SIGTARP | OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM

ADVANCING ECONOMIC STABILITY THROUGH TRANSPARENCY, COORDINATED OVERSIGHT AND ROBUST ENFORCEMENT

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U.S. SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

SUBMITTED WRITTEN TESTIMONY OF

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BEFORE THE
U.S. SENATE COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS

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Chairman Johnson, Ranking Member Crapo and members of the Committee, I want to thank you for holding today's hearing on Wall Street reform and on oversight of our nation's financial stability. The Office of the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP") serves as the watchdog over the Troubled Asset Relief Program ("TARP"), the Federal bailout resulting from the financial crisis. SIGTARP protects the interests of those who funded TARP programs – American taxpayers. Our mission is to promote economic stability through transparency, robust enforcement, and coordinated oversight.

In order to determine where our nation stands today in terms of Wall Street reforms and financial stability oversight, we must understand how our nation found itself in a financial crisis and a bailout in 2008. SIGTARP has examined the past actions by Wall Street institutions that made them "too big to fail" and led to the TARP bailout. The issues that arose in the wake of the financial crisis, and our Government's response, have implications for the future. Indeed, the Congressional hearings on the Dodd-Frank Wall Street Reform and Consumer Protection Act are largely focused on the reasons why Treasury and the Federal banking regulators believed that these institutions were "too big to fail" requiring a TARP bailout, and the reforms that were needed to prevent future bailouts. Only by examining the past, can we take advantage of lessons learned to protect taxpayers better in the future.

Four years after the passage of the TARP bailout, critical questions remain prevalent about financial stability and Wall Street reform. Does moral hazard still exist? Is our financial system still vulnerable to companies that were considered "too big to fail?" Do taxpayers have a stronger, more stable financial system that is less prone to crisis – one in which the U.S. Government need not intervene to rescue a failing institution – as an owner or a shareholder– or else risk financial collapse? Taxpayers need and deserve lasting change arising out of the 2008 financial crisis.

While there have been significant reforms to our financial system over the past four years, more change is needed to address the root causes of the financial crisis and the resulting bailout, including vulnerabilities to highly interconnected institutions, and past failures in risk management. Financial institutions, regulators, and Treasury have a benefit that was missing during the financial crisis: the benefit of time … time to shore up existing strengths and to minimize vulnerabilities.

There are lessons to be learned from the 2008 financial crisis and TARP. And as history has a way of repeating itself, we must take those lessons learned and put into place the changes that will bring a safer tomorrow – a future in which the flaws and excesses of corporate America do not create an undertow for families and small businesses.

Too Interconnected To Fail

One of the most important lessons of TARP and the financial crisis is that our financial system remains vulnerable to companies that can be deemed "too interconnected to fail." In 2008, we learned that our financial system was akin to a house of cards, with a foundation built on businesses that were "too big to fail." But these businesses were not only too big to fail, in and of themselves, they also were highly interconnected. If one were to fall, the house of cards could collapse.

When the crisis hit, regulators were ill-prepared to protect taxpayers because they had failed to appreciate the interconnected nature of our financial system, and the resulting threats to American jobs, retirement plans, mortgages, and loans. Thus, Treasury and regulators turned to TARP.

These same financial institutions continue to form the foundation of our economy. They continue to be dangerously interconnected. And, in fact, they have only gotten bigger in the past four years.[1] In 2012, the Federal Reserve Bank of Dallas reported that the biggest banks have grown larger still because of artificial advantages, particularly the widespread belief that the Government will step in to rescue the creditors of the biggest institutions if necessary – a belief underscored by TARP.

Whether Dodd-Frank's newly created resolution authority will ultimately be successful in ending "too big to fail" will depend on the actions taken by regulators and Treasury. Notwithstanding the passage of Dodd-Frank, the FRB Dallas reports that the sheer size of these institutions – and the presumed guarantee of Government support in time of crisis – have provided a "significant edge – perhaps a percentage point or more – in the cost of raising funds." In other words, cheaper credit translates into greater profit.

After Dodd-Frank, credit rating agencies began including the prospect of Government support in determining credit ratings. In 2011, Moody's downgraded three institutions citing a decrease in the probability that the Government would support them, while stating that the probability of support for highly interconnected institutions was very high. Recently, a Moody's official stated that Government support was receding.

It is too early to tell whether full implementation of Dodd-Frank will ameliorate the need for taxpayers to bail out companies if there is a future crisis. Even without the failure of any one of these institutions, we have learned that their near failure or significant distress could cause ripple effects for families and businesses. Despite TARP and other Federal efforts preventing the failure of these institutions, much of Americans' household wealth evaporated. Treasury

[1] According to Federal Reserve data, as of September 30, 2012, the top five banking institutions (all TARP recipients) held $8.7 trillion in assets, equal to approximately 55% of our nation's gross domestic product. By comparison, before the financial crisis, these institutions held $6.1 trillion in assets, equal to 43% of GDP.

Secretary Timothy F. Geithner testified before Congress in a hearing on Dodd-Frank that there was a “threat of contagion” caused by the interconnectedness of major firms. Given this continued “threat of contagion” to our financial system, Treasury and regulators should take this opportunity to protect taxpayers from the possibility of any future financial crisis.

Through Dodd-Frank, Congress significantly reformed the regulators’ authority to hold “systemically important” institutions to higher standards. However, it remains unclear how regulators will use that authority, and to what degree. The determination of which non-bank institutions are considered systemic also remains unclear. In addition, companies previously described as systemic, such as AIG, have gone without financial regulation for years. Despite the fact that the identity of banks that will be subject to higher standards has been known for two years, the standards for these companies are far from final. Regulators have moved more slowly than expected, due in part to strong lobbying efforts against change.

