



**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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SUBCOMMITTEE ON TARP, FINANCIAL SERVICES, AND BAILOUTS  
OF PUBLIC AND PRIVATE PROGRAMS

**STATEMENT OF NEIL BAROFSKY**  
**SPECIAL INSPECTOR GENERAL**  
**TROUBLED ASSET RELIEF PROGRAM**

BEFORE THE  
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM  
SUBCOMMITTEE ON TARP, FINANCIAL SERVICES, AND BAILOUTS  
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Chairman McHenry, Ranking Member Quigley, and members of the Committee, I am honored to appear before you today to discuss the impact to date of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act” or “Act”) and subsequent financial regulations on market perceptions surrounding the “too big to fail” financial institutions.

Today marks my last day as the head of the Office of the Special Inspector General for the Troubled Asset Relief Program (“SIGTARP”), and before I address the subject of today’s hearing I would like to briefly review the status of SIGTARP. Thanks in no small part to the tremendous support SIGTARP has enjoyed from Congress generally, and members of this Committee specifically, in the time since its inception in December 2008, SIGTARP has had notable success in fulfilling its goals of transparency, oversight, and enforcement. To date, through nine quarterly reports and 13 completed audits, SIGTARP has brought light to some of the darkest areas of the financial crisis and the Government’s response to it, and has offered Treasury 68 recommendations to help program effectiveness and protect the taxpayer from losses due to fraud. When Congress created us, it assigned SIGTARP the responsibility for policing the program to minimize losses to fraud to bring those who attempt to steal from the program to justice. I am proud to report that where fraud has managed to slip in, our Investigations Division has already produced outstanding results. To date, 54 individuals and 18 entities have already been subject to criminal or civil actions related to SIGTARP investigations, with 18 individuals criminally convicted. SIGTARP’s investigative efforts have helped prevent \$555.2 million in taxpayer funds from being lost to fraud, and have assisted in the recovery of over \$151 million, already assuring that as an agency SIGTARP will more than pay for itself. Thanks in part to SIGTARP, and to Treasury’s adoption of many of SIGTARP’s anti-fraud recommendations, it appears that TARP will experience losses from fraud at a substantially lesser rate than what is typically expected for comparable Government programs. And with 158 ongoing investigations, including 77 into executives and senior officers at financial institutions that applied for and/or received Troubled Asset Relief Program (“TARP”) funding through TARP’s Capital Purchase Program (“CPP”), much more remains to be done.

While the reduction in the anticipated direct financial costs of TARP from hundreds of billions of dollars to potentially \$19 billion is certainly good news, the total cost of TARP necessarily involves far more than just dollars and cents. In other words, the good financial news should not distract from the careful and necessary assessment of TARP’s considerable, non-financial costs that, while more difficult to measure, may be even more significant. Those costs include what is essentially at the heart of this hearing, the increased moral hazard and potentially disastrous consequences associated with the continued existence of financial institutions that are “too big to fail.”

In January, SIGTARP published the audit report “Extraordinary Financial Assistance Provided to Citigroup, Inc.,” which details how the Government assured the world that it would use TARP to prevent the failure of any major domestic financial institution. Indeed, public statements by then-Secretary of the Treasury Henry Paulson in late 2008 and Treasury Secretary Timothy Geithner in early 2009 made clear that they were ready, willing, and able to use TARP funds to ensure that none of the nation’s largest banks would be permitted to fail, and then stood behind Citigroup Inc. (“Citigroup”), along with others such as American International Group, Inc. (“AIG”) and Bank of America Corp. In the darkest days of the financial crisis, 18 very large financial institutions received \$208.6 billion in TARP funding almost overnight, and most did not have to meaningfully “apply” for funding or even have to demonstrate an ability to repay taxpayers. Three especially vulnerable institutions with large systemic footprints – Citigroup, Bank of America, and AIG – received additional assistance under programs that were not made

available to smaller, less significant institutions. While these actions and statements succeeded in reassuring troubled markets, they also did much more. By putting the United States Government behind these institutions and explicitly guaranteeing them against failure, Treasury encouraged future high-risk behavior by insulating from the consequences of failure the risk-takers who had profited so greatly in the run-up to the crisis (and indeed, in many cases, continue to reap large profits and rich executive compensation packages), and gave an unwarranted competitive advantage, in the form of enhanced credit ratings and access to cheaper credit and capital, to institutions perceived by the market as having an implicit Government guarantee.

