chairman of the Federal Reserve Board, has found that the [conservator/receiver] must act immediately to prevent the probable failure of the covered bank holding company involved, the approvals and filings [that would otherwise be required under the Resolution Bill] . . . shall not be required and the transaction may be consummated immediately by the [conservator/receiver].

Id. at § 1209(a)(1)(G)(ii)(II); § 1209(h)(10)(B).

This is a big change. Under HSR, both parties to an acquisition must make an initial application on the agencies' "Form HSR-1." The application gives the agencies a chance to decide whether the transaction would violate § 7 of the Clayton Act.[8] It therefore

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merger review statutes. It is possible that an acquiror could acquire a share in the voting stock of a banking entity that is too small to trigger bank merger review but large enough to trigger HSR review. For example, a BHC may acquire up to 5% of the voting stock of a bank without FRB approval. *See* 12 U.S.C. § 1842. But if value of the stock is $50 million or more (as it would be if the target bank's total voting securitites are worth more than $1 bilion) and the BHC has total assets or annual net sales of more than $10 million (as seems likely), then the transaction is reportable under HSR. *See* STEPHEN M. AXINN ET AL., ACQUISITIONS UNDER THE HART-SCOTT-RODINO ANTITRUST IMPROVEMENTS ACT § 6.06[3][f] (2006).

See generally AXINN ET AL., *supra*, at § 6.06[3][g]; ABA BANK MERGER HANDBOOK, *supra* note 5, at 8-9,

[8] Section 7 of the Clayton Act, 15 U.S.C. § 18, provides that an acquisition by one person of the assets or voting securities of another is illegal if it would "substantially lessen competition, or tend to create a monopoly."

requires detailed discussion of the parties' markets, their market shares, and their competitors. So long as the agencies deem the filing complete, it triggers a statutory waiting period under which the parties may not consummate their transaction earlier than 30 calendar days after the filing is received.

As a practical matter, the agencies approve the vast majority of transactions before them during this initial 30-day waiting period. However, where they believe that a transaction may pose substantial competitive risks, they routinely take a few months and occasionally as much as a year or more to consider them. They also enjoy the benefit of interviews, depositions, interrogatories, and document production requests, all of which they may direct to the parties or to third persons. They enforce those disclosure requests through what are in effect very powerful civil discovery tools.[9]

All of this remains true, incidentally, even of transactions involving firms that are in financial distress or even in bankruptcy. HSR still applies in these cases, without any meaningful differences. Bankruptcy law makes only a small timing modification in some cases.[10]

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[9] *See generally* AXINN ET AL., *supra* note 7, at §§ 7.04 – 7.05.

[10] By 1994 amendments, the bankruptcy code provides that where a bankruptcy trustee causes a transfer of assets that would trigger an HSR filing, the trustee must make the filing, but that the initial waiting period and other procedures operate as if the transfer were a "cash tender offer." The HSR causes review of cash tender offers to proceed more quickly than review of other transactions, but otherwise works in the ordinary way. The cash tender offer rules are in no way like the super-fast, constrained review under the Administration's resolution authority bill. *See* 11 U.S.C. § 363(b)(2); *see generally* AXINN ET AL., *supra* note 7, at § 7.03[3][a][iii]. In fact, a purpose of the 1994 amendments was to make clear that the agencies retain their power to make second requests even where the seller is a trustee in bankruptcy. *See id.* at § 7.04[3].

The fact that the firm in receivership is "failing" is of antitrust significance only in that, were an acquisition of that failing entity challenged under Clayton Act § 7, the merging parties might be able to raise the so-called "failing firm" defense. On HSR review, the agencies will consider whether a failing firm defense could be raised successfully if an agency were to challenge a transaction under § 7. A persuasive failing firm argument might cause the agencies to terminate an HSR review more quickly than they otherwise would, but the availability of the defense does not otherwise alter the HSR process. *See* U.S. DEP'T OF JUST. & FTC, HORIZONTAL MERGER GUIDELINES § 5 (1997).

But under the Resolution Bill, this would all be quite different. The agencies would have 30 (presumably calendar) days to make their judgment, period. They must make that judgment solely on the basis of the information initially given on Form HSR-1, and there is a serious possibility under the bill as written that that might amount to only whatever informaion the conservator/receiver decides is enough.[11] The transactions at issue are certain to be complex, because by definition the firms at stake will be systemically significant and are likely to hold massive assets throughout the entire world. Moreover, the risk of getting the analysis wrong is significant. The assets to be sold will be large and the buyer will ordinarily be a very large competitor (or else it would lack the resources to buy all or part of a systemically significant financial holding company) that might be well positioned to use them to anticompetitive ends.[12] Bear in mind that the two federal agencies that perform HSR review are already responsible for oversight of *every other significant merger and acquisition in the entire U.S. economy.* It is hard to imagine how they could provide any meaningful check on anticompetitive transfers under these circumstances.

