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THE STATE OF THE BOND INSURANCE INDUSTRY

===

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS,

INSURANCE, AND GOVERNMENT

SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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C O N T E N T S

THE STATE OF THE BOND
INSURANCE INDUSTRY

Thursday, February 14, 2008

U.S. House of Representatives,
Subcommittee on Capital Markets,
Insurance, and Government
Sponsored Enterprises,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 11:36 a.m., in room 2128, Rayburn House Office Building, Hon. Paul E. Kanjorski [chairman of the subcommittee] presiding.

Members present: Representatives Kanjorski, Sherman, Meeks, Capuano, McCarthy, Scott, Moore of Wisconsin, Davis of

Tennessee, Sires, Klein, Perlmutter; Pryce, Castle, Royce, Capito, Feeney, Price, and Bachmann.

Also present: Representatives Maloney and Bachus.

Chairman Kanjorski. This hearing of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order.

Without objection, all members' opening statements will be made a part of the record.

Good morning. The Capital Markets Subcommittee meets today to learn about the causes and effects of recent bond insurer ratings downgrades. We will, in particular, focus on the spillover effects for municipalities and the financial services industry.

Bond insurance represents a microscopic segment of the insurance marketplace. In 2006, bond insurers collected less than one-third of a percentage point of the total premiums collected by the insurance industry.

We now know, however, that even though it is very small, the importance of the bond insurance industry is significantly greater. Its recent volatility, unless quickly addressed, could produce many negative consequences and affect the financial stability of the broader economy.

Since the issuance of the first license in the early 1970's, bond insurers have guaranteed a stable risk: the timely payments of principal and interest on municipal bonds. In recent years, many bond insurers expanded into insuring structured finance products, including those backed by subprime mortgages.

These business decisions and the decline in the value of the subprime debt have now resulted in downgrades or the threat of downgrades by credit rating agencies.

It now appears that like a child who finds a book of matches, they have gotten burned. We must hope that they did not ignite our economic house as well.

The ratings downgrades of a few bond insurers has produced spillover effects and caused considerable anxiety. A report or rumor about a bond insurer has already led to swings of several hundred points in the Dow Jones Average.

The limited availability of bond insurance has also led to a number of recent failures in the offerings of auction rate securities. These breakdowns have caused significant problems in the financing of student loans. They have also resulted in some municipalities paying 10 percent or more on their outstanding short-term debts.

Ratings downgrades additionally have the potential to reduce the value of bank holdings and insurer reserves causing them to take write-downs or increase capital levels. Moreover, individual investors holding bonds could feel the impact if they want to sell the bonds they hold. Most troublesome to me is the effect of these downgrades on municipalities. Municipal markets issue approximately $2.6 trillion in bonds, about one-half of which are insured. States and localities often use municipal bonds to operate more efficiently, ease budgeting shortfalls, repair bridges, fix roads, and build schools, among other things.

The recent downgrades could therefore cause cities and towns to make difficult decisions about whether they can afford to pay more for bond insurance, pay higher interest on bonds issued without insurance, or delay much needed projects. In this regard, I am especially pleased that Mayor Tom Leighton of Wilkes-Barre, Pennsylvania, is here today. He can describe how municipalities use bond insurance and what the implications of the ratings downgrades are.

In preparation for today's hearing, I previously contacted key regulators to open discussions about these serious matters and determine the most efficient and responsible manner to act. Today, we will hear from many of them. We will also hear from bond insurers, their critics, market analysts and rating agencies.

Everyone--even State insurance regulators--agrees on the need for regulatory reform. We need to prevent a similar situation from happening again in the future. I am hopeful that as we further our understanding of these issues today, we will also begin to explore what we should do going forward. Some policy options include prohibiting bond insurers from guaranteeing complex structured financial products in order to protect municipal bond insurers and creating a Federal bond insurance corporation modeled after the FDIC.

We could also mandate Federal insurance supervision in this narrow field in order to provide greater stability for our entire financial system. Additionally, we could enact a law allowing the Federal Home Loan Banks to enhance municipal bonds with letters of credit like Fannie Mae and Freddie Mac already do. Moreover, we could work toward better transparency in the municipal bond markets. Other policy options include imposing new requirements for credit rating agencies and addressing the differences between ratings on structured financial products, corporate debt, and municipal bonds.

In closing, I look forward to the opening of dialogue today. I want to thank each of the witnesses for appearing. Your thoughts will help the members of the Capital Markets Subcommittee to understand these issues and to determine the best course of action to ensure that our municipal finance markets remain viable and our financial system stays dynamic and strong.

I would now like to recognize Ms. Pryce for her opening remarks.

Ms. Pryce. Thank you very much, Mr. Chairman, for holding this hearing today and for your leadership on this issue. It is clear we are facing a crisis of confidence in the bond insurance marketplace.

Dating back to the 1970's, bond insurers have served a very clear cut function, guaranteeing the timely payment of principal and interest on municipal bonds. They have put investors further at ease about the risk of default in a marketplace that has a rate of default of less than 1 percent.

In the 1990's, insurers began to diversify and to guarantee securities backed by pools of auto, mortgage, credit card, and student loans, and they did not stop there. In recent years, they branched out even further into risky debt products backed by some subprime mortgages.

The stability of the industry rested on the assumption that the insurers and the rating agencies who rated them accurately priced the risk of default of these assets. It is clear now that they got it wrong. In recent months, the prediction of record home loan foreclosures moved credit rating agencies to call into question the capital reserve levels of bond insurers. To date, all but one of the major bond insurers has either been downgraded or placed on a negative watch.

We wish we could turn back the clock, increase capital reserves, and restore the reputation of the industry. However, we are left with the future of a once stable industry in limbo. Investors are not the only ones with something to lose.

There are far reaching consequences in our capital markets. Real concern exists that institutional investors required to invest only in Triple A securities will be forced to sell.

I am particularly worried, as is the chairman, about the effects on small towns, cities, and counties and places like my district in central Ohio, which uses municipal bonds to help raise funds for important projects and improvements. Downgrades on existing bonds and pressure on prices moving forward add to the cost of living in small town America.

This hearing is an important step in determining the future of the bond insurance industry. I share the chairman's sentiment that this crisis gives us pause, and his lengthy list of possible solutions is admirable.

We pause to evaluate the regulatory structure of the industry and the need for better oversight.

I look forward to the testimony of all of our witnesses today. Thank you very much for your participation, and I yield back.

Chairman Kanjorski. Thank you, Ms. Pryce. We will now hear an opening statement from the ranking member of the full committee, Mr. Bachus of Alabama.

Mr. Bachus. Thank you, Chairman Kanjorski.

Three months ago, very few Americans were familiar with the bond insurance industry and the role that financial institutions play in the capital markets.

This once obscure industry is now at the center of an ongoing credit and liquidity crisis in the financial markets in recent months, causing tens of billions of dollars of losses to investors and financial institutions, and unraveling many secondary debt markets.

Unlike other events that have de-stabilized markets since the credit crunch began last summer, where the pain has been felt largely on Wall Street, the fall out from the troubles in the bond insurance industry is hitting Main Street, our cities, our counties, our States, and our different authorities, government authorities.

Bond insurers guarantee over $2 trillion of debt securities. Roughly 50 percent of municipal bonds and a large number of structured financial vehicles are guaranteed by the bond insurers in order to make them safe investments with a Triple A rating.

This provides the credit markets with increased liquidity and reduced borrowing costs particularly for cities, counties, and States that pay lower interest on debt issued to support their infrastructure needs.

The bond insurers' decision several years ago to expand their business lines beyond municipal issues and into more complex securities, including mortgage pools backed by subprime mortgages, has had disastrous consequences.

Bond insurers fundamentally misjudged the risk associated with the cyclic mortgage markets and lenders' lax subprime underwriting standards.

The credit rating agencies have now downgraded seven of the top nine bond insurers, calling into question their ability to make good on hundreds of billions of dollars in potential mortgage related defaults.

Investors in insured bonds relied heavily on analysis by credit rating agencies that were fundamentally flawed. Too late, the credit rating agencies have recognized the added risk of subprime related guarantees to the thinly capitalized bond insurers, which has served to aggravate the credit crunch and create massive uncertainty among market participants.

Local governments across the country are now facing an unfavorable environment in which to raise funds, with new issues plummeting and many municipalities being forced to pay significantly higher interest rates.

For example, in Jefferson County, Alabama, the rate on their insured sewer bonds issued in 2002, this month has increased from 3 percent to 10 percent, more than a triple increase in their payments.

These costs will inevitably be passed along to local taxpayers in the form of reduced services or higher fees and taxes. The impact is also extended to the credit markets, as new offerings of residential mortgage-backed securities have largely dried up.

Fortunately, our economy is still fundamentally sound and not all market participants roll the dice in subprime markets.

Two bond insurers have had their credit ratings affirmed, providing some measure of stability to the bond markets. Several other bond insurers are seeking or have obtained private equity financing and quick action by regulators has helped bring new entrance, such as Berkshire Hathaway, into the industry, to support the ongoing viability of the municipal bond insurance markets.

Last year, SEC Chairman Cox presented a vision for increased integrity, transparency, and accountability in the municipal securities market. Chairman Cox's initiative would require meaningful public disclosures that are current and understandable, with a full accounting of all material information at the time of a new municipal bond issuance.

This committee should closely consider Chairman Cox's proposal, keeping in mind that any Federal reforms of the municipal securities market must take into account the legitimate interest of States and municipalities.

Systemic risk relating to the bond insurance marketplace, while remote, is a risk that could have been avoided with prudent oversight by our credit rating agencies and other regulators.

We need to ensure that our regulators maintain a larger perspective on the potential impact of difficulties in one sector of the financial services industry spilling over into others as has happened with bond insurance.

In addition to guarding against risk to the financial system, Congress must make sure that someone is watching out for the taxpayers. Fourteen months ago, well before the subprime crisis called into question the financial soundness of bond insurers, I met with Chairman Cox and communicated my concern about the municipal securities market in a letter to him, a follow-up letter.

I would like to introduce that letter for the record. It is a letter of January 5, 2007, 14 months ago.

Chairman Kanjorski. Without objection, it is so ordered.

Mr. Bachus. Now my fears expressed in that letter have been realized as the situation in Jefferson County, Alabama, and throughout the country unfolds. Protecting taxpayers and rate payers as well as investors is a major concern for all of us and will guide our efforts going forward.

Hopefully, Chairman Cox's efforts and forthcoming proposals by the Treasury Department on the need for more comprehensive regulatory oversight of the financial services industry will help to inform the committee on the review of these complex issues.

Thank you again, Chairman Kanjorski, for holding this hearing. I am grateful today to all of the witnesses for joining us and I look forward to their testimony.

Chairman Kanjorski. Thank you very much, Mr. Bachus.

We will now hear from Mr. Royce of California.

Mr. Royce. Thank you very much, Mr. Chairman. I appreciate you holding this hearing, especially given the turmoil that we are seeing in the bond insurance industry. I think it is timely.

From the information that surfaced in recent weeks, it appears that the problems faced by these financial guarantee corporations are largely the result of failed business models, but as we listen to the three panels of witnesses that we are going to hear today, it is worth noting that we are not going to hear from an expert on insurance matters from within the Federal Government because no such position exists in our Federal Government.

Mr. Sirri is here representing the SEC. He is going to provide the committee with insights into the current bond insurance turmoil as it relates to the securities industry.

The Federal Reserve can comment on the banking sector, but because these bond insurers, like all insurers, are overseen solely at the State level, we do not have the same type of Federal representation from the insurance sector that we have from the securities and banking industry here today.

I am, of course, the co-author of the National Insurance Act, along with Representative Melissa Bean, and what that bill would have done and will still do if we pass it is establish a world class regulator for the insured and the insurers of our country.

This Federal regulator would be able to provide Congress with valuable insight into the industry it oversees, whether we are responding to a national crisis or we are formulating tax policy, or we are negotiating a major trade agreement to try to get our insurers into other countries.

It is regrettable frankly that it has taken an incident such as this one being discussed to highlight this point. I believe this point has to be made because we are going to have more problems like this one.

The lack of a world class regulator able to effectively comment on the broader insurance industry as it relates to the national economy and capital markets around the world is going to continue to hamper that industry and it is going to continue to hamper our Nation's economy until Congress acts.

Again, I would like to thank Chairman Kanjorski for holding this timely hearing, and I certainly look forward to hearing from our witnesses, but I look forward to the day when we can really effectively from Congress address this issue with the type of oversight we need, and that requires the National Insurance Act.

Thank you again.

Chairman Kanjorski. Thank you very much, Mr. Royce.

Are there any other members of the subcommittee who seek recognition for an opening statement?

[No response]

Chairman Kanjorski. It is time we turn to the witnesses. We will establish the first panel. Without objection, all witnesses' written statements will be made a part of the record, and each will be recognized for a 5-minute summary of their testimony.

For the first panel, we have the Honorable Eliot Spitzer, the Governor of the State of New York, and a long time friend of mine. When he occupied the attorney general position, we worked together on many issues, and now to have him on this issue, I feel at least this committee is supported by a fine equipped mind in the right direction.

Governor, welcome to the committee.

STATEMENT OF THE HONORABLE ELIOT SPITZER, GOVERNOR, STATE OF NEW YORK

Governor Spitzer. Thank you, Mr. Chairman, for your hospitality and your kind words and introduction. All the members of the committee, thank you for permitting me this opportunity to spend a few minutes to explain our concerns and some of the history that I will relate to you and how this problem/crisis has emerged.

