Embargoed until delivery

Acting Assistant Secretary Timothy G. Massad
U.S. Department of the Treasury
Written Testimony Before the
House Committee on Oversight and Government Reform
Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs
March 30, 2011

Chairman McHenry, Ranking Member Quigley, and distinguished members of the Subcommittee, thank you for inviting me to testify today. Your invitation letter asks that I address whether there is a perception that our nation's largest financial institutions are "too big to fail" despite the passage of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("*Dodd-Frank*"). In its most recent quarterly report, the Special Inspector General for the Troubled Asset Relief Program ("TARP") raised that concern and suggested that TARP's most significant legacy may be the moral hazard associated with institutions that are "too big to fail." As the Acting Assistant Secretary responsible for implementation of TARP, I am happy to address SIGTARP's statement and the Subcommittee's question.

We recognize that moral hazard is a real and significant concern. But to suggest that it is TARP's main legacy is to ignore the facts, and to confuse the response to a crisis with the need to address the causes of the crisis. TARP was necessary to respond to the worst financial crisis we faced in decades. Its most significant legacy is that it, combined with a variety of other government actions, helped save our economy from a catastrophic collapse, and may have helped prevent a second Great Depression. And while more work remains to be done, we have since taken significant action to address the moral hazard that comes with any government assistance and specifically the "too big to fail" problem.

Circumstances That Led to TARP

In discussing the "too big to fail" problem, we must remember the situation we faced in the fall of 2008, and why TARP was needed. Over the two decades preceding the crisis, the financial system had grown rapidly in an environment of economic growth and stability. In particular, we saw significant growth of large, short-funded, and substantially interconnected financial firms. Huge amounts of risk moved outside the regulated parts of the banking system to where it was easier to increase leverage. Creditors and investors became hardened in their belief that large firms could grow larger, take on more leverage, engage in riskier activity—and avoid paying the consequences should those risks turn bad.

Legal loopholes and regulatory gaps allowed large parts of the financial industry to operate without oversight, transparency, or restraint; allowed unchecked predatory and abusive lending; and failed to require sufficient responsibility from those who, for example, made loans, sold loans, or packaged loans into complex instruments to be sold to investors.

Derivatives were traded in the shadows, and entities performing the same market functions as banks escaped meaningful regulation on the basis of their corporate form. The financial sector,

under the guise of innovation, piled ill-considered risk upon risk. The lack of transparency hid the growing wedge in incentives facing different players in the system.

Ample credit and accommodative monetary policy around the world had also fueled an unsustainable housing boom in the first half of the last decade, and when the housing market inevitably turned down starting in early 2006, the pace of mortgage defaults accelerated at an unprecedented rate. By mid-2007, rising mortgage defaults were undermining the performance of many investments held by major financial institutions.

These forces continued to build and in the fall of 2008, events accelerated. Credit markets froze. And the over-reliance on short-term financing, opaque markets and excessive-risk taking that had been the source of significant profit on Wall Street and in financial capitals globally, fed a panic that was producing the classic signs of a generalized run. For the first time in 80 years, we faced the risk of a complete collapse of our financial system.

These events remind us why TARP was needed. The government simply did not have sufficient resources to address the worst financial crisis in decades. And the actions taken by both the Bush and Obama Administrations under TARP, along with the government's other emergency programs, worked: they broke the back of the panic and prevented a catastrophic collapse of our financial system. This in turn helped pave the way for an economic recovery. Today, banks are better capitalized, and the weakest parts of the financial system no longer exist. The credit markets on which small businesses and consumers depend—for auto loans, for credit cards, and other financing—have reopened. Businesses can raise capital, and mortgage rates are at historic lows. And, all this was done at a fraction of the initially anticipated cost. There is no doubt that much work remains, but overall TARP has been remarkably effective.

While that record is the most significant legacy of TARP, anytime the government provides emergency assistance to private firms, it raises a moral hazard concern—that is one of the reasons why we needed to take further action. Lehman and AIG highlight many of the key deficiencies of the old regulatory system and underline the necessity of the recent financial regulatory reforms. Our regulatory regime was simply not equipped to effectively monitor, constrain or respond to risks in our financial system, and we did not have the tools to liquidate failing firms that threaten the overall stability of the system in an orderly manner. Those were central lessons of this crisis, and ones on which we needed to act.