* * *

For the sake of clarity, I think I should reiterate that the Resolution Bill's antitrust approach is a bad one not just because of this change in the HSR process. The *entire*

[11] A possibly serious issue of interpretation under the Act is whether the agencies could have any say at all in how much information must be included with the HSR-1 filing. Under current law, the agencies can deem an initial filing incomplete and demand a revised filing, in which case the statutory time period does not begin until the subsequent filing is made. 16 C.F.R. § 803.10(c)(2). But the Act provides that once the filing is made (which presumably would be made on Form HSR-1), the waiting period "shall expire not later than the 30th day following such filing," and that once the filing is made, "no further request for information . . . shall be permitted." This might indicate that no matter what information is included, the agencies would have no recourse to deem the filing incomplete.

[12] As Mr. Krimminger made clear, the conservator/receiver would be obliged in making any transfer to find the highest bidder for the assets in question. But much of the time the highest bidder will be the firm that can use the assets to their most anticompetitive and therefore most profitable end.

approach is problematic, because it incorporates a system of bank merger review that is itself fraught with failures and weaknesses. As I mentioned in my earlier statement, the fact that that idiosyncratic system even continues is an anomaly whose explanation seems increasingly strained,[13] and the system has been the subject of sustained criticism.[14] Among other things, the permissiveness of this system, which has never taken systemic risk as a serious component of analysis, must be held partly to blame for the rise of so many TBTF firms in the first place.

* * *

Having laid out all that regulatory detail, let us consider a practical example. The company that is now Citigroup has been the beneficiary of four different, ad hoc government bailouts since the Great Depression. Assuming that it can regain stability following the current rescue, it will remain an immense entity. Though it has shed some of the assets that as of 1998 made it the largest financial firm in world history—most importantly the Travelers insurance company, which it spun off in 2002—and though it

[13] To be clear, the current system was not created as an exception to HSR after HSR had already been put in place. It came into being long *before* Congress adopted HSR in 1976. It persists as an idiosyncratic exception to HSR review, but the policy justification for this special treatment has changed over the years and seems increasingly strained. As initially conceived, the system was designed to impose *more* competitive discipline on bank mergers than was thought to be available under the law as it existed at the time (the 1950s). Now, after the adoption of HSR, it has come to impose considerably *less* discipline than the law imposes on mergers in almost any other industry. If there is any clear contemporary justification for this more lax treatment, it is only the traditional "destructive competition" concern, manifesting itself as a desire to protect the deposit insurance system. *See* Bernard Shull, *The Origins of Antitrust in Banking: An Historical Perspective,* 41 ANTITRUST BULL. 255 (1996).Lawrence J. White, *Banking, Mergers, and Antitrust: Historical Perspectives, and the Research Tasks Ahead,* 41 ANTITRUST BULL. 323 (1996).

[14] *See* Peter C. Carstensen, *A Time to Return to Competition Goals in Banking Policy and Antitrust Enforcement: A Memorandum to the Antitrust Division,* 41 ANTITRUST BULL. 489 (1996); Peter C. Carstensen, *Restricting the Power to Promote Competition in Banking: A Foolish Consistency Among the Circuits,* 1983 DUKE L. J. 580; *Panel Discussion I: The Development of Bank Merger Law, Symposium: The Antitrust Aspects of Bank Mergers,* 13 FORDHAM J. CORP. & FIN. L. 511, 512 (2008) (comments of Professor Carl Felsenfeld, Fordham Law School); Margaret E. Guerin-Calvert, *Current Merger Policy: Banking and ATM Network Mergers,* 41 ANTITRUST BULL. 289 (1996); *See generally* AMC REPORT, *supra* note 5 , at 363-64 (criticizing all statutory limits on merger review in regulated industries, calling for full application of Clayton Act § 7 and the HSR to all such mergers, and calling for full competition review authority as to such mergers to be returned to the antitrust enforcement agencies).