You will hear in the next panel from Eric Dinallo, who is the superintendent of insurance in the State of New York, and is exquisitely schooled in the intricacies, and indeed, Mr. Dinallo is a world class expert on all insurance matters and has done a world class job addressing this issue.

What I want to do is summarize to a certain extent some of the steps that have preceded the emergence and the public perception of this crisis because I think it bears reflection that this is a deeper problem than perhaps is understood.

Let me first frame this as many of you have observed. There are many victims in the current market uncertainty and the unsettled marketplace that is exacting a price upon many different sectors and groups of individuals.

I begin with individual investors, those individuals around the Nation, virtually every individual who invests in a muni fund, in a 401(k), in a mutual market fund of any sort, holds municipal bonds. Those municipal bonds have dropped in value and as a consequence, there has been an asset value lost to virtually every investor in the Nation, and that is the pool of individuals whom I first think about as their life savings are indeed being if not jeopardized, at least put under temporary pressure because of the market uncertainty.

Second, as you have all referred to, governments. Governments are paying an enormous cost for the spike in interest rates that is being forced upon them in terms of their financing. You have referred to several examples.

You will hear from the Mayor of Wilkes-Barre on the next panel.

This is typical of what every government entity across the Nation is going through. Indeed, just yesterday, the auction rate securities, which are vehicles used by many governments, many authorities/agencies around the Nation, some 60 percent, I believe, of the auction rate security bond auctions failed leading to a spike in what is called a ``reset'' in the interest rates paid.

The Port Authority of New York and New Jersey, which has very significant outstanding debt and uses the auction rate securities, is now paying 20 percent on some debt that of course was in the low single digits before yesterday.

This, I should observe, has absolutely nothing to do with the underlying security of the debt offering. It is merely a consequence of the uncertainty and the unsettled nature of the capital markets.

Third, the third impact we need to think about is to our financial services sector that has needed to take very significant write-downs and although one could say to a certain extent they are responsible for their own willingness to incur this debt, this has had an enormous impact because of their capitalization need, to seek renewed capital and in the intervening period, their inability to extend the liquidity out into the marketplace that we might want has had an enormous impact and not only on their balance sheets and on their market valuation, but also on the economy at large.

Those are the three major entities that have been affected.

Let me quickly run through the sequence of events that got us where we are. I think it is important to remember this data is derived from a great extent from the subprime market, mortgage marketplace.

That is the marketplace where we saw this enormous explosion of debt, debt that is now substantially under pressure, debt that is not and was not, we now understand, affordable by those who incurred it, debt that to a certain extent was marketed with teaser rates that were going to explode, teaser rates that were often not explained, and teaser rates that were unworkable for those who were incurring the long term debt.

There is a fair debate that goes on where the liability and responsibility for incurring that debt should rest, but we should all understand that as an initial matter, much of this derives from the subprime mortgage market, and that is where this debt that is now causing problems comes from.

I will not go through the details but you may have seen a piece that I had in this morning's Washington Post, in which I said that one of the entities that clearly should have been a responsible party in examining the magnitude of the mortgage debt that was being offered and was being incurred and was resting on the balance sheets of many entities was the OCC.

I think it is a very fair question, why the OCC, given its responsibility to ensure that the balance sheets of our banks are stable, did not do much more to examine whether this debt was being issued properly but in fact chose to shut down those of us who were attorneys general at the time in our effort to examine that.

Step two. If step one was the issuance of a debt, step two was the securitization of the debt, this effort to homogenize what was an enormous pool of debt, much of it which was uncertain in its underlying nature, and to somehow transform bad debt into good debt.

As the old cliche goes, garbage in, garbage out. You cannot transform bad debt into good debt simply by homogenizing it through the securitization marketplace. Securitization is of course a critical part of our capital markets. It is necessary. It is good. It has permitted greater liquidity, but it cannot be used to mask the underlying risks of the debt that is outstanding.

The third step was the credit ratings that were applied to much of this debt, and I think it is a critical question that we all must ask, where have the credit rating agencies been.

I think the best way to ask this question quite frankly is have they ever picked up a major inflection point in the debt markets. If you look back over the bubbles, if you look back over the market crises of the past 15 or 20 years, the question I would be tempted to ask, as the SEC as the overseer of these agencies should ask, I believe, is where have they ever been attuned to the underlying realities as opposed to simply following the trend line that the marketplace wants us to follow.

Those trend lines do not continue in one direction forever. If they have missed these inflection points, then are they providing the guidance the marketplace needs.

Step four, as we now are focusing upon, was the insurance of the underlying securities, the insurance of these enormous pools of capital, and the point I would make here, and Mr. Chairman, you alluded to this, the bond insurance companies which are, as you pointed out, infinitesimal, very small participants in the larger bond marketplace, began, and for most of their lives, served only one purpose, and hence their name, monolines, their purpose was to insure municipal debt.

Municipal debt, which is one of the two big pockets we are talking about here, the other being the securitized, the CDOs and all of those sort of acronyms that have emerged over the past couple of years, the municipal debt market is remarkably secure.

When the bond insurance companies' primary and indeed exclusive responsibility and business model was to insure that debt, those insurers themselves were remarkably secure.

It was only when the bond insurance companies decided that whether for reasons of profitability or interest, whatever the rationale may have been, to expand their jurisdiction and began to veer into the securitized market of the subprime mortgage debt and other more sophisticated instruments that they began to incur exponentially greater risk.

That is why we have the problem we have today. Their expansion from monolines to dual lines is what has generated the crisis that we are faced with and what we must think about.

Let me make one point here having seen that sequence as it has gone from the initial issuance, the origination of the debt, to the insurance of the debt by the bond insurance companies.

We are now seeing this unravel piece by piece, as it is clear that the potential implications of a downgrade for the insurance companies, the bond insurance companies, could be to generate a tsunami of selling and could be to generate the necessity of selling into a marketplace that is not terribly liquid which would then generate additional write-downs through the financial services companies, less liquidity, more cost to governments, and more costs to investors.

We are saying to ourselves, how can we stop this? There are many proposals before us. Mr. Chairman, I think you gave us the array and the spectrum that we should probably consider.

I want to make just two points, if I might. First, the role of the States here is necessary because the Federal Government until now and perhaps even as we look into the future, the Federal Government has hesitated and indeed refused to participate as a regulator in a meaningful way in the insurance sector.

Several years earlier, years back, I was here testifying about some investigations that my then Office of the Attorney General was conducting into improprieties in the insurance sector, and I spent a fair bit of time chatting with Members of Congress on both sides of the House and the Senate to see if we could generate support for the notion of a Federal regulatory role in the insurance sector.

I will tell you there was no interest. Whether this was a consequence of a political dynamic or an economic perspective is a question we could discuss, but there really was no interest in creating at that time a Federal role in the oversight of insurance.

Consequently, it has fallen to the States to do this. I think they have done it by and large extraordinarily well.

I know, Mr. Royce, that you want to create a Federal entity and we could have that conversation, but I think it should not be ignored that the States have done an extraordinary job through most of the market up's and down's in regulating the insurance sector.

I want to say that Mr. Dinallo has really, I think, done yeoman's work trying to resuscitate the capital of the underlying insurance, bond insurance companies, to try to preserve their creditworthiness and their credit rating.

The final point I would make is that as the clock is ticking, and as we are moving forward, we are seeing real harm not only to investors and governments, but to the capital markets.

Therefore, it is time for people to act. It is time either for deals to get done, in which case there would be a recapitalization of the underlying bond insurance companies, which is something we hope for, as Secretary Paulson testified earlier today on the Senate side, those are private transactions. There is only so much a government entity can do to encourage or cajole, but we certainly have been doing what we can do to encourage a recapitalization of those companies.

If that does not happen, given the uncertainty in the auction markets, we will be forced to act sooner rather than later. What that might lead to is what we call the ``good book/bad book'' structure, where we peel off the municipal piece of business.

There are, as you are well aware, offers to purchase that, whether it is from Berkshire Hathaway or others who have recently stepped into this market void, there are offers that would permit us to essentially restore stability to the municipal part of this business.

If we get to the point where we think the pain to the municipal part is too great, where governments and investors are suffering too much, we will need to move in that direction.

My message to those who are contemplating various transactions that could be done that are frankly preferable, it is not our first choice that we move in that direction. My encouragement to those individuals, entities, banks, investors of any sort, private equity or major financial institutions, is that they move with some increase in rapidity because time is short.

At this moment, I would welcome your questions.

[The prepared statement of Governor Spitzer can be found on page 261 of the appendix.]

Chairman Kanjorski. Thank you very much, Governor.

I actually took the effort this morning to watch your presentation on CNBC in regard to your evaluation of cause, effect, and responsibility. I tend to agree somewhat but not entirely with you as to the position.

Do you not agree, Governor, that the important thing is in the latter part of your statement, to get to stability as opposed to finding fault at this point?

Governor Spitzer. Absolutely. There is no question. The look back, as it were, and the finger pointing is useful only to the extent that it will be instructive as we look forward to the creation of either an alternative model that Mr. Royce may support in terms of national regulation of the insurance markets, or changes in the way that we look at the underlying credit analysis that we get from S&P, Moody's, and others.

I think the most important thing we need to do right now is to restore stability, which means hopefully not getting to a point where the bond insurance companies themselves suffer the downgrades that could then generate the cascading effect through the capital markets. That is why we are encouraging as we can the infusion of capital into those entities.

Chairman Kanjorski. If the New York Secretary's suggestion of infusion of capital or investment, new equity investment markets, for some reason or another does not come about, do you agree that it would be pertinent for the Congress to act and create either temporarily or permanently a corporation of some sort to underwrite the municipal bond field, to make sure that it continues to exist and go forward, or to authorize the Federal Home Loan Banks to issue letters of credit? Is it so instrumental, is what my question is, that we set a deadline if we can, and then proceed to tell everyone we are going to act accordingly, or just leave the free market flow as it is flowing?

I am particularly aware of what I consider a cascading effect here when you think it all started in the subprime market, but just in the last 4 or 5 weeks, we have seen different elements of the credit market impacted in a very major way. Now some of the markets are absolutely frozen; I am told there just is not a marketplace out there of investors for corporate bonds at this point. The same is true for rating securities--auction rating securities are not being purchased.

It seems to me that we are flying down a road at a tremendous speed here that could bring into collapse the entire financial market as we know it today, not only in the United States but potentially it could move around the world and metastasize.

I am just disturbed that there are not too many people who are really speaking to the issue, and those who are speaking to the issue are assuming that somebody else is doing something about it. Maybe I would like to know what the Governor of New York and what the superintendent of insurance of New York feel you can do surgically in the areas in which you have jurisdiction?

Governor Spitzer. Yes, sir. I agree with your final conclusion there. I am torn between two objectives. One, as I just said in my opening statement, is to generate a sense of concern such that we can move any potential deals with great rapidity, and on the other hand, not to speak with such dire prognostication that the capital markets begin to sense there is no hope out there, because so much of this is emotional and driven by the analysis of what is likely to happen rather than what actually has happened, not to generate that cascading effect that we are concerned about.

With all due respect to Congress, I am not sure congressional enactment could result with sufficient speed if we believe that sometime in the next 3, 4, or 5 business days we would like to see resolution here, which I think is ideally what we would like to see happen.

I think your notion of a Federal guarantee has been raised in a number of articles and it is a very worthy idea and quite frankly, I think, had a guarantee of this sort been discussed and perhaps extended several weeks or several months ago, it would have cut off the decline in our national economy probably to a much greater extent than a stimulus package that perhaps will boost consumer spending but does not go to the underlying concerns of the lack of credit flowing through the economy.

I think your analysis is exactly correct. It is because of the capacity to move with greater speed that Eric Dinallo, the superintendent of insurance, has been working with the Fed and with Treasury to generate interest in the recapitalization of these markets.

I would say to add one more aspect to it, it is a fair question whether the State of New York as the State of New York indeed going forward will seek or need or use bond re-insurance, if you look at one of the interesting things out in the marketplace.

Some of the municipal debt that has been offered and is in the marketplace without the so-called Triple A wrap is selling at a higher price than debt without it.

There could be in an odd way right now a negative effect on pricing by merely being involved with some of these bond re-insurance companies.

There will be a transformation of that marketplace but certainly in the near term, we would like to see a recapitalization. If that does not work, a guarantee of some sort certainly would be an interesting approach.

Chairman Kanjorski. Thank you, Governor. Ms. Pryce?

Ms. Pryce. Thank you, Mr. Chairman. Thank you, Governor, for your testimony.

There certainly is enough blame to go around. There is no sense, aside from the instructive nature of it, pointing many fingers.

The State of New York certainly has a lot on its plate now. I was very interested to hear you say that in years past, you have been up on the Hill talking about a Federal regulatory role.

I know that this current Congress and this committee has investigated that and has shown much interest in it. I just wonder where you fall on that spectrum of advice you might give this committee as to how well that might work.

Governor Spitzer. I am testifying with the superintendent of insurance of the State of New York sitting behind me, so I am trying to be loyal to him. I do not think he wants me to support limiting his jurisdiction in any way.

I will confess that you may remember, I went through an interesting dance with the other Federal financial services regulators, whether the OCC, the SEC, or the Fed at different times when I was attorney general, arguing that State jurisdiction was critically important to not only fill in but step into the front of the regulatory world when there was a void created by a failure of those Federal regulatory entities that had jurisdiction but failed to exercise it.