Just 19 months after TARP was enacted into law, President Obama signed the *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("*Dodd-Frank*"). This Act represents an historic overhaul of our financial regulatory system—the most comprehensive since the 1930s. It is a testament to those Members of Congress who supported this legislation that we were able to adopt such sweeping measures so quickly. Although I am not personally involved in Treasury's day-to-day work to implement *Dodd-Frank*, I am happy to summarize the general status of the Department's efforts, which have been discussed publicly by other senior officials.

Important Dodd-Frank Reforms

Dodd-Frank addresses the failures that led to the crisis and builds a stronger financial system by closing major gaps and shoring up weaknesses in regulation. It puts in place buffers and safeguards to reduce the chance that another generation will go through a crisis of similar magnitude. The main elements of *Dodd-Frank* that work together to address the "too big to fail" problem include: the establishment of an orderly liquidation framework for certain large firms; the creation of a system to better identify and address systemic risk; and the imposition of heightened prudential standards.

First, and most importantly, *Dodd-Frank* gives the government the authority to shut down and break apart large nonbank financial firms whose imminent failure might threaten the broader system. It does this in a way that protects the economy while ensuring that large financial firms, not taxpayers, bear any costs. Modelled on pre-existing authority to wind down failed banks, this liquidation authority closes a gap, with respect to nonbank financial firms, that severely limited the federal government's options during the crisis—for example with AIG and Lehman. *Dodd-Frank*'s liquidation authority provision allows the government to wind down a failing financial firm—wiping out shareholders, firing culpable management, and allowing creditors to take losses, while stabilizing the financial system. Any losses that cannot be covered through sales of the firm's assets will be recouped from the largest financial institutions through an ex-post assessment. In short, *Dodd-Frank* provides us with the tools to ensure that no firm will be insulated from the consequences of its actions. No firm will be protected from failure. No firm will benefit from the perception that taxpayers will be there to break their fall. *Dodd-Frank* makes clear that taxpayers must not be asked to bear the costs of a financial firm's failure.

Second, *Dodd-Frank* creates a new framework for identifying and responding to risk in the financial system. In the lead up to the crisis, gaps and inconsistencies led to regulatory arbitrage, and some of the largest, most interconnected firms were able to escape meaningful supervision. *Dodd-Frank* creates the Financial Stability Oversight Council ("FSOC"), chaired by the Secretary of the Treasury, and composed of the heads of the financial regulatory agencies. FSOC is charged with identifying risks to financial stability, responding to any emerging threats in the system and promoting market discipline. FSOC also is responsible for deciding which nonbank financial companies and financial market utilities will be designated for heightened prudential standards and for making recommendations regarding those standards—with a view not only to the safety of specific institutions, but, critically, to the stability of the entire system.

In order to respond to risk in the financial system, FSOC must be able to monitor that risk more effectively, which requires improvements in financial reporting and analytical capacity in the regulatory community. To that end, *Dodd-Frank* establishes the Office of Financial Research ("OFR"). The OFR was created to address the critical need of regulators, policymakers, and industry for data that are more standardized, more useful, and more reliable. The OFR's capacity to organize and analyze data will help FSOC make more informed decisions about potential threats to the financial system.

Third, *Dodd-Frank* requires regulators to impose substantially stronger prudential standards. Risk-based capital, leverage, and liquidity standards will be tougher, providing a more reliable buffer against both firm-specific failures and systemic shocks. And, firms that are bigger and

more complex will have to hold more capital than smaller and less complex firms, requiring them to internalize risks they impose on the system by virtue of their size and complexity. *Dodd-Frank* also imposes a new mandatory stress-testing regime on the largest bank holding companies and designated nonbank firms. It requires them to establish "living wills," laying out a credible plan for breakup and wind-down in the event of severe financial distress. Regulators are now able to require all financial firms, including holding companies, to take swift action to remedy declines in capital levels and other critical measures of financial health. And there will be restrictions on certain risky activities by banks and their affiliates, such as investing in hedge funds and proprietary trading, as well as on the excessive growth by acquisition of the very largest financial firms.

Finally, *Dodd-Frank* provides comprehensive reform of the financial system. These are beyond the scope of this hearing, but they are important to creating a stronger financial system and helping prevent future crises. These include regulation of the derivatives markets, the establishment of the Consumer Financial Protection Bureau, federal monitoring of the insurance sector, and other tools.

