U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 9:30 a.m., November 18, 2008
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TESTIMONY BY TREASURY SECRETARY HENRY M. PAULSON, JR. BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES

Washington, DC— Good morning and thank you for the opportunity to testify this morning on implementation of the Emergency Economic Stabilization Act. I am grateful and everyone in this country should be grateful, for the efforts of Chairman Frank, ranking member Bachus, this committee and other members of Congress toward adoption of the financial rescue legislation, which created critically important authorities and financial capacity to stabilize our financial system. Before Congress provided these tools, we were facing a financial crisis without the authorities and resources necessary to meet the challenge. At the risk of oversimplification, the financial rescue package is about restoring confidence – restoring the confidence of depositors and investors in our financial institutions, and restoring the confidence that our financial institutions need so that they will get back to normal lending practices.

This law has already allowed us to take decisive action to prevent the collapse of our financial system. But more needs to be done, and it is my responsibility to use the authorities Congress provided to protect and strengthen the financial system, and in so doing, protect the taxpayer.

Let me summarize what the U.S. financial system has had to digest in just a few months' time. We have not in our lifetime dealt with a financial crisis of this severity and unpredictability. We have seen the failures, or the equivalent of failures, of Bear Stearns, IndyMac Bank, Lehman Brothers, Washington Mutual, Wachovia, Fannie Mae, Freddie Mac, and AIG – institutions with a collective $4.7 trillion in assets when this year began. Each of these failures would be tremendously consequential in their own right under normal market conditions – but our economy and our financial system faced them in succession while at the same time the economy was weakening. Other large financial institutions were under significant pressure and market participants around the world were speculating about which institution would be next to fall.

And as you well recall, in September, after 13 months of market stress, the financial system essentially seized up and we had a system-wide crisis. Our markets were frozen, banks had pulled back very substantially from interbank lending. Confidence in our financial system and a number of our financial institutions had been seriously compromised. That was the background against which Chairman Bernanke and I met with the Congressional bipartisan leadership to explain the need for emergency legislation.

Our objectives in asking Congress for a financial rescue package were to first stabilize a financial system on the verge of collapse, and then to get lending going again to support the American people and businesses. We warned that the frozen credit markets were already severely damaging the U.S.

economy and costing jobs. If the financial system were to collapse, it would significantly worsen and prolong the economic downturn that was already underway.

We needed the financial rescue package so we could intervene, stabilize our financial system, and minimize further damage to our economy. The rescue package was not intended to be an economic stimulus or an economic recovery package; it was intended to shore up the foundation of our economy by stabilizing the financial system, and it is unrealistic to expect it to reverse the damage that had already been inflicted by the severity of the crisis.

During the two weeks Congress worked on the legislation, market conditions worsened significantly. Many Americans look at the stock market as an indicator of the economy, and during this period they saw tremendous volatility. The Dow Jones Industrial Average fell more than 700 points on one single day, and over 9 percent during the two weeks the legislation was debated – stock market losses amounted to slightly more than $2 trillion.

But we were focused on the credit markets because they provide our basic economic fuel – borrowing and lending capital – that supports and creates jobs. The confidence in banks and of banks continued to diminish, as did the flow of funds between them. Interbank lending rates relative to policy rates were at the highest level this decade, indicating banks' lack of confidence in one another and in the financial system.

And the problems extended well beyond the banks. Corporate bond spreads continued to increase, as did corporate credit default spreads and overall market volatility. Industrial company access to all aspects of the bond market was dramatically curtailed. For example, blue chip industrial companies were frequently unable to issue commercial paper with maturities greater than a few days as the commercial paper market became severely impaired. We received reports of small and medium-sized companies, with no direct connection to the financial sector, losing access to the normal credit needed to meet payrolls, pay suppliers and buy inventory.

Investor concerns became most evident in the "flight to quality" in the Treasury market, with short-term Treasury bill yields dropping to near zero.

During that same period, the government intervened to protect the financial system. The FDIC acted to mitigate the failure of Washington Mutual by facilitating its sale, and made clear that it would intervene to prevent Wachovia's failure. And turmoil had developed in European markets. In a two-day period at the end of September the governments of Ireland, the UK, Germany, Belgium, France and Iceland intervened to prevent the failure of one or more financial institutions in their countries.

By the time legislation had passed on October 3, the global market crisis was so broad and so severe, we knew we needed to move quickly and take powerful steps to stabilize our financial system and to get credit flowing again. Our initial intent had been to strengthen the banking system by purchasing illiquid mortgages and mortgage-related securities. But by this time, given the severity and magnitude of the situation, an asset purchase program would not be effective enough, quickly enough. Therefore we exercised the authority granted by Congress in this legislation to develop and quickly deploy a $250 billion capital injection program, fully anticipating we would follow that with a program for troubled asset purchases.

There is no playbook for responding to turmoil we have never faced We adjusted our strategy to reflect the facts of a severe market crisis always keeping focused on Congress's goal and our goal – to stabilize the financial system that is integral to the everyday lives of all Americans.

By mid-October, our actions, in combination with the FDIC's guarantee of certain debt issued by financial institutions, helped us to accomplish the first major priority, which was to immediately stabilize the financial system. And, as we worked to hire contractors and prepare our mortgage asset purchase plan for implementation, we continued to assess the economic and market conditions here and around the world.