I do not want us to fall into the mistaken view that merely creating a Federal regulatory entity will solve the problem. There are many Federal regulatory entities that could have acted that did not act. That has been true in many crises in the past, whether it was the issue of the analysts, which is a crisis that cost investors untold billions of dollars and had its own consequences a number of years ago, or the context of insurance where there were other ways to address this.

Bottom line, I feel there might not be any harm that would result from having a more structured organized national regulator for the insurance sector, but I do not want it to be a regulator that would totally supplant the role of the States.

There is a dualism in the banking system and in many other areas of our financial services that benefits consumers and investors, because where one regulator fails, sometimes somebody else steps in and picks up the pieces.

The notion of a Federal regulatory presence is something that we should consider. I suggested several years ago the SEC expand its portfolio to include insurance, especially given the convergence of so many financial instruments.

It is no longer quite as clear that there are discrete silos, as people call them, of financial instruments. We might as well expand and have one entity that can examine all these products.

Ms. Pryce. I do not disagree. I think part of the problem is there are so many entities, nobody knows who the ultimate authority and jurisdiction rests with. Your ``garbage in/garbage out'' analogy, someone is responsible for assessing the risk of the garbage. That did not happen correctly, with these facts, as we have had the luxury of looking at them in hindsight.

The dual nature of a regulatory system, I think, is something that this committee grasps well and has worked and could work.

I just wanted to know if you were willing to go on record.

Governor Spitzer. I certainly think it is something we need to look at. The devil is not only in the details but conceptually, we need to think how this would work.

Frankly, many of the insurance companies, let alone the bond re-insurance companies, which is really as the chairman pointed out, a tiny little subsector of the industry, the insurance industry itself, despite some noises to the contrary, does not support, in my experience, the creation of a Federal entity.

There is a comfort level right now for reasons we could discuss with a de-Balkanized State-led regulatory structure, and I think that may be part of the problem.

It will be a heavy lift, I will tell you, politically, to move this forward. It might be better nonetheless for the markets to move in that direction, but just to pick up on my comment of ``garbage in/garbage out'' that you picked up on; I am usually for recycling.

The problem is we are recycling this garbage in and out of the financial services sector and it is not helping anybody.

Ms. Pryce. Thank you very much, Governor.

Chairman Kanjorski. Thank you, Ms. Pryce. Mr. Capuano?

Mr. Capuano. Governor, I want to preface my remarks by simply stating to you that I am a former mayor. I floated municipal bonds and I will tell you that every single time I did, when it came to the credit agencies, we can call them all the nice things they want, it was legal extortion.

Not a single community in Massachusetts has defaulted on a single bond in memory. In memory. Yet, it did not matter. It did not matter one bit. Still needed credit enhancements because I came from a working class city and well, you know, we are not so sure.

So, legal extortion. That is what it was. That is what it is today. I for one will not stand here for 1 minute and defend any of the bond insurers who took municipal money, good debt, and put it into bad debt.

I know you say they cannot do it, and I agree with you, but they did. This is not the only case. Subprime is part of it. It is a huge animal that we are looking at. We are looking at one little tail today. It is a big one, but it is just a tail.

For me, I think it is a little bit more than just we have a little market problem. We have people who have been engaged in legal extortion for generations, and nobody said a word.

Cities and counties across this State were forced to pay them without adequate reasons. Nobody looked at it and nobody cared until today.

I am glad we are here today. I do not think we can just say we only have to look forward; I do think we have to look back. This is not the beginning. I respectfully disagree with the--I generally agree with everything you said, the big stuff, I agree. It is not the beginning.

Subprime is not the beginning of this. Enron was not the beginning of it. It was the same type of thing. The word ``regulation'' has become a swear word here in Washington, D.C.--don't regulate anything; let the free market go. I am all for a free market to a certain extent.

I just want to ask, to some extent, you have said there should be Federal regulation. I disagree with you. Some of the insurance companies are now coming to see that. They are trying to get ahead of the curve, which I think is smart.

I agree with you totally that it should be dualistic, but I wonder, do you really think that the State system alone has really worked? If it really worked, why are we here?

If it really worked, how do we get to long term capital? How do we get to Enron? How do we get to all the subprime problems? How do we get credit rating agencies that are doing what they are doing? How do we get all these things if the State system alone really worked?

I am not saying it has not worked well in retrospect. Once they realize a problem, they do act reasonably well. I think your State is a leading example of it on many situations.

Governor Spitzer. I would answer, sir, in the following way. First, to begin with your point about the rating agencies and since they rate New York State bonds and I have to meet with them next week, I will not call it ``legal extortion.'' I will try to be a little more polite than that.

Mr. Capuano. You did not have to deal with them as a mayor. I did. I am getting back at them.

Governor Spitzer. I got that sense, I have to say.

[Laughter]

Governor Spitzer. You may want to run for Governor some day and then you will find out--no. We will talk about that.

[Laughter]

Mr. Capuano. I already said ``no'' to that.

Governor Spitzer. I would say this. You heard me say earlier that New York State may not in fact use this re-insurance model in the future because there are many debt offerings out there, municipal debt offerings, and as I pointed out, this is the rock solid part of the market that are selling at par and above without the insurance where those that have been insured that are selling below par.

We are going to look at that. As you have just articulated, it is not clear what value we get.

I agree with your larger point. It must be at most a dual system. I would not agree to exceed regulatory authority from the State exclusively to the Federal Government. Too often, that is used merely as a vehicle to drop the bar too low and them preempt States from coming in to protect either consumers or government entities or whomever. That, I would certainly not agree with.

I disagree with you only to the extent that when you bring in several of the prior scandals, whether long term capital or Enron or the analyst scandal, those were areas where the Federal Government had existing regulatory authority that was not exercised.

Those were not areas where the State in the first instance would have been viewed as the entity that should have stepped into the void.

I agree with your larger point, and I made this point earlier today on CNBC, when you have Federal regulators who invoke ``and ran'' as the definition of what the market should be, then we have a problem. When you have Federal regulators who run away from fulfilling their job, which is to ensure that the rules are enforced, there is integrity in the marketplace, we generate these crises.

Mr. Capuano. I agree with you, Governor. Thank you.

Governor Spitzer. I think what we have to take away from this, as we should have from prior scandals, is that when regulators are asleep on the job, the ultimate victim is going to be the investor, the taxpayer, and the government.

Mr. Capuano. We have had regulators come to this committee and tell us they did not have the authority to do the very things that--I agree with you. I think they had the authority to do all these things. They claim they did not.

I have had them just recently with banks, who have these off the books CDOs, saying oh, no, we do not regulate them because they were not on the books. If they were not on the books, why are they raising money now to pay them off?

I totally agree with you but understand, in Washington lately, regulators are the first to say we do not have any power, which I think is completely back asswards, but it is unfortunately the life we live down here.

Thank you, Governor.

Governor Spitzer. Thank you.

Chairman Kanjorski. The gentleman from Alabama, Mr. Bachus.

Mr. Bachus. Thank you, Governor. Governor, in your written testimony and your oral testimony today and in some of your public statements, you have talked about shortcomings at the OCC?

Governor Spitzer. Yes, sir.

Mr. Bachus. You have talked about investment banks and some things they have failed to do?

Governor Spitzer. Yes, sir.

Mr. Bachus. You have talked about the SEC, where they should have had greater scrutiny?

Governor Spitzer. Yes, sir.

Mr. Bachus. And the credit rating agencies. Your testimony today, I did not actually hear you talk about the one entity that regulates the bond insurers, and that is the New York State Insurance Department.

Do you also have some criticism of their shortcomings and their failures?

Governor Spitzer. Certainly not since January 1, 2007, when I became Governor, and when Mr. Dinallo shortly thereafter took over, at which point he has thoroughly and totally revitalized an agency that until then was not exercising the oversight perhaps that it should have.

But understand and that is why I laid out before you the history of how this problem emerged and how it was an accretion of issues and developments within the financial services industry that built upon themselves to the point where then you had the bond re-insurers extending their guarantee and applying their creditworthiness or supposed creditworthiness to entities that should not have been within their domain arguably to insure in the first place or with respect to which they did not have enough capital to extend that insurance.

You will hear Mr. Dinallo testify in the next panel. He will explain to you with some precision precisely what standards his office applies to the re-insurance entities and why they are trying to get them to--

Mr. Bachus. Let me ask you this. During your tenure, and I think what you are saying is you are acknowledging there was a fundamental failure of the New York Department of Insurance.

Governor Spitzer. No. What I am saying is there was a multitude and a sequence of events that led to the subprime mortgage guarantees--

Mr. Bachus. Doesn't the New York Department of Insurance--they approved the bond insurers investing in the subprime securitization market which was a risky market.

Governor Spitzer. I think that is a topic of conversation, and as I said, one of the underlying causes here was expansion of their jurisdiction from what used to be monoline businesses into the much more risky area of the securitized market.

Mr. Bachus. The State Department of Insurance would have to approve their investment.

Governor Spitzer. It is a fair question whether that is a wise business model to embrace and whether in fact, as your colleague from Massachusetts has indicated, whether this has not led to the cross subsidization from the municipal market over to the other side of the business.

Mr. Bachus. Let me ask you this. Since 2007, when you became Governor, your insurance commissioner who will testify in a few minutes, he approved both regular dividends and special dividends where capital was transferred from the bond insurers to their parent companies, which made them lower their capitalization. Is that true?

Governor Spitzer. I do not know if that is the case or not. I will tell you this, that it was only in the past months that we have seen a subprime crisis that the Bush Administration, the Fed, the Treasury, the SEC, and the OCC failed to address over the last--

Mr. Bachus. I am not debating that.

Governor Spitzer. Mr. Bachus, you are involved in a finger pointing exercise. I am more than happy, sir, to get involved in that and go through with precise detail where this Administration failed at a regulatory level to stop multiple scandals.

Mr. Bachus. I will say I actually introduced the first subprime bill into this.

Governor Spitzer. If you wish to hear from us about the Insurance Department in the State of New York, we will explain to you how we have stepped into this breach to save governments, investors, and taxpayers billions of dollars.

Mr. Bachus. Governor, since you became Governor, you approved special dividends which drained resources from--

Governor Spitzer. No, sir. What the superintendent has done is act diligently to protect investors, governments, and taxpayers and recapitalize these markets where others did not.

Mr. Bachus. Let me ask you this, Governor. Since 2007, we now all agree there was not adequate capital standards, has your superintendent raised those capital standards since 2007?

Governor Spitzer. We are taking the lead. In fact, if you look at the press, we have done everything possible within our jurisdiction to increase the capitalization--

Mr. Bachus. When was that done, Governor?

Governor Spitzer. That was done the moment this problem began to emerge.

Mr. Bachus. And when was that?

Governor Spitzer. We can get you that date, sir.

Mr. Bachus. Was it in the last month or two?

Governor Spitzer. No, it precedes that. The dividend was approved by the prior Administration, sir.

Mr. Bachus. There was a special dividend approved in early 2007.

Governor Spitzer. In fact, the dividend was approved by the prior Administration and was cut back when Mr. Dinallo got here because he believed there was an issue here.

If you want to pursue that, you can do so, sir.

Mr. Bachus. How about the regular dividends, were they suspended or have they been suspended?

Governor Spitzer. You cannot do so.

Mr. Bachus. Let me ask you this, if we address--

Governor Spitzer. Mr. Bachus, are you saying that the superintendent should be in the position to suspend the dividend payment of a public company?

Mr. Bachus. No. I am saying if there are not adequate capital requirements, he can--

Governor Spitzer. Do you think the superintendent should be in a position to suspend dividend payments of a publicly traded company, sir? We could do for General Motors. We could do it for Exxon. We could do it for others.

Mr. Bachus. I believe to protect those that are relying on the bond insurers' capitalization, I believe the superintendent of the New York Insurance Department could have raised the capital standards.

Governor Spitzer. Sir, I think you misapprehend--

Mr. Bachus. I believe there was inadequate capitalization.

Governor Spitzer. And the role that he has played stepping into the breach when this problem, as the chairman said metastasized because of the meltdown in the subprime mortgage market. That was the causative factor, as I laid out before you, that led to the credit failures that have generated this problem.

Mr. Bachus. We have had several CEOs of major financial companies who have resigned because they invested in these subprime derivatives. That was a mistake. Those were risky investments.

I am just saying that if we are to say what went wrong, the one entity that regulated, that was the regulator for the bond insurers, it was not the SEC, it was not the credit rating agencies. I am not absolving them.

I am simply saying that to avoid this problem in the future, if New York State is going to continue to regulate these entities, they are going to have to do a much better job. Would you agree?

Governor Spitzer. No, sir. I think the State Insurance Department has done a spectacular job over the last year under Superintendent Dinallo examining not only this problem but a multitude of other problems in the insurance sector that are the consequence of failed national Federal policies which have permitted this debt to ripple through the economy and to metastasize and to generate a credit crisis that should have been addressed much earlier.

Mr. Bachus. Governor, Mr. Ackman, I have read his testimony, he actually says that 6 years ago, he pointed out--let me see what he said--he pointed out some of the problems with the bond insurers and that actually you launched an investigation of those criticisms and to MBIA.

Did you find his criticisms to be credible?

Governor Spitzer. There is a distinction, I'm sure you will appreciate, between fraud, which is the jurisdiction of the attorney general's office, and there being regulatory risk that perhaps one should not assume.

What we found after an exhaustive inquiry was that there was risk that was within tolerable bounds of business behavior, so we did not, and we would stand by this after a thoroughly exhaustive inquiry, did not believe there was fraud being conducted.