Financial institutions now operate in an environment where size matters because the Government guarantee that naturally flowed from the mid-crisis statements by Secretaries Paulson and Geithner that they will not be allowed to fail grossly distorts normally functioning markets, in which an institution's creditors, shareholders, and executives bear the brunt of poor decisions, rather than the taxpayers. As Federal Reserve Chairman Ben Bernanke stated just last week, "[t]he too-big-to-fail problem is a pernicious one that has a number of substantial harmful effects." The prospect of a Government bailout reduces market discipline, giving creditors, investors, and counterparties less incentive to monitor vigilantly those institutions that they perceive will not be allowed to fail. For executives at such institutions, the Government safety net provides the motivation to take greater risks than they otherwise would in search of ever-greater profits. This "heads I win, tails the Government bails me out" mentality promotes behavior that, while it may benefit shareholders and executives in the short term if the risks pay off, increases the likelihood of failure and, therefore, the possibility of another taxpayer-funded bailout. Ratings agencies continue to give such "too big to fail" institutions higher credit ratings based on the existence of an implicit Government backstop. Creditors, in turn, give those institutions access to debt at a price that does not fully account for the risks created by their behavior. Cheaper credit is effectively a Government-granted subsidy, which translates into ever-increasing profits, and which allows the largest institutions to become even larger relative to the economy while materially disadvantaging smaller banks. According to Chairman Bernanke, "[t]his competitive distortion is not only unfair to smaller firms and damaging to competition today, but it also spurs further growth by the largest firms and more consolidation and concentration in the financial industry." In short, these institutions and their leaders are incentivized to engage in precisely the sort of behavior that could trigger the next financial crisis, thus perpetuating a doomsday cycle of booms, busts, and bailouts.

The "too big to fail" problem pre-dated TARP, and to the extent that bailouts were necessary, a temporary worsening of the problem to some degree was probably unavoidable. Nevertheless, TARP's most significant legacy may be the exacerbation of the problems posed by "too big to fail," particularly given the manner in which Treasury executed the bailout, largely sparing executives, shareholders, creditors and counterparties, reinforcing that not only would the Government bail out the largest institutions, but would do so in a manner that would do little harm to the responsible stakeholders. Further, to the extent that huge, interconnected "too big to fail" institutions contributed to the crisis, the Government's management of the crisis, including TARP, has left those institutions larger than ever, fueled by Government support and taxpayer-assisted mergers and acquisitions. According to retiring Kansas City Federal Reserve Bank President Thomas Hoenig, "after this round of bailouts, the five largest financial institutions are 20 percent larger than they were before the crisis. They control \$8.6 trillion in financial assets – the equivalent of nearly 60 percent of gross domestic product." A total of 334 small and medium-sized banks, however, have failed since the TARP's inception. In other words, for all its help in rescuing the financial system from the brink of collapse, TARP may have left a truly alarming bequest: It has increased the potential need for future Government bailouts by

encouraging the “too big to fail” financial institutions to become even bigger and more interconnected than before, therefore *increasing* their ultimate danger to the financial system.

The Dodd-Frank Act, signed into law by President Obama last July, was intended, in part, “to end ‘too big to fail’” and “to protect the American taxpayer by ending bailouts.” Secretary Geithner, testifying before the Congressional Oversight Panel (“COP”) in June 2010, shortly before the Act’s passage, proclaimed that “the reforms will end ‘too big to fail.’” The Act’s proponents cite several provisions as particularly important components of this effort. These include creation of the Financial Stability Oversight Council (“FSOC”), charged with, among other things, the responsibility for developing the specific criteria and analytic framework for assessing systemic significance; granting the Federal Reserve new power to supervise institutions that FSOC deems systemically significant; granting the Federal Deposit Insurance Corporation (“FDIC”) new resolution authority for financial companies deemed systemically significant; requiring the development of “living wills” designed to assist in the orderly liquidation of such companies; and granting regulatory authority to set more stringent capital, liquidity, and leverage requirements and to limit certain activities that might increase systemic risk.