intends to sell more, Citigroup retains about 200 million business and consumer customers in more than 140 countries. Along with its core banking business, the company apparently intends to retain a large investment banking operation, a global private banking/wealth management operation, and significant businesses in hedge funds, private equity, and other investment vehicles. Also, though it apparently intends to sell them, for the time being it retains the Smith Barney brokerage firm, the large life insurance and financial services firm known as Primerica, and significant businesses in real estate and consumer finance.[15] But Citigroup remains a severely troubled institution, and if the Resolution Bill were to pass there is no small chance that it would be the first firm put into a federal receivership. If so, when a buyer is found for Citigroup's traditional banking businesses, their transfer would be subject only to review by the FRB under existing bank merger law, and the Resolution Bill would automatically trigger the emergency time periods contained in that law. In other words, the FRB would probably make its decision in about one or two months, and the DOJ would have to provide a "report on competitive factors" *in ten days* of FRB's request for it.[16] These decisions would have to be made about transfer of a firm that, by number of customers, remains the world's single largest bank.[17] Then, when buyers are found for the non-banking parts, DOJ would get a filing on Form HSR-1, which really might include only as much or as little information as the conservator/receiver wants to give, and must decide within 30

[15] *See generally* Andrew Martin & Gretchen Morgensen, *Can Citigroup Carry Its Own Weight?*, N.Y. TIMES, Nov. 1, 2009, at BU1 (discussing Citigroup's history of government rescues and its current state); http://www.citigroup.com/citi/business/ (company website explaining its current businesses).

[16] Resolution Bill §§ 1209(a)(1)(G)(ii)(I) and 1209(h)(10)(A) both trigger this 10-day competition report provision. That provision is also available under existing bank merger law where the responsible bank regulator determines that one of the banks might fail; the Resolution Bill triggers it automatically.

[17] All the same would be true of the many lines of Citigroup's business that are "closely related" to banking, and therefore exempt from HSR, like some of its real estate investment businesses, much of the Smith Barney brokerage business, mergers-and-acquisitions advisory functions, and some other affairs. *See* 12 C.F.R. § 225.28.

days whether it would be anticompetitive to sell a large range of non-banking assets, including a massive securities underwriting operation and the Primerica firm, which among other things manages tens of billions of dollars of life insurance obligations for six million clients. Finally, if the Treasury Secretary and the FRB Chairman deem there to be emergency conditions, then *all* of Citigroup, one of the world's largest financial institutions, could be sold to one or many buyers *with no antitrust review of any kind.* The last part is the most breathtaking. Recent events make it seem likely that in many cases of failing, systemically significant FHCs the federal government will consider there to be an "emergency."

* * *

Both under the traditional bank merger review and the new, hybrid HSR review, the time constraints and the magnitude of the transactions will ensure that major transactions under the Resolution Bill will not get meaningful antitrust review. This is sufficiently clear to beg the question why the Act fails just to exempt these transactions from antitrust altogether; it is fairly clear that the bill's drafters have no concern for it.[18] Presumably doing so explicitly would have seemed too impolitic. But if outright exemption from antitrust review is in some way a bad thing, then one must acknowledge that the procedures in the Resolution Bill are also inadequate, as they will reach much the same result.

[18] *See supra* note 4; *see also* U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION (2009) (88-page report explaining Administration's financial regulatory reform package, including the Resolution Bill, which never mentions antitrust and only very obliquely discusses competition).

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October 27, 2009

BY FEDERAL EXPRESS AND E-MAIL

Honorable John Conyers, Jr.
Chairman
Committee on the Judiciary
House of Representatives
Washington, D.C. 20515

Re: October 22, 2009 Hearing on: Too Big To Fail – The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform

Dear Mr. Chairman:

Reference is made to Chairman Ben Bernanke's letter to you dated October 21, 2009 (the "Bernanke Letter"), in support of the establishment of a new resolution regime for systemically important financial firms ("SIFFs"). I write to address the unfortunate blurring of two different and very distinct issues in the Bernanke Letter, as well as in the written and oral statements submitted by Michael Barr and Michael Krimminger at the October 22 hearing of the Subcommittee on Commercial and Administrative Law. These issues are (1) the detection and prevention of the "disorderly failure" referenced in the Bernanke Letter; and (2) the administration of failure – after failure has occurred – and avoidance of systemic consequences.