We did that investigation. What we found, and Mr. Ackman, whom I know well from both that set of allegations that he raised and other dealings in New York State, he is a short seller, and I say that not in any critical way, obviously his predictive skills in this one have been correct, but he certainly was for many years now saying there could be inaccuracies here, but that is a different matter than the fraud.

Mr. Bachus. What I guess I am saying is you have said, and I am not disputing it, that it was only in the last 2 or 3 months that you became aware that the bond insurers may have been inadequately capitalized, but 6 years ago, Mr. Ackman made the representation that they were inadequately capitalized.

As a result of that, the attorney general's office, you actually investigated them for fraud, but--

Governor Spitzer. And we concluded there was none.

Mr. Bachus. His representations were that they were inadequately capitalized.

Governor Spitzer. The conclusions we drew then in the jurisdiction of the attorney general's office is to pursue fraud and legal impropriety.

Mr. Bachus. I understand that, Governor.

Governor Spitzer. What we concluded was that there was none, but that the market risks there were real.

Mr. Bachus. When he said 6 years ago that they were inadequately capitalized, did you see any indication of that 6 years ago?

Governor Spitzer. That was not an issue that we really asked. We do not examine inadequate capitalization at the attorney general's office. What we examine is fraud, impropriety, and failure to disclose to the marketplace. Those are pretty distinct issues.

Mr. Bachus. Would you agree today they were in fact and are inadequately capitalized?

Governor Spitzer. Back then?

Mr. Bachus. No, now.

Governor Spitzer. Of course they are now because that is what we have been working diligently and Mr. Dinallo has been working diligently as many people in State government have to recapitalize those companies.

Mr. Bachus. I very much appreciate that.

Governor Spitzer. That is the critical link that is now being challenged.

Mr. Bachus. I guess my only point is as we look at these various agencies, the credit rating agencies, the investment banks, I think the State of New York has to accept some responsibility in that they were primarily--the bond insurers--were regulated by the New York Department of Insurance. Whether that was under your watch or someone else's, I think that is a fact.

Governor Spitzer. We are trying to recapitalize these companies because the market conditions that exploded changed the adequacy of the capital sufficiency and the analysis that would go into that.

Mr. Bachus. Yes, and I compliment you for that. Thank you.

Chairman Kanjorski. Thank you, Mr. Bachus. Mr. Meeks?

Mr. Meeks. Thank you, Mr. Chairman. I would like to welcome my Governor from the great State of New York. It is always good to see you and to be with you.

I just have a couple of quick questions for you, Governor, to get your opinion on. How at risk do you believe the municipal bond assets are right now?

Governor Spitzer. I think first it is always great to see you, Mr. Meeks, Congressman. I would say the municipal market is as stable now in terms of the creditworthiness of the underlying securities as it ever has been, and as you will hear repeatedly, the default rate is de minimis within that market, and therefore, I think investors should take great comfort from the fact that their holdings in that area are secure.

Mr. Meeks. Maybe this happened with Mr. Capuano when I walked in. In your opinion, because I heard you talking about regulatory steps, etc., and what the regulatory agencies do or do not do, one of the questions I had for you was what steps do you think the Federal Government should take to support and to address the effects of downgrading for bond insurers?

Governor Spitzer. I think the concern we have about a downgrade for the bond insurance entities is that it would then have a cascading effect of a market evaluation of an enormous volume of bonds that are in the marketplace.

What we therefore think the first and best step to undertake is a recapitalization of the bond re-insurance companies so that they do not themselves get downgraded.

In the absence of that, Chairman Kanjorski has raised at one extreme, the possibility of a Federal guarantee that would come in to reassure the marketplace that these bonds are not in fact going to default.

At the other end of the spectrum, one can imagine lesser steps such as the creation of new insurance entities, and Mr. Dinallo has very effectively sought the entry of other potential participants, whether it is Berkshire Hathaway's offer to buy the muni part of the book of these companies or something between that and a full Federal guarantee.

Mr. Meeks. Lastly, Governor, Mr. Buffett made an offer the other day about putting in or underwriting re-insurance policies of about $800 billion on municipal bonds.

My question is, good move? Bad move? What do you think of his offer?

Governor Spitzer. I would not want to second guess Mr. Buffett, but I think I would state it this way. The fact of the offer has been very affirmative for the marketplace, because what it has done is demonstrate to municipal bond holders and the municipal marketplace that there is as a backstop always the possibility of this division of the businesses into what is referred to as the good bank/bad bank, so that you could split off the municipal part of it, which is secure and find a guarantor to lend stability to that marketplace.

It is not perhaps the optimal result because it would be preferable to have the entire bond insurance market stabilized without taking away the municipal part of from the other piece of business, making sure, as your colleague from Massachusetts suggested, that there not be a subsidy that goes from municipalities over to the other part of the business is also, I think, a legitimate governmental objective.

While we are happy that there is the offer from Mr. Buffett and arguably others who could step in based upon their own valuation of that business, we are also hopeful that there could be a resolution that does not require that sort of division.

Mr. Meeks. Thank you, Governor. I yield back.

Chairman Kanjorski. Thank you, Mr. Meeks. Mr. Feeney?

[No response]

Chairman Kanjorski. Mr. Castle?

Mr. Castle. Thank you, Mr. Chairman. Thank you, Governor, for taking the time to be here and to educate us about these issues.

My question may be a little different but it pertains to the subject of the credit issues in this country. As we all know, we face an ongoing credit and liquidity crisis that has caused billions of dollars of losses to investors and financial institutions.

I am concerned that recently introduced legislation to regulate the credit card industry has the potential to make the credit crisis much worse.

I raise this issue today, Governor, because it seems that you might agree. In August, you vetoed a bill that would have prohibited credit card issuers from raising the cardholder's interest rate or imposing a fee based solely on the reported delinquency of the cardholder on another creditor's account. This is commonly referred to as ``universal default.''

You said, ``To the extent that this bill might have a practical impact, it would harm rather than benefit New York credit card customers,'' and then you added, ``In particular, a consumer's delinquency on a creditor's account is an indication that the consumer may be at risk of not paying other accounts.

This bill would force credit bill issuers to increase interest rates or fees charged to all credit card holders, shifting the financial burden from those who are in default on an account to those who are not.''

My question is if the bill or provisions to ban universal default is appropriate right now during these difficult economic times?

Governor Spitzer. I would have to think about that and analyze it more carefully. As you can see from my veto message then, I believe there were also preemption issues that were at play in terms of whether or not the State was empowered to do certain things or the things that were in the bill, if I remember it. I would have to look at the whole veto message.

Also, as you can see from the portion you read, what we were trying to do was determine what the benefits would be to various payers and what the cross subsidy would be between those who had good credit and those who did not have good credit, and whether or not this amounted to a subsidy that we did not want to ask some consumers to foot.

Mr. Castle. I thank you. Let me change subjects. I want to talk about the credit rating agencies. This may not be a correct interpretation, but I believe there are discrepancies in how they are paid. Often they are paid by the entity they are doing the rating for.

Also, I am a little concerned about the fact that once something is rated, they are able to go from a bank which has issued a mortgage to a conglomeration putting together a package to be sold. Sometimes these ratings follow the customer, which also concerns me. Are you looking at the general subject of the credit rating agencies in terms of how they go about their business? Should there be any kind of a Federal role in this? I am not saying there should be; I am just asking the question about whether or not all this is being handled correctly.

My suspicion in watching all of this unfold over the last several months is that there is something not quite right in the whole credit rating agency business.

Governor Spitzer. As I think I said earlier and you have heard from some of your colleagues, there is a general perception that the credit rating agencies have not always picked up on those inflection points and led the market, rather they have followed, which is of course not really their purpose.

The particular issue you point to, which is the potential conflict of interest that derives from the fact that they are paid by the very entities whose ratings they are issuing, is something that has been examined and nobody has yet forced any change in that.

I think it is a fair topic of conversation. There are others who have suggested what I think is called a ``subscription model,'' everybody pays in and therefore there are different ways of generating the funding stream to do the credit analysis.

More particularly, I think just as regulated entities, they go back to the SEC in terms of the SEC having direct oversight of their behavior. I am not sure that means that the SEC should be faulted necessarily for not challenging this particular structure, but I do believe the SEC is examining right now whether the credit rating agencies themselves have been handling those determinations properly.

Mr. Castle. Thank you, Governor. I think it is at least a fair subject for examination. I am not sure what the outcome should be.

Governor Spitzer. Critical subject for examination because as I think we would all agree, if you cannot rely upon the value of those ratings which are relied upon for better or for worse by many investors, then a fundamental piece of information in the marketplace is not doing what it should be doing.

Mr. Castle. Thank you, Governor. I yield back, Mr. Chairman.

Mr. Bachus. Mr. Chairman, if I could ask unanimous consent to introduce into the record the Governor's signing statement on the legislation that would have restricted universal default, to offer that into the record.

Chairman Kanjorski. Is there any objection?

[No response]

Mr. Bachus. By the way, I totally agree with what you said in that signing statement.

Governor Spitzer. Thanks. I am happy to send you an original.

[Laughter]

Chairman Kanjorski. Without objection, it is so ordered.

Mrs. McCarthy of New York.

Mrs. McCarthy. Thank you. Thank you, Governor, for being here. One of the concerns that I have with all this fallout are my little towns and villages and their ratings and how that is going to be affected.

Certainly, on Long Island, where we are paying high taxes, each one of my villages is really just hanging on by a shoe string in the majority of cases, even when they need the capital improvements.

Following through with my colleague from Massachusetts, Mr. Capuano, when he was talking about when my villages apply for their ratings and basically have to pay extra money to be wrapped up so they can have a better rating, is there any way that the municipalities can get out of dealing with the bond insurance without putting at risk being the history, as my colleague has mentioned, the defaults are very, very, very rare?

Governor Spitzer. We can imagine a different structure but I think as of this moment, the reality is that for those municipalities, villages, towns, authorities, and agencies, the smaller entities whose creditworthiness is not routinely analyzed by the marketplace at large, it would end up being unfortunately somewhat difficult to float the bonds and gain the liquidity they need and actually get the marketplace to accept their debt offerings unless there is some arbiter of creditworthiness, which at this moment at least is or are the very credit agencies that we are talking about.

I can imagine an alternative structure where government itself, because as I think we have all agreed, the default rate among government issued debt is de minimis at most and really almost negligible and even where there has been technically a default, there has been payment, one can imagine another structure where that role was played by some other type of entity, so you would not necessarily need to go back to those particular entities that now fill that market function.

Mrs. McCarthy. Thank you. The other thing that I was curious about, when these bond agencies come into my village and they are basically negotiating, and I understand the bond insurance industry said they are separate, but when they wrap up somebody who might be an A or an A-, and they wrap them up and bring them up to a Triple A, is that not kind of a conflict of interest?

Governor Spitzer. I think the tensions that are there are real and as I said in response to Congressman Castle's questions, I think there are some issues that could be investigated and probed about whether or not that has played any role.

I think the larger problem is whether the underlying credit analysis itself has been proper, whether or not there was a conflict that motivated it, which is always harder to prove. I think there is now some sense that there has not been just the adequate analysis of much of this underlying debt.

Mrs. McCarthy. Thank you. Just to mention that I did not want you to think that I was ignoring you. I never do opening statements. I happen to believe that I would rather hear from the witnesses than everybody on the panel.

Thank you.

Governor Spitzer. Thank you.

Chairman Kanjorski. Mr. Price of Georgia.

Mr. Price. Thank you, Mr. Chairman. I appreciate it. Governor, welcome. We thank you for coming today.

I want to remind you and others that the title of this hearing is, ``The State of the Bond Insurance Industry.'' If I might ask a question about the bond insurance industry, and I will delve into the other things in just a moment.

Who is it that regulates the bond insurers?

Governor Spitzer. There are really multiple layers. There is one layer, obviously, the State insurance department, which oversees their solvency and that is something that we have done, which is why we are trying to recapitalize them. There are obviously many other entities that oversee aspects of what they do.

Mr. Price. In the area we are talking about right now, it is the States?

Governor Spitzer. We have a role; absolutely.

Mr. Price. Do you think that ought to change?

Governor Spitzer. As I said in my conversation with Congressman Royce, I think there is a discussion that could be had about a duality, that one could imagine an entire Federal overlay of regulation in the insurance sector at large.

I think if you are going to have a conversation about where insurance regulation should reside, Federal or State, the conversation should go way beyond the bond insurance sector.

That is as the chairman pointed out really a tiny subset of the marketplace. It is a subset right now that is critically important, but I think the larger question is does the Federal Government want to intercede and become part of the regulatory environment with respect to insurance.

Mr. Price. We got to where we are right now with the States regulating the bond insurers.

Governor Spitzer. No. We got where we are today because of a multitude and a sequence of decisions, and that is why I laid it out as I did in my testimony.

Mr. Price. I asked an incorrect question. Up until this point, the States have regulated the bond insurers and we find ourselves in the situation that we find ourselves for a variety of reasons that we could talk about. Would that be accurate?

Governor Spitzer. We could sparse that statement and say as each piece of it is correct, but I think it does not properly capture the causative factors that got us--

Mr. Price. I got you. You have had some criticisms, significant criticism for the OCC. Their jurisdiction is truly, in this instance, in this capacity, just over the national banks; is that not accurate?

Governor Spitzer. Their jurisdiction is to examine the creditworthiness and ensure the solvency of national banks but I would point out that was the foundation upon which they argued that we at the State level in an effort that all 50 attorneys general and the 50 State treasurers of both parties sought to participate in, to examine the issuance of much of the subprime debt by subsidiaries of those national banks.

In other words, much of that was issued by subsidiaries of the national banks.