Dodd-Frank sets a clear path forward, and we have made important progress since enactment to implement its provisions. But much work remains to be done. The financial markets are closely watching this progress, which underscores the importance of efforts to implement these authorities.

The Role of TARP

Let me now turn back briefly to TARP, because another important part of what we need to do to restore a strong financial system is to unwind the extraordinary assistance that had to be provided during the crisis. Since I last appeared before the full Committee two short months ago, TARP has continued to make good progress in this task.

Quickly Exiting Investments in Larger Firms

Treasury has moved quickly to reduce the dependence of the financial system on emergency support and to return our financial institutions to private hands as quickly as possible. When President Obama took office, the government had made investments in financial institutions representing 75 percent of the entire banking system by assets. Today, the government's remaining investments in banks represent only about 10 percent of the banking system. Moreover, taxpayers have now recovered more than 99 percent (approximately $244 billion) of the approximately $245 billion in total funds disbursed for TARP investments in banks (inclusive of dividends, interest and other income). In this month alone, taxpayers have recovered $690 million from investments made in the TARP Capital Purchase Program. This means that nearly every dollar recovered from banks from now on will constitute a positive return to taxpayers. Indeed, Treasury currently estimates that bank programs within TARP will ultimately provide a lifetime positive return of nearly $20 billion.

We have also made enormous progress in recovering our investment in AIG—two and a half years after the government was faced with the terrible choice of either assisting AIG or facing a failure that would have brought down our financial system. Today, AIG has been restructured—it has new management, a new board of directors, it has wound down some of the riskiest,

unregulated parts of its business, and it is much more focused on its core business. This past January, AIG, the Treasury, and the Federal Reserve Bank of New York closed a major restructuring plan that will accelerate the repayment of taxpayer funds and that put the government in a position to recover its entire investment. AIG has already repaid the Federal Reserve $47 billion and repaid Treasury $9.1 billion. Because market prices fluctuate, there is no guarantee of what the ultimate returns will be. However, if Treasury sells its investments in AIG at current market values, including the AIG shares that Treasury received from the trust established by the Federal Reserve, taxpayers will get back every dollar put into AIG and will realize a positive return. This is a dramatic turnaround, and a result that stands in sharp contrast to what most observers expected in the fall of 2008.

Treasury, under the Bush and Obama Administrations, invested $80 billion in the domestic automotive industry. These actions saved jobs across the country—as many as one million, by one estimate—and created many new ones. Treasury's strategy is helping to restore the domestic auto industry to profitability, and we have already begun to recoup our investments. Recently, General Motors reported net income of $4.7 billion for 2010—old GM had not reported an annual profit since 2004. Chrysler reported four consecutive quarters of operating profit in 2010 totaling $763 million. Ford's 2010 net income reached $6.6 billion, its best level in more than 10 years.

Moving forward, Treasury has set a pathway for exiting its remaining GM investment, and is working to exit investments in Chrysler and Ally Financial. To date, Treasury has recovered almost 40 percent, approximately $30 billion, of its total investment in the domestic auto industry. Through a highly successful initial public offering of General Motors in November of last year, Treasury recovered almost half of its $50 billion GM investment and has reduced its stake in the company from 60.8 percent to 33.3 percent. And, earlier this month, taxpayers received a $2.7 billion TARP repayment from the sale of Treasury's trust preferred securities in Ally Financial, Inc.

Helping Responsible but Struggling Homeowners

Housing is an area where there is still much work to be done. It should be remembered that the forces that created this housing crisis had been building for nearly a decade. When the Obama Administration took office in January 2009, millions of American families could not make their monthly mortgage payments—having lost jobs or income—and were unable to sell, refinance, or find meaningful modification assistance. The Administration took aggressive steps to address the crisis facing many American homeowners. The strategy focused on providing stability to housing markets and giving Americans who are struggling, but with a little help could afford to stay in their homes, a chance to do so. By reducing mortgage rates and providing sensible incentives to prevent avoidable foreclosures, our programs and policies have helped hundreds of thousands of families stay in their homes, and they have helped to change the mortgage servicing industry generally. They are vital to the recovery of the overall housing market.