Oversight, detection and prevention of financial distress and potential failure is a separate and distinct subject. Dealing with failure and the consequences of failure is an entirely different discipline. Financial assistance, adequate capitalization, increased oversight and regulation all go far to *prevent* failure. As I have stated, while the events surrounding Lehman's failure were extraordinary, what Lehman needed on the eve of its failure was liquidity to provide a bridge to a sale or an orderly wind-down to avoid systemic consequences. *See* Testimony of

Harvey Miller at p. 15. In the words of Timothy Geithner, there was a need to put foam on the runway. A liquidity shortfall is the harbinger of failure. The failure of SIFFs could, therefore, be *prevented* through the imposition of enhanced capital requirements and increased regulatory oversight, along with an expansion of the government's ability to provide emergency financial assistance if necessary to protect the public interest. Even if these measures do not prevent failure, they would go far in mitigating its impact – *i.e.*, in providing a soft landing rather than a "disorderly" crash. It must be acknowledged that the definition of bailout is plural. A bridge loan is a bailout as is a Bear Stearns rescue plan. Accordingly, the issue presented is whether a form of bailout or bankruptcy adequately protect the public interest and provides the transparency and respect for the separation of powers that is appropriate.

Once failure occurs, the question is *what is the most efficient and economical process to deal with it*? We are fortunate in the United States to have developed a body of laws dealing with the *consequences* of failure. Yet the recommendations of the United States Department of the Treasury (the "Treasury"), the Federal Deposit Insurance Corporation (the "FDIC"), and Chairman Bernanke are stubbornly premised on their unexplained conclusion that "the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm." *See* Bernanke Letter at p. 4. What is the basis for this conclusion?

The Bernanke Letter argues that a new regime is necessary that would replace the bankruptcy code and the bankruptcy courts, and empower the FDIC "to take control of the management and operations of the failing firm; to sell assets, liabilities, and business units of the firm; to transfer the viable portions of the firm to a new 'bridge' entity that can continue these operations with minimal disruptions while preserving value; and to repudiate contracts of the firm, subject to appropriate recompense." All of these tools, however, are available within the framework (and, specifically, section 363 and 365) of the bankruptcy code. The Bernanke Letter also states that we need "credible processes for imposing losses on shareholders and creditors of the firm is essential to restoring a meaningful degree of market discipline and addressing the too-big-to-fail problem." As I have stated, the bankruptcy code does impose the losses on creditors and shareholders by virtue of the application of the principle of absolute priority. *See* Testimony of Harvey Miller at p. 14.

The Lehman, General Motors, and Chrysler chapter 11 cases are concrete examples of this. The Lehman case demonstrates not only how monumental a task it can be to resolve a SIFF, but that such resolution is possible within the framework of the bankruptcy code, and *without* the need to spend one cent of taxpayer funds.[1] The General Motors and Chrysler

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[1] As the bankruptcy court overseeing Lehman's case has recognized, despite

> ... the history that we've had in this case for the last, approximately, nine months in which we have been dealing with any number of unprecedented commercial transactions that I believe have never been presented in a bankruptcy court at least to this level of

cases have demonstrated that the use of government bridge loans to effectuate orderly transfers of assets and wind-downs may be accomplished through the bankruptcy process, with the cost imposed on creditors and shareholders of the particular entity. The shareholders of Lehman, General Motors, and Chrysler have been wiped out. Creditor recoveries in those cases will be minimal. In addition, the administration of the chapter 11 case of Lehman has not cost the federal government a single dollar. Reliance on government assistance is not the preferred course of action for any firm if it can be avoided. However, it may facilitate a post-bankruptcy sale. Such a sale may occur expeditiously and repay such assistance. In Lehman, the sale of the North American capital markets business occurred within one week of the commencement of the bankruptcy case. Similarly, the General Motors and Chrysler sales occurred within 46 days of their respective commencement dates.

Bankruptcy cases proceed in the clear light of transparency, with full respect for the rights of all parties in interest and for the due process of law. As the bankruptcy court overseeing Lehman's chapter 11 cases has observed:

> Transparency, the sharing of information, cooperation, investigation, these are the hallmarks of this bankruptcy case up to this point.

See Tr. of July 15, 2009 Hr'g, at 135:17-19. The "open courtroom has been a fundamental feature of the American judicial system." *Brown v. Williamson Tobacco Corp. v. Federal Trade Comm'n*, 710 F.2d 1165, 1178 (6th Cir. 1983). How open would the process be under a regime that takes the process out of the courts and leaves it in the hands of the executive branch? When the FDIC attempts to sell assets, liabilities, and business units of the firm, will creditors have an opportunity to object to the price or the manner of sale, as they can under the bankruptcy code? When the FDIC decides to repudiate contracts of the firm "subject to appropriate recompense," who will be the judge of what is "appropriate"? When the FDIC engages in a "credible process" for imposing losses on shareholders and creditors, who will be the judge of what is "credible"? The answer that an action may be initiated by a complaint in the appropriate Federal District Court is hardly satisfactory.