Mr. Price. I will get to the subsidiaries in just a second. You are not suggesting that the OCC ought to regulate the State banks?

Governor Spitzer. No, we are not. What we are suggesting is that the OCC, when it sought to preclude, if you were to go back to the litigation where the States sought to overturn the preemptive acts of the OCC, what we sought to argue, unsuccessfully as a matter of law, but I think as a matter of policy, we were correct, that by acting as it did, the OCC prevented States from enforcing laws of general applicability in terms of both consumer fraud and fairness and consumer protection with respect to an entire sector that has now, to use the chairman's phrase, metastasized, such that much of that debt has become toxic in the capital markets.

Mr. Price. I think there is some question as to whether or not the preemption actually provided for that to occur or not.

Governor Spitzer. Could I interrupt for just one second? I think you and I might agree on that point, but the preemption that they invoked was deemed sufficient, as a matter of law. They won in the Second Circuit.

Mr. Price. I got you. I'm running out of time.

Governor Spitzer. In other words, they succeeded as a matter of law.

Mr. Price. It is my understanding of the subprime loans that are out there, that the financial banks were responsible and their subsidiaries for only about 10 percent. Is that a number you would agree with, in that ball park?

Governor Spitzer. I simply do not have that number before me right now. I do not know.

Mr. Price. I think that is probably the case. That is my understanding. I would hope that as we concentrate on the issue of the bond insurers and for whom we ought to address a solution, if there is in fact a Federal solution, that the OCC and national banks are probably not the area where the bulk of the problem lies.

Governor Spitzer. Again, I think it would depend on how you measure it. As I said, the preemptive acts and the preemptive efforts by the national banks was read as broadly as possible.

We were successful, the State of New York and many other States, many multi-State actions in changing behavior. One of the early cases was Delta. Then there were a sequence of cases with settlements and change in behavior that totaled hundreds of millions of dollars over the course of the intervening years.

We were pursuing this in a multi-State level with as much breadth as was possible against those non-Federal banks as we could.

Mr. Price. One final question, if I may, Governor. I am aware of some press reports that there has been some pressure that has been placed on rating agencies by New York State officials to delay further downgrades of the bond insurers during the bailout discussions organized by your superintendent.

Are you aware of those reports and if so, are they true?

Governor Spitzer. I have seen those reports. In fact, I would say if there are reports which discuss pressure, those would be improper. In other words, it would be wrong for any government entity to pressure a rating agency to do anything one way or the other in terms of an analysis of the creditworthiness of an institution.

There have been conversations with the rating agencies. I have not had any, but I know there have been conversations including Federal officials at many Federal agencies as well as State agencies to keep them informed of what is happening because it is critically important information for them to make their appropriate and relevant determinations.

They have sought information as a part of their effort to ensure the flow of information they are responsible for into the marketplace is accurate.

They have sought and been provided with ongoing information about what is transpiring.

Mr. Price. You would not describe those as pressure, those conversations?

Governor Spitzer. As I said, I have not had any of those conversations personally. I have had zero contact with the rating agencies.

I know that Federal entities and individuals have. State entities have as well.

Not having been a party to them, I was not there, but I would say that certainly nobody should or would and that I am aware of, nobody has, done anything that would suggest pressure. It is a question of keeping them informed.

Mr. Price. Thank you. Thank you, Mr. Chairman.

Chairman Kanjorski. Mr. Scott of Georgia.

Mr. Scott. Thank you, Mr. Chairman.

Governor, I would like very much to get your thoughts on what Congress has done so far, particularly given the fact that from what I understand, you are saying that so many of our subprime mortgages or the insurance for those are provided by bond insurance companies, costs are going on, there is a direct impact on what is happening from the frontal cause of the subprime mortgage crisis, as you point out in both your testimony and in your statements.

I think it would be very interesting for the committee to know what your thoughts are on the reaction that Congress has given so far to this, and the economic stimulus package.

First of all, is this sufficient? Does it get to where we are? Is there something more we need to do, specifically in the part where we are trying to deal with some stemming of the foreclosure rate in terms of expanding the loan capacities of FHA loans with the Federal Government guarantee, and also this 1-year extension of increasing the loan limits for Freddie Mac and Fannie Mae from about $430,000 level mortgages up to about $785,000 mortgages.

Your thoughts on that. Is what we have done so far sufficient to kind of respond to this, and what would you recommend we do going forward?

Governor Spitzer. I would say the response has been judicious and measured and thoughtful. I think it has all been affirmative but the bottom line, not sufficient.

I think that the inquiry the chairman is conducting today is hugely important and the ideas that the chairman has proposed in terms of using as a final backstop the notion of a Federal guarantee is an important notion to place in the marketplace. Hopefully, we do not need to get there.

Having said that, I think it is a concept that perhaps would have been more important and more useful as a stimulus package than the stimulus package that was actually enacted, which is certainly beneficial and helpful to many consumers and taxpayers and will help and provide some supposedly measurable bump to the economy, but did not address the underlying credit crisis that I think is what is hindering the economic growth at this moment.

I think that the notions of resuscitating credit by relieving the credit markets of some of the overhang of the bad debt would probably be more important in the long run.

Mr. Scott. Let me ask your opinion on the national regulator. You may have mentioned that prior to my coming in.

Where do you fall down on that and why?

Governor Spitzer. I think it is a notion we should discuss. As I mentioned, it is an issue I raised and a notion I raised several years back when I was involved in another set of inquiries into the insurance sector.

There did not at that point in time seem to be tremendous receptivity for the notion here in D.C., but I think as an overlay on some of the State regulation, it is certainly something we should consider.

As an effort to supplant entirely State regulation, I think you would find significant opposition, and I think you would also find significant opposition if it were an effort to impose regulation and then preempt State regulations with a bar that was too low in terms of the effectiveness of the regulatory framework.

Mr. Scott. Let me just get your thoughts on this somewhat complicated issue of the impact on municipal bonds. I am particularly concerned about that because so many of our smaller and rural communities rely on municipal bonding.

I am just concerned about the impact that is being placed on this from these just astronomical higher borrowing costs, and what impact that will have on their capital projects.

Governor Spitzer. It will have unfortunately a very detrimental effect. In my testimony, you will see that I delineate at least three victims, as it were, of the current credit crisis. One of them is the municipal governments whose resources, scarce resources, especially these days, are being forced to be used to pay higher interest rates, and if you look at the auction rate security market, just yesterday, a lot of that debt was reset as high as 20 percent, those are scarce dollars that are now being used to pay interest rates that should be much lower if you merely look at the credit risk of the underlying securities.

Mr. Scott. Finally, I have a serious problem with these teaser rates. How do you feel about these teaser rates? Should we get to a point where we should just basically outlaw them?

So much of the problem that we have now with our mortgages, these loan originators are going in there knowing full well that these people cannot pay. Their credit is bad. They tease them in. When the adjustable rates come in, you know, there goes the home.

Governor Spitzer. Congressman, I think what we have is a crisis that results from the inappropriate marketing of many mortgages and borrowing by individuals who did not perhaps understand what the transaction was.

It is very hard to define what a teaser rate would be in any individual transaction, in any individual instance, and who can pay what.

What we have focused on more in our effort, whether it was some of the cases I made when I was attorney general, or where we are now crafting legislation at the State level, is to ensure that there be an analysis done to ensure a capacity to pay.

Often what happens with much of the subprime debt is people saw a teaser rate that did, as the term would suggest, seduce them in, but no underlying analysis was done about the capacity of the borrower to pay once that teaser rate expired and there was a significant jump to the rate that would apply for most of the duration of the mortgage.

We have sought to ensure that lenders go through that sort of analysis in order not to create the sorts of problems that we have today.

Mr. Scott. Thank you, Mr. Chairman.

Mr. Price. Mr. Chairman?

Chairman Kanjorski. Yes, Mr. Price.

Mr. Price. Thank you, Mr. Chairman. I ask unanimous consent that a statement from the Comptroller of the Currency, Mr. Dugan, be allowed to be placed into the record.

Chairman Kanjorski. Without objection, it is so ordered.

Mr. Price. Thank you.

Chairman Kanjorski. Mrs. Capito, you are recognized for 5 minutes.

Mrs. Capito. Thank you, Mr. Chairman. Thank you, Governor, for being here today.

I have two questions. First of all, I want to ask with the chairman's permission to insert into the record a letter from my community bankers.

Chairman Kanjorski. Without objection, it is so ordered.

Ms. Capito. I am from the State of West Virginia, a very rural State.

Knowing you were going to be before us when we were talking about bond insurance, they are calling attention to H.R. 2091, which would allow community banks to partner with Federal Home Loan Banks. It is actually not in our jurisdiction but I wanted to highlight that.

They feel that this legislation would allow our banks to assist smaller West Virginia communities, charitable health care facilities and institutions of higher education to raise tax exempt funds where such borrowers are unable to obtain bond insurance or letters of credit from large market players on or at more attractive terms.

Do you find as Governor of your State that you do have these entities that are really sort of left out because of the expense of the bond insurance and other things, and that we need to try to find, for instance, something like this, to be more a more creative backstop for them?

Governor Spitzer. I certainly support the concept of providing greater access to the capital markets in ways that might circumvent the need to get the bond insurance. I am not sure I could say definitively as I sit here that there are entities in New York State that have been precluded from getting the raise in capital they need because of this. I just do not know if that is how the market has played out.

I certainly believe as we look back now at the premiums that are paid and ask what is the value derived for it, that is a fair question, whether government entities are getting fair value or whether or not this is the best mechanism for them to raise capital.

Mrs. Capito. I think this is a topic I would like to get into in terms of small community banks.

The other thing I would like to ask you is in our background information on this hearing, I have been reading about this because this is very complicated and most of the bond insurers, I understand, are domiciled in New York? Is that correct, as far as you know?

Governor Spitzer. I think most of them are, yes; that is correct. Some of them are elsewhere in the Nation, but yes, most of them are in New York State.

Mrs. Capito. It goes onto say that generally speaking, since they are State regulated, that basically New York State is sort of looked at as the marque.

Do you feel that because most of these entities are domiciled in New York--do you feel like your insurance commissioner or you call him the--

Governor Spitzer. Superintendent.

Mrs. Capito. --superintendent, has been a default Federal regulator?

Governor Spitzer. I think it is to a certain extent the case that when there are a limited number of entities that act in a particular sector and they all, as you say, by default or by statute are regulated by one entity, it has a national impact. One could even argue an international impact.

By virtue of that, yes, the superintendent's office in New York has become the regulatory entity that has defined to a certain extent the playing field.

Mrs. Capito. Taking that one step forward in defining some of the issues, and I realize that you have lined out several areas where you think maybe to lay the blame or wherever things fell through the cracks or however you want to state it, lessons learned, I guess, through your superintendent being the default Federal supervisor over these bond insurers.

I suppose we could look to New York to help us develop in a very professional way ways that we could avoid this in the future.

Governor Spitzer. I certainly would hope so. The superintendent is sitting right behind me. I think he will be on your next panel. I am sure he will volunteer some ideas that he thinks at least will benefit or could benefit the marketplace as we move forward to try to create that regulatory framework.

Mrs. Capito. Thank you, Governor. Lastly, I would like to echo some of the comments of my fellow members from the other side of the aisle.

In representing small communities, it is extremely important for infrastructure development, for clean water, for all the things that maybe big city livers think, you know, everybody has, we still have a great need and I know you do in the State of New York as well.

The stability in this market and affordability is extremely important for us to be able to move forward.

I thank you.

Governor Spitzer. Thank you.

Chairman Kanjorski. Thank you, Mrs. Capito. Ms. Moore?

Ms. Moore. Thank you so much, Mr. Chairman, and thank you, Governor.

I have listened very carefully and perused your testimony with great interest. You seem to have laid out really where you think this problem has started, with the subprime miss and the underwriting that was poorly done or fraudulent, whatever the case may be, and then step two, securitization, which you say will continue. We cannot really look at that not being something that we are not going to do.

And then the credit rating agencies, make them appear to be safe, and then finally, the monoline insurers, make them appear to be even more safe.

Here we are talking about more Federal oversight. Do you think that it is possible that these monoline insurers have done a great job with floating municipal bonds?

We all agree it is very little de minimis risk, and this is what they were accustomed to doing, and in order to remain competitive and to have more customers, they sort of ran ahead of their lights.

When they are evaluating the risk, there are three things they look at: Credit risk; market risk; and liquidity risk.

Do you think it is possible that there is something missing? I do not know what it would be called, maybe re-marketing risk. It seems that at the point at which the underwriting is bad and the securitization occurs, that there just seems to be a rubber stamp, rubber stamp, rubber stamp to these monoline insurers.

Is it possible or is there any discussions going on about revamping or re-evaluating how risk is evaluated, particularly as these asset backed securities and credit swaps occur?

I do not know. Maybe this will be a re-marketing or transitory risk added on top of it. Sort of like your mother's favorite recipe. You start adding more stuff in and taking other stuff out. It is not what you are used to in the recipe.

Governor Spitzer. At risk of picking up on your metaphor because I am not a great chef, but I think really what happens is they just completely changed the recipe.

I think what happened was when they were dealing with the municipal debt, basically the market would say got it right, and as you pointed out, they were reasonably effective, and you could argue, and some of your colleagues have said that the towns and villages around the Nation did not necessarily either need them or get full value and they felt somewhat abused by the fee structure, and that is a fair topic of conversation.

I think nobody has yet really challenged the underlying analysis they conducted in that context, whereas when you switch over to the other sectors in which they were active, you do begin to feel that somehow the analysis was lacking and the analysis upon which they relied and which they then projected into the marketplace was inadequate.