Whether these provisions will ultimately be successful remains to be seen. They rely heavily on many of the very same financial regulators whose “widespread failures in financial regulation and supervision proved devastating to the stability of the nation’s financial markets,” according to the Financial Crisis Inquiry Commission (“FCIC”). Many commentators, from Government officials to finance academics to legislators, have expressed concern that the Act does not solve the problem. Kansas City Federal Reserve Bank President Thomas Hoenig remains unconvinced “that our too-big-to-fail problem has been solved,” noting just last month that “[m]arket participants and large financial institutions have little reason to doubt that they will be bailed out again” and that “the existence of too big to fail financial institutions poses the greatest risk to the U.S. economy.” Massachusetts Institute of Technology Professor Simon Johnson agrees, stating in September 2010 that “there is nothing [in the Act] that ensures our biggest banks will be safe enough or small enough or simple enough so that in the future they cannot demand bailout — the bailout potential exists as long as the government reasonably fears global financial panic if such banks are allowed to default on their debts.” In his recent testimony before COP, Nobel laureate and Columbia University Professor Joseph E. Stiglitz stated that “too-big-to-fail institutions, whether they be mortgage companies, insurance houses or commercial investment banks, pose an ongoing risk to our economy and the solidness of government finances,” and emphasized that the Act’s “[r]esolution authority has made little difference, because few believe that the government will ever use the authority at its disposal with these too-big-to-fail banks.” Professor Stiglitz thus concluded that the Act “did not go far enough; it was riddled with exceptions and exemptions. It did not adequately deal with the too-big-to-fail banks. . . .”

Senators Sherrod Brown and Ted Kaufman, now the chairman of COP, have argued that the Dodd-Frank Act could not and did not by itself provide the *global* regulatory framework required to resolve incredibly complex megabanks operating around the world. Chairman Bernanke has noted that “[r]esolving a large, multinational financial firm safely will likely always be a difficult challenge.” Professor Johnson, less optimistically, recently testified before COP that without a cross-border resolution authority, we “cannot handle in orderly fashion the failure of a bank like Goldman Sachs or JPMorgan Chase or Citigroup, which operate in 50, 100, 120 countries.” Other critics of the Dodd-Frank Act, including Congressman Spencer Bachus, Speaker of the House John Boehner, and Chairman Patrick McHenry of this Committee, have expressed concern that the Act’s provisions, particularly those relating to designation and resolution, will

not only fail to solve “too big to fail” but actually make it worse by institutionalizing Government bailouts.

As even its proponents now concede, the new authorities in the Dodd-Frank Act are a work in progress — a tremendous amount of research and rule making by FSOC, FDIC, and a host of other regulators remains to be done. Their tasks will not be easy. Secretary Geithner told SIGTARP in December 2010, for example, that identifying non-bank financial institutions as systemically significant, one of the Act’s premier mandates, “depends too much on the state of the world at the time,” and that he believes “you won’t be able to make a judgment about what’s systemic and what’s not until you know the nature of the shock.” If the Secretary is correct, and regulators have difficulty properly identifying non-banks as systemically significant and therefore subject to the Dodd-Frank Act’s restrictions, then the Act’s effectiveness will undoubtedly be undermined.

While it is too early to tell whether the Dodd-Frank Act will eventually rein in the moral hazard problem, the path regulators choose to take will make all the difference. Federal Reserve Chairman Ben Bernanke recently discussed how the regulators are working to implement the Dodd-Frank Act by developing more stringent prudential standards (including enhanced capital and leverage requirements, liquidity requirements, single-counterparty credit limits, and requirements to produce resolution plans and conduct stress tests on a routine basis) for banking firms with assets greater than \$50 billion and all nonbank financial firms designated as systemically important by the FSOC. According to Chairman Bernanke, the goal is to “force these firms to take into account the costs that they impose on the broader financial system, soak up the implicit subsidy these firms enjoy due to market perceptions of their systemic importance, and give the firms regulatory incentives to shrink their systemic footprint.”