As we had seen and communicated to Congress and the American people, much damage had already been done to our economy. The economic data since the legislation passed underscored the challenges we were facing: On October 31, third quarter GDP showed negative 0.3 percent growth. Jobs data showed a rise in the unemployment rate to a level not seen in 15 years, and a loss of 240,000 jobs in October alone. Data released on October 28 showed that through August, home prices in 10 major cities had fallen 18 percent over the previous year, demonstrating that the housing correction had not abated.

The slowing of European economies has been even more dramatic, as have the actions taken to rescue failing European banks and nationwide banking systems such as those in Iceland and Hungary.

Throughout this period, we continued to assess how best to use the remaining TARP funds, given the uncertainties around the deteriorating economic situation in the U.S. and globally, and the continuing financial market stresses. We have always said that the housing correction is at the root of the economic downturn and our financial market stress. And as the economy slows further, it threatens to prolong the housing correction, as well as the stress on our financial institutions and financial markets.

We recognized that a troubled asset purchase program, to be effective, would require a massive commitment of TARP funds. It became clear that, while in mid-September, before economic conditions worsened, $700 billion in troubled asset purchases would have had a significant impact. Half of that sum, in a worse economy, simply isn't enough firepower.

If we have learned anything throughout this year we have learned that this financial crisis is unpredictable and difficult to counteract. So early last week, we concluded it was only prudent to reserve our TARP capacity, maintaining not only our flexibility, but that of the next Administration.

We have identified other priorities that I believe the government will need to address through the TARP and other existing authorities. In particular, by investing only a relatively modest share of TARP funds in a Federal Reserve liquidity facility, we can improve securitization in this market and have a significant impact on the availability of consumer credit.

And we need to continue our efforts to use a variety of authorities to reduce avoidable foreclosures. The government has made substantial progress on that front, through HUD programs, through the FDIC's program with IndyMac, through our support and leadership of the HOPE NOW Alliance, and through the new GSE servicer guidelines announced last week that will set a new standard for the entire industry. While I understand the interest in spending TARP resources on other approaches, the efforts already underway will do more to prevent foreclosures than might have been achieved through very large purchases of mortgage-related securities through the TARP.

Although we are not planning to initiate another capital program beyond those already announced, an emphasis on capital seems to us to be the better strategy going forward. In the weeks since enactment of EESA, we have seen that capital purchases are clearly powerful in terms of impact per dollar of investment, which is a major advantage under the current circumstances. More capital enables banks to take losses as they write down or sell troubled assets. And stronger capitalization is also essential to increasing lending which, although difficult to achieve during times like this, is essential to economic recovery.

Our current Capital Purchase Program for banks and thrifts has already dispersed $148 billion, and we are processing many more applications. And yesterday we posted the term sheet for participation for non-publicly traded banks, another important source of credit in our economy. We are developing a matching program for possible future use which could apply to banks and/or non-bank financial institutions.

Recently I've been asked two questions. First, Congress gave you the authorities you requested, and the economy has only gotten worse. What went wrong and why won't you use this authority for other industries? Second, if housing and mortgages are at the root of our economic difficulties, why aren't you addressing this?

The answer to the first is that the purpose of the financial rescue legislation was to stabilize our financial system and to strengthen it. It is not a panacea for all our economic difficulties. The crisis in our financial system had already spilled over into our economy and hurt it. It will take a while to get lending going and repair our financial system, which is essential to an economic recovery. This won't happen as fast as any of us would like, but it will happen much, much faster than it would have had we not used the TARP to stabilize our system. Put differently, if Congress had not given us the authority for TARP and the Capital Purchase Program and our financial system had continued to shut down, our economic situation would be far worse today.

The answer to the second question is that the most important thing we can do to mitigate the housing correction and reduce the number of foreclosures is to increase access to lower cost mortgage lending. The actions we have taken to stabilize and strengthen Fannie Mae and Freddie Mac, and through them to increase the flow of mortgage credit, together with our bank capital program, are powerful actions to promote mortgage lending. We are also working actively to reduce preventable foreclosures.

In summary, I am very proud of the decisive actions by Treasury, the Fed and the FDIC to stabilize our financial system. We have done what was necessary as facts and conditions in the market and economy have changed, adjusting our strategy to most effectively address the urgent crisis and preserving the flexibility of the President-elect and the new Secretary of the Treasury to address the challenges in the economy and capital markets they will face in the coming months.

While difficult challenges lie ahead, the new administration will begin with two significant advantages: a significantly more stable banking system where the failure of a systemically relevant institution is no longer a pressing concern rattling the markets; and the resources, authorities, and potential programs available to deal with the future capital and liquidity needs of credit providers. Deploying these new tools and programs to restore our financial institutions and financial markets is critical to restoring the flow of lending and credit - which will determine, to a large extent, the speed and trajectory of our economic recovery. I am confident in a successful outcome, because our economy is flexible and resilient, rooted in the entrepreneurial spirit and productivity of the American people. And of course, I will focus intensely on the challenges before me and on making this a seamless transition during my remaining nine weeks.

Thank you again for your efforts and for the opportunity to appear today.

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