Recently, however, some in Congress have been working hard to eliminate the Home Affordable Modification Program, or HAMP, and other housing programs. In addition to ending much needed help to tens of thousands of new families each month, terminating HAMP would relax the pressure on mortgage companies to offer better assistance to struggling homeowners, and

damage the prospects of recovery in our still-fragile housing market. There is no easy or quick way to repair all the damage that the housing crisis has caused—it will take hard work, sustained effort, and bipartisan cooperation. But ending HAMP and other housing programs will make the situation worse.

Efficiently Managing Taxpayer Funds

TARP will use far fewer funds than were originally authorized, and Treasury is unwinding TARP faster than anyone thought possible. Congress originally authorized $700 billion under TARP. To date, $411 billion have been disbursed under the program, and nearly 70 percent of that amount has been repaid. Earlier this month, the Congressional Budget Office estimated the overall cost of TARP to be approximately $19 billion—just a fraction of their initial estimate of $356 billion. We expect the cost of TARP to be roughly equal to what we spend on the housing programs. The TARP investment programs taken as a whole—including financial support for banks, AIG, the domestic auto industry, and targeted initiatives to restart the credit markets—are expected to result in very little or no cost to the taxpayer.

Furthermore, the direct fiscal cost of TARP and all the other interventions by the government to stabilize the financial system—exclusive of the costs and benefits of broader stimulus measures such as the American Recovery and Reinvestment Act—is quite low when compared to past systemic crises. An International Monetary Fund study found that the average net fiscal cost of resolving roughly 40 banking crises since 1970 was 13 percent of GDP. The Government Accountability Office estimated that the cost of the U.S. Savings and Loan Crisis was 2.4 percent of GDP. In contrast, last year Treasury estimated that the direct cost of all our interventions, including TARP, the actions of the Federal Reserve, the Federal Deposit Insurance Corporation, and our efforts to support the Government-Sponsored Enterprises—would be less than 1% of GDP. We must remember that the financial crisis has resulted in significant costs to our economy that are not included in that estimate. Jobs were lost, businesses failed, wealth was destroyed, and tax revenues fell because our economy suffered. But that damage would have been far worse without the government's emergency response.

Conclusion

TARP was necessary because we did not have the tools to confront the worst financial crisis since the Great Depression. The crisis had many causes, one of which was the fact that our regulatory system was in need of an overhaul. We did not have the tools to monitor or constrain the buildup of risks in the financial system or liquidate firms that could threaten the stability of the system in an orderly manner.

To suggest that TARP's "most significant legacy" is "too big to fail," is to fundamentally misunderstand the history of the crisis. It confuses what was needed to put out the fire from the reforms needed to prevent a future fire. TARP and the other actions taken by the government were necessary because the consequences of not acting would have been catastrophic. The legacy of TARP is that it worked: it helped bring stability to the financial system and laid the foundation for economic recovery. And, it did so at a fraction of the expected cost.

The passage of *Dodd-Frank*—just 19 months after TARP—was the vital next chapter in this history. *Dodd-Frank* gives the government the critical tools it needs to address the fundamental

failures that led to this crisis. We must now implement these tools swiftly and effectively, and use them wisely.

Thank you again for the opportunity to testify. I look forward to your questions.

Timothy G. Massad, Acting Assistant Secretary for Financial Stability

Timothy Massad serves as the Acting Assistant Secretary for Financial Stability. In such capacity he heads the Office of Financial Stability (OFS) which administers the Troubled Asset Relief Program (TARP). He joined Treasury in May 2009 as the Chief Counsel for OFS. He also later became the Chief Reporting Officer for OFS.

Prior to joining Treasury, Massad was a partner with the law firm of Cravath, Swaine & Moore LLP in New York. He had a diverse corporate practice, with an emphasis on corporate finance, international transactions and representation of some of the firm's corporate clients. From 1998 to 2002, he was the co-manager of the firm's Hong Kong office, where he was involved in transactions throughout Asia, including in particular India and China. He also worked in the firm's London office.

Massad left Cravath from December 2008 to February 2009 to assist the newly formed Congressional Oversight Panel, one of the oversight agencies for TARP. He served as a special legal advisor to the COP for its first report on the TARP investments.

Massad received a B.A. from Harvard College and a J.D. from Harvard Law School. He is married, has two children and lives in Washington, D.C