Testimony of Professor Elizabeth Warren
Chair, Congressional Oversight Panel
Joint Economic Committee
June 9, 2009

Thank you, Chairman Maloney, Vice Chairman Schumer, Ranking Member Brownback, Representative Brady, and members of the Joint Economic Committee for inviting me to testify regarding oversight of the Troubled Asset Relief Program (TARP). We share a desire to bring accountability and transparency to the TARP program, and I am pleased to assist your efforts in any way I can.

From the outset I would like to stress that although I am Chair of the Congressional Oversight Panel, I do not have a pre-approved script. The views I express today are my own and do not necessarily represent those of each member of the panel.

The Congressional Oversight Panel was created in last year's Emergency Economic Stabilization Act. The job of the Panel is to "review the current state of the financial markets and the financial regulatory system" and report to Congress every 30 days. We have released seven oversight reports, as well as a special report on regulatory reform required by the legislation.

The Oversight Panel is one of three organizations to which the TARP legislation gives oversight responsibilities. My staff and I work closely with GAO and the Special Inspector General to ensure that all our oversight efforts complement, not duplicate, one another. We all want to make the whole of our work greater than the sum of its parts.

The Oversight Panel is the smallest of the three organizations. We see our contribution as fact-based analysis designed to raise issues about the operation and direction of the TARP and about the broader effort to restore stability to the economic system. In the Emergency Economic Stabilization Act, Congress specifically asked that the Oversight Panel conduct oversight on: the use of Treasury's authority under TARP; the Program's effect on the financial markets, financial institutions, and market transparency; the effectiveness of foreclosure mitigation efforts; and the TARP's effectiveness in minimizing long-term costs and maximizing long-term benefits for the nation's taxpayers. Our ultimate question is whether the TARP is operating to benefit the American family and the American economy. If we believe the answer is no, we will ask "why not," and try to suggest alternatives.

Today marks the release of the Panel's seventh report, entitled "Stress Testing and Shoring Up Bank Capital," and I would like to begin by reviewing our report.

Across the country, many American families have taken a hard look at their finances. They have considered how they would manage if the economy took a turn for the worse, if someone were laid off, if their homes plummeted in value, or if the retirement funds they had been counting on shrunk even more. If circumstances get worse, how would they make ends meet? These families have examined their resources to figure out if they could weather more difficult times—and what they could do now to be better prepared. In much the same spirit, federal banking regulators recently undertook "stress tests" to examine the ability of banks to ride out the financial storm, particularly if the economy gets worse.

Treasury recognized the importance of understanding banks' ability to remain well capitalized if the recession proved worse than expected. Thus, Treasury and the Federal Reserve announced the Supervisory Capital Assessment Program (SCAP) to conduct reviews or "stress tests" of the nineteen largest bank holding companies. Together these nineteen companies hold two-thirds of domestic bank holding company assets. As described by Treasury, the program is intended to ensure the continued ability of U.S. financial institutions to lend to creditworthy borrowers in the event of a weaker-than-expected economic environment and larger-than-estimated losses.

Understanding the recently completed stress tests helps shed light on the assumptions Treasury makes as it uses its authority under EESA. As Treasury uses the results of these tests to determine what additional assistance it might provide to financial institutions, the tests also help determine the effectiveness of the TARP in minimizing long-term costs to the taxpayers and maximizing taxpayer benefits, thus responding to another key mandate of the Panel.

As part of their regular responsibilities, bank examiners determine whether the banks they supervise have adequate capital to see them through economic reversals. Typically, these bank supervisory examination results are kept strictly confidential. The stress tests built on the existing regulatory capital requirements, but because the stress tests were undertaken in order to restore confidence in the banking system, they included an unprecedented release of information.

The stress tests were conducted using two scenarios: one test based upon a consensus set of economic projections and another test using projections based on more adverse economic conditions. The only results that have been released are those based on the adverse scenario. These test results revealed that nine of the nineteen banks tested already hold sufficient capital to operate through 2010 under the projected adverse scenario; those banks will not be required to raise additional capital. Ten of the nineteen banks were found to need additional capital totaling nearly $75 billion in order to weather a more adverse economic scenario. Those banks that need additional capital must present a plan to Treasury by June 8, 2009, outlining their plans to raise additional capital. All additional capital required under the stress tests must be raised by

November 9, 2009, six months after the announcement of the stress test results. Some bank holding companies have already successfully raised billions in additional capital.