Ms. Moore. My question is, do you know of, or is this another panel's question, is there any conversation about evaluating these indices of risk?

These are very broad generalized indicators. Credit risk, market risk, liquidity risk. When is the last time they have revamped these? We have all these new derivatives and new products.

When is the last time that they have really overhauled how they look at risk?

Governor Spitzer. I think part of the problem is they just got it wrong, when we now look back at some of the analysis that was done about some of the more sophisticated instruments and the underlying debt, people now say wait a minute, it was much more risky than was understood.

I am not sure the methodology was wrong. They just drew the wrong conclusions because they did not look at the data, did not gather the right data. There was this enormous--as I said earlier on, they tried to homogenize a lot of bad debt and somehow by the end claim it was good debt. You cannot do that.

The analysis was wrong. It has come back to bite us.

Ms. Moore. Without trying to assign more or less guilt, it concerns me that the monoline insurers have a really strong profit incentive, you know, in order to expand their business from their usual municipality bond rating, to not really evaluate the risk.

Did they know that these securitized instruments were as risky as they were? Did they know that the underwriting was tenuous? Were they just bamboozled, lied to?

Governor Spitzer. I have not seen any evidence to suggest that they knowingly misstated risk or that they knowingly took their credit rating by insuring the underlying debt and therefore put themselves at risk.

I think you could argue that if they intended to play that game, they are now the ultimate losers because if there is, and it is an ``if,'' if there is a successful effort to recapitalize themselves, their own companies, there will be significant dilution to current shareholders.

It has not been in their interest to play that game if that is what they understood. I think it is more likely they just got it wrong.

Ms. Moore. My time is running out. Just one last question. What we have to determine here in Congress is whether to regulate more, get some other bureaucracy in place to regulate again, or have the industry inside to sort of re-assess how they evaluate risk.

Do we do both? Do we do one or the other or what?

Governor Spitzer. We certainly at this point think about doing both. There is no question that the re-insurance companies as well as the credit agencies themselves and all the other entities involved in the steps that preceded are going to have to evaluate what they did and how they did it.

The bottom line answer to your question is certainly the re-insurance companies are looking very hard at what they did and how they extended the re-insurance. The credit analyst companies are doing the same thing.

As the chairman suggested, there is serious thought being given to an overlay of a Federal regulatory structure that could perhaps lend some additional buttressing to this entire effort.

Ms. Moore. Thank you.

Chairman Kanjorski. Thank you, Ms. Moore. Mrs. Maloney of New York, one of your constituents, Governor.

Mrs. Maloney. Thank you very much, Mr. Chairman, for giving me the privilege to ask a question even though I am not a member of this particular subcommittee, but I am a member of the overall committee.

First of all, welcome, Governor, and thank you for your help and your department's help in the passage of TRIA, the reform bill. It is very, very important. It is good to see you here trying to help us with this challenge today.

First of all, very briefly, how did the bond insurance marketplace get to where it is now, and is it possible for this sector to continue as an Triple A business?

Governor Spitzer. Very briefly, it got to where it is today by evolving from what we refer to as the monolines, where they really did limit themselves to the municipal market and expanded their scope in the insurance they extended to much more sophisticated and what we now know to be much more risky types of investments in securities.

Can they maintain themselves as a Triple A? Of course. Will that necessarily happen? Only the marketplace will let us know hopefully in the next few days as we see what steps are taken to recapitalize either those companies or new companies emerging to step into that void.

Mrs. Maloney. Governor, what will you do if the financial guarantee insurers are unable to complete their own restructuring deals?

Governor Spitzer. What I have suggested and I think the superintendent will testify to some greater detail about is if the progression is such that there is no opportunity to resuscitate the existing companies by recapitalizing them, it would perhaps--this is not our optimal choice--it would perhaps be necessary to move forward with what have been referred to as a good bank/bad bank structure to protect the municipal marketplace, which is at its core the first marketplace that we should be concerned with.

Mrs. Maloney. What does the Berkshire Hathaway offer mean to the industry, and would you ever insist or compel a company to accept the Berkshire offer?

Governor Spitzer. I would state it differently. I think one can imagine--first of all, I would say the offer has been beneficial to the marketplace. I think when it became public that offer had been extended, I am not sure there is necessarily causation, but the Dow jumped pretty quickly.

I think the marketplace appears at least to have taken that as a positive sign with respect to the likelihood of the bond reinsurers' underlying economic security.

Having said that, I am not sure that we would in as many words force companies to enter into a transaction where they accepted that offer.

The superintendent has significant regulatory authority and he can explain the scope of it a bit later on.

I am not sure I would use the words ``force them'' to enter into that transaction.

Mrs. Maloney. What regulatory lessons have you learned from this experience?

Governor Spitzer. I think once again there was an accretion of market steps, each of which contributed to the situation we are in right now, and that is why I replayed that sequence to make it clear that there were a series of moments where intervention would have been possible, could have been called for, and the due diligence that was done perhaps was not sufficient to prevent our getting to a point where we now have a very significant volume of debt that has been insured where the underlying debt insurer claimed to be Triple A, where the underlying debt is really significantly more at risk.

Mrs. Maloney. Lastly, the OCC decision, many of us are being criticized now in Congress and regulators are being criticized that we did not act quickly enough in the subprime crisis, that we did not intervene earlier.

What is your view of the decision that really said that attorneys general could not get involved in the subprime problem solving and were preempted by the OCC?

Governor Spitzer. I disagree with the OCC's actions in that regard, in extending their notion of preemption to extend not only to all subsidiaries of national banks but in a way that precluded the application of laws of general applicability in terms of consumer fraud and certain principles of fairness that should be taken as elementary in the capital markets.

Having said that, I think the lesson we take from that is that as we discuss the potential of Federal regulation here, we need to be careful that the mere presence of a Federal regulation does not give us some false sense of comfort, that by the mere presence of a Federal regulatory entity, all problems will be solved.

I think that regulatory entities, whether at the State or Federal level, can be either successful or unsuccessful based upon who runs them and what their view is of the marketplace and whether they have the appropriate decision making capacity.

Mrs. Maloney. Certainly the question is if someone wants to help a consumer, why in the world would you cut off the opportunity to help the consumer.

Governor Spitzer. In that vein, we were somewhat frustrated, as I said, by the OCC's response, and as we said to them, fine, if your view is you are the exclusive entity that can in fact oversee this area, then at least we would like to see you fulfill that mandate.

What frustrated us was that having invoked preemption, the OCC then stepped away from the problem and permitted it to fester.

Mrs. Maloney. My time has expired. Thank you very much for being with us today.

Governor Spitzer. Thank you, my good friend, Congresswoman Maloney.

Mrs. Maloney. Thank you.

Chairman Kanjorski. Thank you, Mrs. Maloney.

I thank the Governor for participating in today's hearing. We have a vote in process on the House Floor. We are going to stand in recess to make that vote and then come back for the second panel who will be taking their place in the interim.

Governor, I want to thank you for your participation today. We certainly have an issue here that is not only important to this committee and to the Federal Government, but certainly to the State of New York. We hope to work in cooperation to come up with some solutions, I want to say in the plural, to see if we cannot stabilize and increase the faith and support of this great marketplace without further erosion to the American economy.

I thank you very much for coming and participating today.

Governor Spitzer. Thank you, Mr. Chairman.

[Recess]

Chairman Kanjorski. I cannot say this never happens but it does not happen quite as severely as it happened today.

I was thinking on the Floor, for a hearing that was supposed to start at 10:00, we had a death in the House that interfered with our starting time. Then we had a motion during the memorial service that caused a personal privilege question that went on the Floor, and then we had 12 or 14 votes interspersed there.

We actually were--some people would call it ``working''--we actually were occupying our time. I am not sure we were working.

This among other panels in the House have been held up severely because of that.

I do not know how I make up for Mr. Sirri's wife and the plane on Valentine's Day. You will just have to tell her that it was because we love you so much that we kept you here.

[Laughter]

Chairman Kanjorski. We will make it up to her in some way, do something.

I was talking with the Governor. We were talking over some of the testimonies and how much we were looking forward to these two additional panels.

First, let me welcome the second distinguished panel. I see the Mayor is here, too. Very good.

Our first witness will be the Honorable Eric Dinallo, superintendent of the New York State Insurance Department.

Mr. Dinallo?

STATEMENT OF ERIC R. DINALLO, SUPERINTENDENT, NEW YORK STATE INSURANCE DEPARTMENT

Mr. Dinallo. Thank you, Mr. Chairman, it is a pleasure to be here. You obviously heard from the Governor. We have also separately submitted about 30 pages of material to you.

I thought I would just take the time to just go over for you what the Department of Insurance is doing and what our plans are, and a brief chronology of how we got here today I thought would be helpful.

I took office in very late January at the Department. I first became concerned in the early spring when MBIA requested the billion dollar dividend that was referred to previously.

It was within the four corners of the law and had been previously okay'ed by my predecessor, and in fact, even when it was okay'ed by him, the company was Triple A rated by all the rating agencies, and in fact, no monoline insurer had been downgraded, and there was no concern for the subprime area at that time.

I was beginning to have some concerns about the economy and about the subprime area. It was extraordinary but I reversed the decision, so to speak, and I cut it in half is what I did, based on where I thought we were.

That, so to speak, is actually something that I am proud of, not very embarrassed of. I wish Congressman Bachus was here to talk about it, but I thought it was the right decision and it seemed to be the prudent thing to do.

Then they came back in June or July, I do not remember when. I think it was early to mid-summer, requesting another $500 million, the balance of the billion.

At that time, they were still Triple A rated by all the insurers. No monoline had been downgraded. All the senior traunches, in fact, all of the CEOs were at their original ratings, there had been no indication of what was coming, but we denied that request because I just felt and the Department felt and the staff at the Department felt that what looked like on the horizon as a potential for a recession or something around the subprime area made it so that we wanted to decline it and we did.

Obviously, there are regular dividends. We cannot really decline those. Those are in the statute. Indeed, these are publicly traded companies. I think there would be other regulators that would have a problem if we went to court and without the proper basis started to put a request on stopping the dividends.

At that same time, we sent inquiries to the financial guarantee insurance companies concerning their activities in these areas. We also began the process of getting permission to hear directly from the rating agencies about the financial guarantee companies and that the financial guarantee companies would agree to give us sort of real time information about their process with the rating agencies.

We began to have regular meetings with them and almost daily contacts. We began some discussion at the staff level with the Federal Reserve and other regulators.

In the fall, it became apparent that the rating agencies were possibly going to downgrade some of the monolines. We continued to meet with them on a regular basis. The company would keep in daily contact with us. We had a very good dialogue with the rating agencies at this point.

The subprime situation then was starting to deteriorate. We had concerns over the broader financial markets.

That would bring us to about the very beginning of November, maybe late October, and we developed a three point plan at that point.

Here was the three point plan: to inject or seek to inject new capital into preexistent monoline insurers, and to begin to bring other players into the monoline industry who were not encumbered, sort of fresh capital in freshly minted companies, to deal with potentially distressed companies in the monoline area, and to sort of re-write the rules of the road, begin to think about how to re-write the regulations in this area.

We also then send inquiries to the monoline companies concerning exactly where their positions were on structured investment vehicles.

On November 15th, I called Ajit Jain of Berkshire Hathaway and asked him if we could talk about the possibility of Berkshire entering the market, and I sort of promised him we could get him a license in a week or two. My staff fainted apparently when that was communicated to them.

We did proceed at a record pace and we had them licensed by the end of the year, and started the process of having them licensed across the country working with NAIC, and that was the beginning of the execution of point number one of the plan.

We then started to facilitate injection of capital into preexistent players. With MBIA, we very quickly facilitated the senior note that was for, I believe, $1 billion.

We became concerned that Ambac at pretty much the middle of January was potentially going to suffer a downgrade, and we sent examiners to Ambac on January 17th and 18th, I think.

Although it is regulated primarily by Wisconsin, they are in New York City, and I felt that we needed to make sure we were on top of any situation that could be developing.

From January 7th to the 19th, we held daily meetings and calls with the companies, the rating agencies, and some of the Federal authorities. We had lots of internal meetings.

Over the Martin Luther King weekend, I received some very concerned calls from some of the counterparties, some of the insurance companies and some of the representatives of those parties.

I cut my family trip short and had a lot of those conversations and then came in on Martin Luther King Day to meet again with Ajit Jain to ask him if he could give us a price for the municipal side of the book.

The letter that you have heard about, his offer on the municipal side of the book, was something that came out of conversation with him over Martin Luther King Day weekend.

And then we come to Tuesday, January 22nd. We called the rating agencies to get a feel for what kind of capital would be necessary across the whole space, not a company by company discussion, and we got an answer of something in the magnitude of $5 billion currently, but of course, estimates and assumptions could change and it could go as high as an additional $10 billion.

On that same day, I called about 10 or 12 of the investment banks who were counterparties to the insurance companies, asked them to come in. We held a meeting at the Department on the 23rd. At the meeting, I sought their advice and said here is the problem, which I will lay out in a second, and I asked them what they would do with the following concerns that I had.

The concerns were that we were potentially looking at a systemic or credit freeze if there was a downgrade, that there were potential markdowns of the books they were holding if there was such a downgrade, and with a downgrade of one of the insurance companies, would come not just a mark down of their books at the banks, but also a capital call because now instead of holding Triple A, they were holding say Triple B, and that requires a lot more capital to hold those on the books of the investment banks.