FDIC Chairman Sheila Bair has argued repeatedly that regulators should take a more proactive role, and use the Dodd-Frank Act’s “living will” provisions as a tool to force companies to simplify their operations and shrink their size if necessary to ensure that orderly liquidation is possible:

Under Dodd-Frank, the FDIC and the Federal Reserve wield considerable authority to shape the content of these [living will] plans. If the plans are not found to be credible, the FDIC and the Fed can even compel the divestiture of activities that would unduly interfere with the orderly liquidation of these companies. The success or failure of the new regulatory regime will hinge in large part on how credible those resolution plans are as guides to resolving those companies. And let us be clear: we will require these institutions to make substantial changes to their structure and activities if necessary to ensure orderly resolution. *If we fail to follow through, and don’t ensure that these institutions can be unwound in an orderly fashion during a crisis, we will have fallen short of our goal of ending Too Big to Fail.* (Emphasis added.)

If Chairman Bair prevails in ensuring that the Dodd-Frank Act is used to simplify and shrink large institutions as necessary, if Chairman Bernanke’s incentive structure proves to be effective in compelling meaningful change, or if some other effective regime is adopted, along with similar provisions being implemented internationally, then perhaps in the long run the Dodd-Frank Act will have a chance to end “too big to fail.” But as Secretary Geithner acknowledged to SIGTARP in December 2010, “In the future we may have to do exceptional things again if we

face a shock that large,” even though “[w]e have better tools now thanks to Dodd-Frank.”<sup>1</sup> His acknowledgement of the reality of potential future bailouts under the current regime serves as an important reminder that TARP’s price tag goes far beyond dollars and cents, and that the ultimate cost of the moral hazard that accompanied TARP will remain unknown until the next financial crisis occurs.

Regardless of whether all the required regulations are properly calibrated and fully implemented, the ultimate success of the Dodd-Frank Act depends on market perception. As long as the relevant actors (executives, ratings agencies, creditors and counterparties) believe there will be a bailout, the problems of “too big to fail” will almost certainly persist. Federal Reserve Chairman Ben Bernanke, in a speech to community bankers in March 2010, summed up the problem this way:

The costs to all of us of having firms deemed too big to fail were stunningly evident during the days in which the financial system teetered near collapse. But the existence of too-big-to-fail firms also imposes heavy costs on our financial system even in more placid times. Perhaps most important, if a firm is *publicly perceived* as too big, or interconnected, or systemically critical for the authorities to permit its failure, its creditors and counterparties have less incentive to evaluate the quality of the firm’s business model, its management, and its risk-taking behavior. As a result, such firms face limited market discipline, allowing them to obtain funding on better terms than the quality or riskiness of their business would merit and giving them incentives to take on excessive risks.

As to Dodd-Frank’s impact on this ultimately determinative issue – market perception – thus far the Act has clearly not worked. Reflecting Secretary Geithner’s candid assessment of the likely limits of Dodd-Frank in the event of a full blown financial crisis, the largest institutions continue to enjoy access to cheaper credit based on the existence of the implicit Government guarantee against failure. Standard & Poor’s (“S&P”) and Moody’s Investors Service (“Moody’s”), two of the world’s most influential credit rating agencies, recently reinforced this significant advantage for those institutions. In January of this year, S&P announced its intention to make permanent the prospect of Government support as a factor in determining a bank’s credit rating, a radical change from pre-TARP practice, stating that it expected “this pattern of banking sector boom and bust and government support to repeat itself in some fashion, *regardless of governments’ recent and emerging policy response.*” (Emphasis added.) Similarly, also in January, Moody’s stated its belief that the proposed resolution regime “will not work as planned, posing a contagion risk and most likely forcing the government to provide support in order to avoid a systemic crisis.” Because of this belief, Moody’s also intends to continue assuming government support for the eight largest banking organizations. In short, S&P and Moody’s are telling the market that they do not believe that the Dodd-Frank Act has yet ended the problems of “too big to fail,” and given the discounts that such institutions continue to receive, the market seems to be listening. In fact,

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<sup>1</sup>It was apparent to SIGTARP from the context of the interview, including the reference to doing something exceptional “again” in the face of a future financial crisis, that Secretary Geithner was referring to the possibility of future bailouts. While Treasury has not disputed the quotation attributed to Secretary Geithner or the context in which it was presented in SIGTARP’s audit report, “Extraordinary Financial Assistance to Citigroup, Inc.,” at least one Treasury official has suggested that Secretary Geithner was actually referring to using the tools of the Dodd-Frank Act.