Like the case of the family conducting its own stress test of personal finances, the usefulness of the bank stress test results depends upon the methods used and the assumptions that went into conducting the examinations. To help assess the stress tests, the panel engaged two internationally renowned experts in risk analysis, Professor Eric Talley and Professor Johan Walden, to review the stress test methodology.

Based on the available information, the professors found that the Federal Reserve used a conservative and reasonable model to test the banks, and that the model provides helpful information about the possible risks faced by bank holding companies and a constructive way to address those risks.

The professor also raised some serious concerns. They noted that there remain unanswered questions about the details of the stress tests. Without this information, it is not possible for anyone to replicate the tests to determine how robust they are or to vary the assumptions to see whether different projections might yield very different results. There are key questions surrounding how the calculations were tailored for each institution and questions about the quality of the self-reported data. It is also important to note that the stress test scenarios made projections only through 2010. While this time frame avoids the greater uncertainty associated with any projection further in the future, it may fail to capture substantial risks further out on the horizon. Based on testimony by an analyst from Deutsche Bank at the Panel's May field hearing in New York City, the projected rise in the defaults of commercial real estate loans after 2010 raises concerns.

In evaluating the useful information provided by the stress tests, as well as the remaining questions, the Panel offers several recommendations for consideration moving forward:

- The employment numbers for 2009 have already exceeded the harshest scenario considered so far, suggesting that the stress tests should be repeated.

- Stress testing should also be repeated so long as banks continue to hold large amounts of toxic assets on their books.

- Between formal tests conducted by the regulators, banks should be required to run internal stress tests and should share the results with regulators.

- Regulators should have the ability to use stress tests in the future when they believe that doing so would help to promote a healthy banking system.

The Federal Reserve should be commended for releasing an unprecedented amount of bank supervisory information, but additional transparency would be helpful both to assess the strength of the banks and to restore confidence in the banking system. The Panel recommends that the Fed release more information on the results of the tests, including results under the baseline scenario. The Fed should also release more details about the test methodology so that analysts can replicate the tests under different economic assumptions or apply the tests to other financial institutions. Transparency will also be critical as financial institutions seek to repay their TARP loans, both to assess the strength of these institutions and to assure that the process by which these loans are repaid is fair.

Finally, the Panel cautions that banks should not be forced into counterproductive "fire sales" of assets that will ultimately require the investment of even more taxpayer money. The need for strengthening the banks through capital increases must be tempered by sufficient flexibility to permit the banks to realize full value for their assets.

I would like to briefly mention the Panel's other reports, which cover a wide range of important topics.

In December, we issued our very first report, identifying a series of ten primary questions regarding Treasury's goals and methods. These questions must be answered in order for Treasury to be successful:

- What is Treasury's strategy?
- Is the strategy working to stabilize markets?
- Is the strategy helping to reduce foreclosures?
- What have the financial institutions done with the taxpayers' money received so far?
- Is the public receiving a fair deal?
- What is Treasury doing to help the American family?
- Is Treasury imposing reforms on financial institutions that are taking taxpayer money?
- How is Treasury deciding which institutions receive the money?
- What is the scope of Treasury's authority?
- Is Treasury looking ahead?

These questions were posed to then-Treasury Secretary Paulson in a letter. They were further expanded with subsidiary questions seeking additional information.

In January, the Secretary's response provided the basis for our report. An analysis of the response revealed that many answers were non-responsive or incomplete. It was disappointing that the answers were, and in some cases continue to be, elusive, given that the questions are basic and should have been answered when initially framing the program. It was disconcerting, to say the least, having hundreds of billions of dollars spent seemingly without a plan. The report found that, in particular, Treasury needed to provide additional information on bank accountability, transparency, asset valuation, foreclosures, and strategy.