I was concerned about the auction rate security market looking sort of down the horizon. I thought the optics were going to be difficult, that if in some way it seemed that Wall Street hurt the municipal side of the book here, it would be a damaging situation.

I was very concerned that downgrades were coming in the next several days and there could be a lack of confidence if we did not come up with a plan.

The solutions we discussed at the meeting were the $5 billion of a potential equity investment with a $10 billion backstop, or a $10 billion line of credit, a backstop rights' offering, or some other kinds of capital infusions where maybe at the beginning if the insurance companies were corrected, they were totally okay, it would be less beneficial to the banks, and if the insurance companies were wrong, more control by the investors would come at that point.

I discussed that the potential outcomes were basically either some kind of a capital infusion or as has been reported, there might be a split of the book. That was talked about way back then. It is not something that just came up out of desperation. It has been something that we have been discussing for several weeks.

I also told them that I was considering having the Department retain an advisor in the form of Corrella & Weinberg, and they thought that was a good idea, because we would have to communicate about complex deals, etc.

For the next couple of weeks, I sort of felt a little bit like Cassandra or Will Smith in ``I Am Legend,'' because I went around trying to make sure that people understood how serious the problem was potentially.

I spoke to a lot of the banks, their CEOs, whom I had originally called on that day, the insurers and the rating agencies. I also spoke to other sources of potential income, large shareholders in the companies themselves, private equity, large insurers outside of the space, and held constant meetings to sort of begin to determine what the best path is.

Here we are today, I can sort of conclude and just tell you where we are in the three point plan. Obviously, some of the companies are in discussions with their counterparties. There are possible deals. I have optimism. Nothing is a certainty. I do believe that a lot of progress has been made.

But remember, there are several monoline insurers and you could have different outcomes for each one. For some, you could have a split book. For some, you could have a consortium based capital infusion, and for some, you could have some kind of a good book/bad book outcome.

In all of those, you are sort of dealing with what is clearly a distressed situation.

On the rules of the road, we are working very hard on that. We do have the beginnings of drafts of regulations, which I am happy to share and I want expert input on that.

Obviously, on new capital and new players, you see the results with Berkshire Hathaway, and other large institutions, large financial institutions have come in and have applied to begin the process of being a monoline insurer with us.

The hallmark here is that under no circumstances, I think, should the whole book get downgraded. The municipal book should be preserved. That was always the point of having the meeting. It was not about bailing out these insurers or in some ways worrying about the stock price of the companies.

It was always about the policyholders and that you need the Triple A rating to have that across-the-board, and to get to what we did wrong--I am actually proud of what we have done across the year. I am even proud of the Department's work in this historically.

What I think we did wrong, and I can explain more later, is there is a very important distinction between a Triple A rating and the solvency of an insurance company. They are not the same thing. I can explain some more of that in questions and answers.

I think we could regulate more towards the rating in the monoline because it turns out that the rating is maybe as important as the solvency of the company when you are linking everyone's Wall Street activity to it.

Thank you.

[The prepared statement of Mr. Dinallo can be found on page 219 of the appendix.]

Chairman Kanjorski. Thank you very much, Mr. Dinallo.

Next we will hear from Erik R. Sirri, Director of the Division of Trading and Markets, United States Securities and Exchange Commission.

STATEMENT OF ERIK R. SIRRI, DIRECTOR, DIVISION OF TRADING AND MARKETS, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. Sirri. Chairman Kanjorski, and members of the subcommittee, thank you for inviting me here to testify on behalf of the SEC about recent events in the financial markets and the implications arising from concerns about the creditworthiness of certain bond insurers.

As a threshold matter, the Commission does not regulate these financial guarantors, commonly known as monoline insurers. However, the securities markets and their participants, which the Commission does regulate, may be affected by the declining creditworthiness of the monoline insurers.

One example of this is the large securities firms or investment banks that the Commission supervises on a consolidated basis through its CSE or Consolidated Supervised Entity Program.

Commission staff has discussed and reviewed the CSE's current and potential exposure to monoline insurers. These exposures fall into three categories: Credit risk; market risk; and liquidity risk.

In terms of credit risk, many CSE's firms execute derivatives trade with monolines, generating direct counterparty credit exposure. For instance, a CSE may purchase a credit default swap from a monoline. In such a transaction, should the credit underlying the credit default swap default, the monoline would be expected to make a protection payment to the CSE.

In terms of market risk, the CSE firms are exposed to the perceived creditworthiness of monolines through wrapped securities they may hold in inventory. These include municipal securities, tender option bonds, auction rate securities, and certain mortgage products.

In addition, most of the CSE firms have trading and hedging positions linked to the monolines' creditworthiness. Finally, the CSE firms may also have an implicit and explicit liquidity risk exposure to monolines through their activities as re-marketing agents for certain products, such as auction rate securities and tender option bonds.

These programs fund longer term obligations such as municipal debt with liabilities that have characteristics of short term paper. Often, monolines wrap the underlying long term obligations. A CSE may be at a liquidity risk explicitly by acting as a liquidity provider for a particular program. For example, for tender option bonds or variable rate demand obligations.

A CSE bears an implicit liquidity risk when acting as the re-marketing agent on a program, as it may decide to support the program and take securities on its balance sheet out of client franchise considerations.

The CSE firms are highly aware and actively manage their exposures to the monoline sector. Although the exposures may in some instances be significant, based on the information available to us through our supervision of the firms, we believe the CSEs have adequate capital and liquidity to deal with the consequences of a downgrade or even default of one or more monoline insurers.

The Credit Rating Agency Reform Act of 2006 permits credit rating agencies to apply to register with the Commission as nationally recognized statistical rating organizations or NRSROs, and establishes a regulatory regime for those that become registered.

Nine credit rating agencies have voluntarily registered as NRSROs, including three that assign ratings to monoline insurers, Fitch, Moody's, and S&P.

Beginning in December 2007, these three rating agencies have undertaken a number of rating actions on monoline insurers. Each of the three has issued downgrades to the ratings of certain monoline insurers and each has placed others on review for possible downgrade.

The rating actions on monoline insurers have primarily been driven by the poor performance of subprime residential mortgage-backed securities and CDOs, for which the monoline insurers have provided guarantees.

Using our new authority, the Commission staff has been examining credit rating agencies to see if they diverge from their stated methodologies and procedures for determining credit ratings, and to see if they follow their stated procedures for managing conflicts of interest.

I expect the findings of these examinations will better inform the Commission's oversight of rating agencies including the ratings of monoline insurers.

The Commission staff is also closely monitoring developments in the municipal securities markets to the concerns about creditworthiness of monoline insurers, and the actual or potential downgrades of bond insurers and associated rating changes on insured municipal securities, which comprise about half of all outstanding municipal bonds.

Downgrades and withdrawals of ratings on many bonds issues result from the downgrades of a bond insurer. Although such downgrades will negatively effect the prices of most bonds insured by the companies that have been downgraded, the issuers with primary responsibility for the payment of these securities generally have been investment grade credits or higher, investment grade credits or equivalent credit string, mitigating the effect of downgrades for other insurance providers.

We are aware of the failures of recent auctions of auction rate securities in the municipal and corporate markets in which too few bidders participated in the auction to establish a clearing rate resulting in higher interest rates on those securities for a period of time.

The Commission staff is closely monitoring these bonds with respect to bond insurers and their actual or potential effects on municipal bond and money market funds.

Investment companies of all types hold 37 percent of the $2.5 trillion municipal securities bonds outstanding. The vast majority of these municipal bonds that funds hold are in so-called municipal or tax exempt funds. A small percentage of the tax exempt funds primarily invest their assets in municipal bonds that carry insurance issued by the monolines.

These funds generally have the word ``insured'' in their name and have an investment policy that requires at least 80 percent of their assets be invested in muni bonds, the payment of interest and principal on which is guaranteed by a Triple A rated insurance company.

Although it is difficult to predict the effective declining creditworthiness of bond insurers on municipal bond funds, a downgrade may require many insured funds to change their investment policy with respect to the rating quality of their portfolio holdings.

In addition, portfolio securities held by tax exempt money funds are often wrapped or guaranteed by monoline insurers, and may have liquidity backstops provided by large financial institutions.

In most cases, the liquidity backstops require that the muni bonds maintain certain ratings, which may be threatened by the ratings downgrade of the monolines.

Based on its oversight of the industry, Commission staff is presently unaware of any municipal money market fund currently threatened with breaking the buck as a result of recent downgrading and potential downgrading of the monoline insurers.

In the long term, however, the inability of bond insurers to maintain high credit ratings may restrict the supply of high quality paper for municipal money market funds.

Thank you for the opportunity to testify and I would be happy to answer any questions.

[The prepared statement of Mr. Sirri can be found on page 251 of the appendix.]

Chairman Kanjorski. Thank you. Next, we will hear from Patrick Parkinson, Deputy Director, Division of Research and Statistics, of the Board of Governors, Federal Reserve System.

The Federal Reserve does not regulate the monoline insurers, but clearly has an interest in the soundness of the overall financial system. As such, we understand it is monitoring the ongoing situation.

Moreover, many of the entities that the Federal Reserve directly regulates use the monolines as counterparties for their transactions.

Mr. Parkinson?

STATEMENT OF PATRICK M. PARKINSON, DEPUTY DIRECTOR, DIVISION OF RESEARCH AND STATISTICS, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. Parkinson. Chairman Kanjorski, and members of the subcommittee, thank you for the opportunity to testify on the potential effects on financial stability of further financial deterioration and ratings downgrades of financial guarantors.

The growing possibility of credit losses on certain collateralized debt obligations of asset backed securities has caused some of the guarantors to report financial losses and the rating agencies to require those guarantors to raise capital to maintain or regain their Triple A ratings.

Those guarantors reportedly are exploring various options for bolstering their financial strength but it is not clear that all of them will succeed. Thus, it is well worth thinking through how further downgrades to some guarantors' credit ratings might affect overall financial stability.

Such downgrades might adversely affect financial stability through several channels. These include: (1) the potential for disruptions to municipal bond markets; (2) potential losses and liquidity pressures on banks and securities firms that have exposures to guarantors; and (3) the potential for further erosion in investor confidence in financial markets generally.

Further downgrades of some guarantors could spark a retreat from a municipal bond market by some retail and institutional investors. Of particular concern is the potential for disruptions to the markets for short term securities based on municipal and other tax exempt debt.

These short term securities include tender option bonds and variable rate demand obligations, which typically have credit support from one of the guarantors and liquidity support from a large bank or securities firm, and auction rate securities, which often have credit support from a guarantor but have no explicit liquidity support.

Some money market funds reportedly have already drawn on liquidity support facilities for some securities insured by those guarantors with significant exposure to CDOs that contain subprime residential mortgage-backed securities.

In addition, earlier this week there was a rash of failures of auctions for student loan auction rate securities or ARS. Although largely unrelated to concerns about the financial guarantors, this development undermined confidence in auction rate securities generally, and subsequently quite a few auctions for municipal ARS have failed.

It appears that financial stress on the guarantors has restrained new issues of municipal bonds in recent weeks, although these effects are difficult to disentangle from the effects of tighter budgets for many municipalities, a deepening concern about the financial condition of some of the guarantors could at least temporarily limit the availability of credit and increase the cost of funding for some lower rated or smaller municipalities.

Over time, however, funding for those municipalities would be restored as the downgraded firms were replaced by the surviving healthy firms and by new entrants.

U.S. banks' direct exposures to losses from downgrades of guarantors' ratings appear to be moderate relative to the banks' capital. However, even if banks' losses from exposures to the guarantors are moderate relative to their capital, banks could experience significant balance sheet and liquidity pressures if they take significant volumes of tender option bonds or variable rate demand obligations onto their balance sheets.

If these banks take on significant enough volume of such securities, the resulting downward pressure on their capital ratios might prompt some of them to raise additional capital or constrain somewhat the growth of their balance sheets to ensure that they remain well-capitalized.

Efforts to constrain the growth of their balance sheets could be reflected in somewhat tighter credit standards and terms for a variety of bank borrowers, which would add to the financial head winds that the economy already is encountering.

In addition to the direct effects of stress of financial guarantors on the municipal bond markets and banks, stress on the guarantors could have adverse indirect effects on investor confidence in the financial markets generally.

If the drop in confidence was sudden, asset markets could become less liquid and asset prices could become more volatile.

However, a sudden drop in confidence seems unlikely. Financial market participants seem well aware of the difficulties the guarantors are facing and of the potential for further ratings downgrades.

The Federal Reserve has been carefully monitoring and assessing the channels through which deterioration in the financial condition of the guarantors could adversely affect financial stability.

As primary supervisor of State chartered banks that are members of the Federal Reserve System and umbrella supervisor for bank holding companies, the Federal Reserve has collected and analyzed information on banking organizations' exposures to the financial guarantors.

We also have been monitoring closely developments in the municipal securities markets and in the markets for residential mortgage-backed securities and asset-backed CDOs, from which the principal pressures on the guarantors have originated.

Thank you. I would be pleased to answer any questions you may have.

[The prepared statement of Mr. Parkinson can be found on page 244 of the appendix.]

Chairman Kanjorski. Thank you very much, Mr. Parkinson.

Finally, we come to my friend, the Mayor of the City of Wilkes-Barre, Mayor Leighton. Mayor, first I want to apologize. I know you intended to get out of the City by 4:00 today; we may make it if we hurry.

[Laughter]

Chairman Kanjorski. That is Washington speak.
[Laughter]
Chairman Kanjorski. If you will, Mr. Mayor. If you could give us the municipal reaction to all of these technical things we have been talking about up to this time.