some recent reports suggest that the largest banks' funding advantage over their smaller competitors has actually *increased* since the passage of the Dodd-Frank Act.<sup>2</sup>

As former Treasury Secretary and National Economic Council Director Lawrence Summers said more than a decade ago, “a healthy financial system cannot be built on the expectation of bailouts.” Federal Reserve Chairman Ben Bernanke reiterated this sentiment just last week, stating that “[a] financial system dominated by too-big-to-fail firms cannot be a healthy financial system.” The continued existence of institutions that are “too big to fail” — an undeniable byproduct of former Secretary Paulson and Secretary Geithner’s use of TARP to assure the markets that during a time of crisis that they would not let such institutions fail — is a recipe for disaster. Unless and until institutions viewed by the market as “too big to fail” are either broken up, so that they are no longer a threat to the financial system, or a structure is put in place to assure the market that they will be left to suffer the full consequences of their wanton risk-taking, the prospect of more bailouts will potentially fuel more bad behavior with potentially disastrous results.

As Chairman Bernanke stated last week, “[a] clear lesson of the past few years is that the government must not be forced to choose between bailing out a systemically important firm and having it fail in a disorderly and disruptive manner.” For several decades, our nation has had a framework in place to resolve failing banks in a manner that preserves market discipline. While the Dodd-Frank Act sought to establish a comparable framework for resolving systemically important non-bank financial firms, including bank holding companies, in a manner that insulates the broader financial system from the possibly destabilizing effects of the firm’s collapse, much work remains before these new authorities become fully effective. Indeed, based on the market’s reaction to date, the early results have been far from encouraging. Nevertheless, bold regulatory action, as embodied in the forceful advocacy of Chairman Bair, is still at least possible. Unfortunately, the status quo has powerful defenders, and only time will tell whether the agents of meaningful change will prevail. The stakes – the future integrity of our financial system – could not be higher.

Finally, on a personal note, today is my last day, and my last time testifying before Congress, as the Special Inspector General before stepping down to join New York University’s School of Law as an adjunct professor and senior fellow for its Center on the Administration of Criminal Law and the Mitchell Jacobson Leadership Program on Law and Business. I have been blessed with the opportunity to serve our country as it has struggled through this financial crisis, and I would like to thank the members of this Committee for their unwavering and bipartisan support of our office. Without that support, it is unlikely that SIGTARP would have ever been able to achieve our goals of bringing transparency to TARP, holding its participants accountable, and

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<sup>2</sup>In a recent editorial, the *Wall Street Journal* cited an analysis conducted by Mike Mayo of Credit Agricole Securities (USA) that shows that the “10 largest bank holding companies, on average, paid 29 basis points less on interest-bearing liabilities than the next 40 bank holding companies” over the course of 2010. Furthermore, according to the editorial, FDIC and Federal Reserve data illustrate that the funding advantage enjoyed by the largest financial institutions has increased since the passage of Dodd-Frank. For example, the FDIC’s data on non-deposit, interest-bearing liabilities demonstrates that “the funding advantage enjoyed by banks with more than \$100 billion in assets over those in the \$10 - \$100 billion range rose from 71 basis points in the first quarter [of 2010] to 78 basis points in the third quarter . . . to 81 [basis points] in the fourth quarter.” “Still Too Big, Still Can’t Fail,” *Wall Street Journal* (Mar. 5-6, 2011) (online at [online.wsj.com/article/SB10001424052748703530504576164880968752682.html](http://online.wsj.com/article/SB10001424052748703530504576164880968752682.html)). See also Harry Terris, “Measuring ‘Too Big to Fail’ Subsidies,” *American Banker* (Mar. 11, 2011) (discussing how large banks continue to enjoy an overall funding advantage in the wake of Dodd-Frank).

detering and prosecuting those who have sought to take criminal advantage of this national crisis.

Chairman McHenry, Ranking Member Quigley, and members of the Committee, thank you again for this opportunity to appear before you, and I would be pleased to respond to any questions that you may have.

If you are aware of fraud, waste, abuse, mismanagement or misrepresentations affiliated with the troubled asset relief program, please contact the SIGTARP Hotline.

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