Treasury and regulators must provide incentives to the largest, most interconnected institutions to minimize both their complexity and their interconnectedness. Treasury and regulators should send clear signals to the financial industry about levels of complexity and interconnectedness that will not be accepted. Treasury and regulators must set the standards through increased capital and liquidity requirements to absorb losses, as well as tighter margin standards. Treasury and regulators should limit risk through constraints on leverage. And companies, in turn, must do their part.

Risk Management

Companies must engage in effective risk management, and regulators must supervise this risk management. According to Treasury Secretary Geithner’s Congressional testimony in support of Dodd-Frank, the biggest failure in our financial system was that it allowed large institutions to take on leverage without constraint. Leverage — debt or derivatives used to increase return — has risk because it can multiply gains and losses. Large interconnected financial institutions had woefully inadequate risk management policies, which allowed problems to intensify.[2] Financial institutions made risky subprime mortgages, which they then sliced, diced, and repackaged into complex mortgage derivatives to be sold to each other and to other investors. These companies and investors were heavily dependent on inflated credit ratings. Institutions bought these long-term illiquid securities with short-term funding that froze in 2008, causing severe liquidity crises. Treasury asked Congress to approve TARP because these illiquid mortgage assets had, in essence, choked off credit.

Insufficient attention was placed on counterparty risk, with many of the companies believing they were "fully hedged" with zero risk exposure. Companies developed elaborate methods of hedging, including buying insurance-like protection against the default of these investments (called credit default swaps). Companies hedged through offsetting trades that bet on the increase and decrease in the value of the security. These hedges, many of which did not fully protect against exposure, provided a false sense of protection that led to decreased risk management and decreased market discipline.

The financial system was opaque, impeding an understanding of the true exposure to risk by institutions, rating agencies, investors, creditors, and regulators. Products such as credit default swaps went unregulated. Offsetting trades occurred on the over-the-counter market – a market that, unlike the New York Stock Exchange or other exchanges, has no transparency. With no effective curbs on risk, executives often ignored risk, with many receiving extraordinary pay based on how many mortgages they created, while at the same time transferring their risk in

[2] Testimony of Treasury Secretary Henry Paulson, Financial Crisis Inquiry Commission, May 6, 2010.

the ultimate success of the mortgages. In short, Wall Street cared more about dollars than sense. And yet, we must ask ourselves: Has anything changed?

In 2008, the U.S. Government assured the world that it would use TARP and access to the Federal Reserve's discount window to prevent the failure of any major financial institution. But in so doing, it encouraged future high-risk behavior by insulating the risk-takers from the consequences of failure. This concept – known as moral hazard – is alive and well. A 2012 study by Federal Reserve economists found that large TARP banks have actually increased the number of loans that could be considered "risky," which "may reflect the conflicting influences of Government ownership on bank behavior." Fannie Mae and Freddie Mac also operated with an implicit Government guarantee, which led to lower borrowing costs that enabled them to take on significant leverage. According to Treasury, these entities "were a core part of what went wrong with our system."[3] Dodd-Frank did not address Fannie Mae and Freddie Mac.

Financial institutions must practice discipline and responsibility by reforming risk management and corporate governance. Companies cannot write off risk management believing that their exposure is removed by hedging. Companies must understand their exposure to risk, including conducting heightened reviews of counterparty risk.

Recent scandals such as JPMorgan's "London whale" and LIBOR manipulation have shown that excessive risk-taking continues unchecked by executives and boards of directors. Companies should make a deeper assessment of their assets. Assets carry different amounts of risk; collateral for some loans may be stronger than others. In determining the amount of TARP funds to invest in a bank, Treasury used the total risk-weighted assets, rather than total assets. Executives and boards must better understand, monitor, and manage risk.

[3] Testimony of Treasury Secretary Timothy F. Geithner, Senate Banking Committee, June 18, 2009.

We learned from the crisis that we cannot expect companies to constrain excess risk-taking on their own initiative. Regulators therefore must protect hardworking Americans by setting constraints on leverage. Given their interconnectedness, risk at one institution (Lehman Brothers, for example) can shock our entire system. Our regulators must require "strong shock absorbers," as described by Treasury Secretary Geithner.

Bank examiners must increase their supervision of risk management at all banks, and the supervision of companies that pose a risk to our financial system must be even stronger. Regulators can use information from on-site examiners, Federal Reserve stress tests, and plans called "living wills" (submitted by these companies) to determine areas of risk. While regulators are still going through the process to write rules establishing these standards, other rules have not yet been written.

Treasury and regulators should set strong capital requirements and liquidity cushions to absorb shock; longer-term funding to prevent a liquidity crisis; strong rules regarding leverage; and constraints on specific products or lines of business that hide true exposure to risk.

In the wake of the 2008 financial crisis, we realized that change was necessary. There has been meaningful change to our financial system. But there is much more to be done. Americans need and deserve a financial system with regulation that encourages growth, but that minimizes susceptibility to current risks – and one that is flexible enough to protect against emerging risks. Treasury and regulators must have courage and steely resolve to enact change as they are up against Wall Street executives who simply wish to return to "business as usual," with no public memory of the bailout or the lasting impact to the American taxpayer. Enduring progress will not be easy, but it can, and must, be achieved.