In February, the Panel returned to the central question of whether the public was receiving a "fair deal" when Treasury used TARP funds to make capital infusions into financial institutions. We worked with recognized independent experts to develop multiple valuation models to determine whether the securities Treasury received had a fair market value equal to the dollar amount of the infusions. With minimal variation, the models all demonstrated that Treasury made its infusions at a substantial discount. Treasury received securities that were worth substantially less than the amounts it had paid in return. In all, Treasury overpaid by an estimated $78 billion. For each $100 Treasury invested in these financial institutions, it received on average stock and warrants worth only about $66 at the time of the transaction. While there may have been good reasons to subsidize the banks last fall, it is critical that Treasury be clear in explaining its goals in these transactions. It will be especially important going forward to have independent valuations and transparency as many financial institutions intend to repay TARP funds and buy back their warrants. Treasury will be making many important policy choices as it negotiates the sale of these warrants, including timing, procedures, terms, and pricing for the redemption by banks. We will take up these issues in our July report.

In March, the Panel examined the foreclosure crisis, as directed in the statute. In considering mortgage foreclosure mitigation, we gave particular consideration to impediments to mitigation efforts. We offered a checklist of items to evaluate the likely effectiveness of any proposal to halt the cascade of mortgage foreclosures.

- Will the plan result in modifications that create affordable monthly payments?
- Does the plan deal with negative equity?
- Does the plan address junior mortgages?
- Does the plan overcome obstacles in existing pooling and servicing agreements that may prevent modifications?
- Does the plan counteract mortgage servicer incentives not to engage in modifications?
- Does the plan provide adequate outreach to homeowners?
- Can the plan be scaled up quickly to deal with millions of mortgages?
- Will the plan have widespread participation by servicers and lenders?

We were pleased to see that the Administration's Homeowner Affordability and Stability Plan addressed many of these issues, although the Panel noted serious concern with areas left unaddressed in the original plan, including lack of a safe harbor for mortgage servicers that results in impediments to restructuring mortgages, incomplete consideration of second mortgages, unclear enforcement, and a failure to address seriously underwater mortgages. It is encouraging to see that the initiative is evolving to deal with some of these concerns. The Panel plans follow up work over the coming months to measure progress in foreclosure mitigation.

In April the Panel further analyzed the evolving strategy of Treasury. We focused on lessons from the previous financial crises, both foreign and domestic, to help inform our analysis of the current situation. The report examined four case studies of particular relevance: the Japanese "Lost Decade" of the 1990s; the Swedish experience with bank nationalization in the 1990s; the establishment of the Resolution trust Corporation (RTC) in response to the American Savings and Loan collapse in the late 1980s; and the actions taken to stabilize the financial and housing sectors during the Great Depression. The report highlighted the benefits and problems of several basic approaches to dealing with failing banks- liquidation, reorganization, or subsidization- based on these historic examples. The review highlighted that each successful resolution of a financial crisis involved four key elements: transparency, assertiveness, accountability, and clarity.

In May the Panel considered the state of small business and consumer lending and provided an assessment of the Term Asset-Backed Securities Loan Facility (TALF). The TALF is intended to support more lending by financing credit through asset-backed securities. These are securities that represent interests in pools of loans made to small businesses and households. Our primary question was whether the TALF program is well-designed to attract new capital. The program allows the investors to reap a substantial portion of the potential profits, but leaves taxpayers to absorb a large portion of potential losses. Even with this asymmetry, there was a slow initial uptake to the program. More recent subscriptions have shown greater participation. Unfortunately, other factors may mean that even a well-designed program could have difficulties helping market participants meet the credit needs of small businesses and households. Families are awash in debt and in the process of deleveraging. Stagnant wages and rising unemployment further constrain the ability of households to manage ever-larger debt loads, suggesting that strategies to increase consumer lending may be counterproductive for American families—and ultimately for the economy. TALF is unlikely to have a meaningful impact on small businesses, as asset-backed securities have never been a significant source of small business funding. The report raises questions about whether taxpayer support for small business lending should be concentrated elsewhere, such as increased availability of SBA loans.

What have we learned thus far? In a crisis, transparency, accountability and a coherent plan with clearly delineated goals are necessary to maintain public confidence and the confidence of the capital markets. Sophisticated metrics to measure the success and failure of program initiatives are also critical. Assuring that the TARP reflects these elements underlies all of our oversight efforts.

Thank you again for the opportunity to explain the work of the Congressional Oversight Panel. I look forward to answering your questions.