Indeed, the bankruptcy code (with appropriate amendatory corrections) and the bankruptcy courts are perfectly capable -- if not *more* capable -- of dealing with the consequences of a failed SIFF. Such failures are bonnd to be of an unimaginable scope. As the Lehman court

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> volume and sophistication…somehow, counsel have been able to work out procedures, whether related to open trades or…to proofs of claim for derivatives. And I think that it's going to be possible to deal with particular problems all of which I can't presently foresee as they arise.

See Tr. of June 29, 2009 Hr'g, at 36:25 - 37:8.

has commented, Lehman's case "involves a level of complexity that probably goes beyond that of almost any other case [this court] can identify." *See* Tr. of May 13, 2009 Hr'g at 20:3-4. There is no reason to think that the next failure will be any simpler. On the contrary: today, the ten largest financial institutions hold 60% of the financial assets of the United States, as compared to 10% in 1990. If we expand the number of institutions to 20, they hold 80% of the financial assets.

Given these figures, the size of a first tier non-bank financial holding company, if in distress, will be well beyond the capabilities of the FDIC to deal with. Mr. Krimminger testified that the FDIC's staff is comprised of approximately 300 individuals – individuals who seem to be substantially occupied with handling the more than 100 small and medium-size bank failures that have occurred since the beginning of 2009. To date, Lehman's case has absorbed the full-time resources of more than 650 persons. How can the FDIC believe that it will be *physically* capable of handling the failure of another SIFF? What experience does the FDIC have in resolving international securities transactions and the unwinding of esoteric financial instruments such as swaps, repos, forward sale contracts, foreign exchange contracts, and the structured investment vehicles and special purpose entities created to hold collateral for derivatives transactions? SIFFs are likely to engage not only in these trades, but in a wide variety of businesses on a global level. What experience does the FDIC have with the management and control of multinational financial enterprises and the administration of multinational insolvency proceedings? (In the Lehman cases, there are more than 80 separate insolvency proceedings commenced in 16 different jurisdictions.) Finally, any SIFF, such as a tier-1 non-bank financial holding company, may also encompass within its corporate group a regulated broker-dealer subject to the Securities Investor Protection Act of 1970 (15 U.S.C. 78aaa et seq.). How would a resolution regime reconcile its powers with that of the Securities Investor Protection Corporation?

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Honorable John Conyers, Jr.

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There need to be as many options available to the government as necessary to *prevent* the failure of a SIFF. But once failure becomes inevitable, it is most probable that the FDIC will not be capable of dealing with the consequences. The bankruptcy courts *are*. They have proven this time and again, and clearly during these extraordinarily difficult times. Moreover, they have done so while preserving the constitutional rights of creditors, shareholders, and other parties in interest. The process has been fair, transparent, and zealously protective of the due process of law. We must not underestimate these values for the sake of expedience or convenience.

Respectfully,

Harvey R. Miller

cc: Honorable Steve Cohen, Chairman of the Subcommittee on Commercial and Administrative Law

Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System

Michael S. Barr, Esq., Assistant Secretary for Financial Institutions, United States Department of the Treasury

Michael H. Krimminger, Esq., Special Advisor for Policy to the Chairman of the Federal Deposit Insurance Corporation

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October 28, 2009

BY E-MAIL

Honorable John Conyers, Jr., Chairman
Committee on the Judiciary
House of Representatives
Washington, D.C. 20515

Re: October 22, 2009 Hearing on: Too Big To Fail – The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform

Dear Mr. Chairman:

I refer to my letter to you dated October 27, 2009, concerning the establishment of a new resolution regime for systemically important financial firms. In my letter, I cite Michael Krimminger as having testified at the October 22 hearing of the Subcommittee on Commercial and Administrative Law that the FDIC's staff is comprised of approximately 300 individuals. With my apologies to Mr. Krimminger, I write to inform you that I appear to have misheard his testimony, as he has since informed me that the FDIC staff is today comprised of approximately 6,300 individuals.

Respectfully,

Harvey R. Miller (MH)
Harvey R. Miller

cc: Honorable Steve Cohen, Chairman of the Subcommittee on Commercial and Administrative Law
Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System
Michael S. Barr, Esq., Assistant Secretary for Financial Institutions, United States Department of the Treasury
Michael H. Krimminger, Esq., Special Advisor for Policy to the Chairman of the Federal Deposit Insurance Corporation

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