STATEMENT OF THE HONORABLE THOMAS M. LEIGHTON, MAYOR, WILKES-BARRE, PENNSYLVANIA

Mr. Leighton. Chairman Kanjorski, and members of the House Financial Services' Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee, thank you for the opportunity to testify today on the need to find a solution to the turmoil in the bond insurance industry.

My name is Thomas M. Leighton and I am the Mayor of the City of Wilkes-Barre, a city in northeastern Pennsylvania. I am a constituent of Chairman Kanjorski who has been a leader in economic development issues in our area.

I would like to thank Chairman Kanjorski for inviting me here today and commend him for taking the initiative on this very important issue.

Wilkes-Barre is the urban core and seat of Luzerne County, welcoming nearly 100,000 people to our City each day. We have the 4th largest downtown workforce in Pennsylvania, but this number drastically decreases after the 9:00 to 5:00 p.m. rush. We face significant challenges providing municipal services for the substantial workforce because only 45,000 residents contribute to the City's tax base.

Upon taking office in 2004, my administration was faced with over $10 million in unpaid bills in a technical bond default by one of the City's authorities. Because of this default in 2002, the City could not utilize traditional bank financing because of our weak credit rating. These circumstances combined with inherent regional economics created a bleak financial outlook for the City of Wilkes-Barre.

After working diligently to re-establish the City's finances and maintain our fiscal responsibility, Ambac Financial Group agreed to insure $40 million of debt restructuring and new money. Without Ambac's willingness to help the City, major layoffs or tax increases would have been necessary. Ambac's confidence in the City's future gave us the opportunity to access the marketplace, allowing the City to continue on a path to a solid financial future.

Despite making great strides financially, the City of Wilkes-Barre still struggles to obtain bond insurance, especially at competitive rates. As a result, turmoil in the municipal bond market is a significant concern for the City of Wilkes-Barre.

Similar to many other mid-sized cities across the Nation, we rely on monolines. When they are faced with volatility in the market, there is volatility for us.

Many small issuers such as the City of Wilkes-Barre are dependent on credit enhancements. Without them, we cannot access much needed capital for public projects, such as street paving, sewer repairs, and other major infrastructure improvements. As we work to advance our City, cutbacks in basic services like these are not an option.

Currently, the economic climate in Wilkes-Barre is weakening due to the growing expenditures and declining revenues. For example, the subprime mortgage crisis has resulted in increased foreclosures and decreasing tax revenues. Increased need for City services are challenged by lower revenues and budget challenges.

Wilkes-Barre, like other cities nationwide, is forced to turn to the debt market to avoid raising taxes, but is unable to do so because of the instability in the market.

Included in the City of Wilkes-Barre's 2008 plan are issuance of $4 million in re-funding to fill budget gaps and a $5 million in economic development for a Coal Street Park renovation project.

Coal Street's renovation will transform a park into ice hockey rings, playgrounds, and athletic fields. Under the current market conditions, this necessary development will be extremely difficult for the City of Wilkes-Barre to complete.

In addition to this venture, the City of Wilkes-Barre will continue to maintain and improve its aging infrastructure. For example, work on the remaining two bridges that span Solomon's Creek will be completed. The area surrounding the Creek is prone to severe flooding, devastating thousands of residents and an area hospital 3 times in the past 4 years.

In order to meet the basic needs of our residents, such as preventing flooding and paving roads, we must be able to access the affordable bond insurance market.

One beneficial piece of legislation is H.R. 2091, which would change the Tax Code to allow Federal Home Loan Banks to offer letters of credit to communities like Wilkes-Barre. Chairman Kanjorski, we want to thank you for supporting this helpful legislation.

The City of Wilkes-Barre is undergoing a comprehensive social and economic revitalization. Without access to the capital, we will be unable to continue the progress that we have worked so hard to accomplish over the past 4 years. We will be forced to halt work on major projects such as the Coal Street Recreational Park or limit basic services that we provide to our residents.

Mid-sized cities nationwide must have access to the bond insurance market to improve their credit ratings. Also, there must be stabilization in this market so that Wilkes-Barre and other cities can continue to provide basic quality of life services for their residents and participate in economic development projects.

I want to thank you for the opportunity to address this subcommittee and for considering my perspective as a Mayor of this mid-sized city. Thank you.

[The prepared statement of Mayor Leighton can be found on page 236 of the appendix.]

Chairman Kanjorski. Thank you very much, Mr. Mayor.

We will now have the questioning. Mr. Dinallo, I am going to ask you one or two questions that have been posed to me several times over the last 2 weeks.

That is, that the holding companies can draw on the insurance companies' dividends. Do you have legal authority to order the suspension of that and to stop it in its entirety or would you need some additional legal authority either on the State level or the Federal level?

Mr. Dinallo. I think the answer is the following, when you are dealing with extraordinary dividends as we discussed, we control those, and we have suspended all of those in the monoline insurance companies.

When you are dealing with regular dividends, they are statutorily able to dividend. One way that one could prevent the dividend from being processed would be give essentially the company an order to bring in more capital, and one way they could do it would be to suspend the dividends.

I think there might be mechanisms to do it. That would be in a certain sense us beginning to control the companies, and that would be like as if we had put them in rehabilitation or taking control of them, we would begin to basically tell management how they are going to run the company.

I think that the answer is on the extraordinary, we have pretty much absolute authority. On the regular dividends, especially when you are dealing with publicly traded companies, I think you would be more likely that you would first get to the point where you would be doing either orders of capital infusion and if they cannot meet those orders, one could presumably put them into rehabilitation or maybe by then they would already be losing the rating and you would have the possibility of a run off, which we discussed earlier.

Chairman Kanjorski. So many people have mentioned the fact that they cannot comprehend how a division would be sending dividends up to their holding company when in fact their solvency may be in question, if conditions were to continue as they apparently are.

Mr. Dinallo. I think that is one of the issues, Congressman. There is a difference between solvency and the rating or the share price. Solvency in the insurance world is a fairly simple question. It is the ability to pay claims as they come due.

The rating is a very different question, and here, I think it is very important that we kind of de-link them. The question of regulating the insurance companies and the questions around the dividending process generally goes to the solvency of the company.

We have never regulated, although as I said, I think in the last year we have now started to regulate this particular line of insurance companies on their rating because of course, it does matter.

I will give you an example. There is a theory under which you could put a company into rehabilitation and you could still have a Triple A rated company ironically. It would be a closed book. It would be Triple A because there would be no dispute it was going to pay on the claims as they came due. It probably would not trade very high because it would not have a business plan except just paying off the claims, and it certainly would not have a return on equity and a revenue growth plan, but it would in fact be both solvent and highly rated in the sense that it could pay on its claims.

Chairman Kanjorski. There seems to be a legitimate fear that because there are two books here, one, the municipal, and then the other, the high flyer risk category, that even though they appear to be solvent, the likely failures will occur on the high risk book and they could drain out all the funds of the corporation. When you get down to the municipalities, there would be nothing left for them.

I am really stuck on the idea and the concept that we have to return trust and faith to the marketplace as fast as possible. I think it is necessary that anything that we can do at a governmental level or a regulatory level to accomplish that probably should be done now rather than being reactive after the circumstances occur.

Mr. Dinallo. Yes.

Chairman Kanjorski. If there is something that we can do, these are the types of surgical legislation that I would certainly be willing to have the committee put together and submit for very fast action if necessary, as we move towards some sort of resolution of this problem.

Mr. Dinallo. Obviously, if Congress wanted to help re-insure the municipal side of the book as you said today in essence on CNBC, that would be extraordinarily helpful because then you would have a backstop that would certainly help capitalize the companies.

The good book/bad book that you have discussed is done in this instance. If we did it quickly, it would be done to preserve the rating of the good book. You would have a good book of municipal business that would stay Triple A rated, and you would have a stressed book that would be substantially less.

It would not necessarily be done right now because of solvency or claims paying ability. As you said earlier, there is no evidence yet that the claims on the CDO side will exhaust the entirety of the municipal book. All the actions we have taken and the meetings that I have held and the concerns that I have had is they will get downgraded because of the confluence of the two books and that will have a systemic impact and will put the companies into a run off and will have obviously impacts on the economy that we have been discussing.

It is not yet the case, I believe, that they do not have claims paying ability. I think that is an important distinction.

Chairman Kanjorski. Work with us on it. Because the stimulus moved through as quickly as it did, I am a little bit under the impression that we are going to get unusual cooperation from Treasury and the White House.

Mr. Dinallo. Great.

Chairman Kanjorski. As a matter of fact, while I was out, I was notified that Secretary Paulson announced that I am formulating a letter requesting support systems for the student loan process.

I understand that as soon as he receives my letter, and we have it being hand carried to Treasury this afternoon, that he is going to take action to shore up that marketplace.

Mr. Dinallo. I will ask if we could have a line of credit not even actually capital, a line of credit of $10 billion, my instinct is that more capital would come in before that, because you would have the line of credit in place, which is what I told the banks in the first place, and I think it would be an increasingly less likelihood you would ever need the line of credit because ironically--

Chairman Kanjorski. Do these insurance institutions have the rate to participate with Federal Home Loan Banks?

Mr. Dinallo. I am sorry. I did not hear the very last part.

Chairman Kanjorski. Why could the insurance companies not make an application to the Federal Home Loan Bank system for a line of credit?

Mr. Dinallo. I do not know the answer to that. Certainly, the investment banks that are the counterparties to their policies could make such an application, and you could do the re-insurance that way.

Chairman Kanjorski. We should look into that. I certainly would be amenable, and that is one way to spread the risk.

Mr. Dinallo. That is right, extremely broadly.

Chairman Kanjorski. Incidently, while we were over voting, another insurer, FIGC, was downgraded by Moody's, as you may or may not know, from Triple A to A-; that is a big jump, 6 levels.

I guess the equity markets sort of gave some indication of their appreciation of that by dropping 175 points. I think we are into a very volatile situation and things that we should do and can do should be done as quickly as possible and as cleanly as possible.

Mr. Dinallo. I have been trying, Congressman. I will take the brass cup anywhere.

Chairman Kanjorski. I am saying on our side, and I am sure the Governor would say this would be a bipartisan effort. We want to get this done.

I have a question for our other participants here, both the Federal Reserve and the Securities and Exchange Commission: Is there a working group being put together at the executive level to closely monitor what is happening in the economy so that you are not individually by institutions watching what is happening, but have a cooperative overall working group view of what is happening so that all of us, including the Treasury and the White House and the Congress, can get faster information as to what we can anticipate, and not from a technocrat standpoint?

I do not want to categorize your testimony in any way as technocrat. You all sounded like you were telling us what you could do in normal times. Maybe I am unusual in thinking that these are extraordinary times.

Make the assumption of my foolishness to deal with me. If we are in extraordinary times, what are we doing extraordinarily in the executive and independent agency areas of the government to really come together very quickly so we can have faster responses, legislatively and by executive order if necessary?

Mr. Parkinson. The SEC, the Fed, Treasury, and CFTC all meet as members of the President's Working Group. We have been at work for some time to produce a diagnosis of the underlying causes of all the problems we are seeing in financial markets and to develop a comprehensive package of reforms to address that.

Chairman Kanjorski. That is the Working Group and we are awaiting that package of reforms. In the meantime, we could get into some financially disastrous circumstances before the Working Group is over or before the long-term solutions could be put into place.

I am looking at brakes that could be put on as were put on after the 1987 crash on the market that have really worked wonders since 1987 to stop run away situations in the equity markets.

Are we thinking along the lines that in the credit markets, there are things that can be done, sort of in extraordinary circumstances and timeframes that could help us from freezing up?

I was visited last week by issuers of corporate bond instruments. The story that they gave me of what they feared was extraordinary, that there is no market out there and if we do not do something very quickly, what little market is out there is going to disappear and the needs of American business to have a line of credit to operate in 60 or 90 days is going to be fast restricted or disappear.

That sounds to me like extraordinary circumstances. I am not in a position to know whether what they are telling me is true. I have no reason to believe it is their benefit to excite the market in any way. Of course, I have probably now excited the market.

[Laughter]

Chairman Kanjorski. We have to find ways to talk to each other and to know what is going on.

I was struck, I will be honest that this is the first time in 7 years that I can recall the White House and Treasury coming to Congress and asking for fast bipartisan action. This is the reason I got very involved in the stimulus package these last 2 weeks and the reason this committee got so involved.

The Administration has not even done this for the war, but they did it in the last 2 or 3 weeks. My suspicion is, and it is strictly a suspicion, that they have unproven indicators that really flash tilted extraordinary extreme situations.

I am not going to put the Federal Reserve on the spot to tell us whether you have that hidden box down there of undisclosed indicators, but I suspect you do, or somebody got ahold of this and realized this was something serious and we ought to make every attempt in the world to get in here and put some firewalls up. I think that is what the stimulus package was.

If it was not, then what it means to me is that we have had a genuine re-birth at the White House. That is probably good, too. I do not expect that happened. I expect what happened is the White House got scared, but they have not and we have not disclosed it to the American people. Maybe it cannot be disclosed or maybe it does not have sufficient validity to be disclosed.

Since that precedent-setting action was taken just in the last several weeks between all these important financial institutions of our government, and since the Congress did positively react, I am just wondering if we cannot find a way, because we have not been informed, to my knowledge, no one on the committee, including the chairman, has been informed of this.

We have to find ways of knowing how serious things are out there, whether there is something we can do or should prepare our fellow Members to do, or whether we should just sit around with our thumbs in our mouth and wait until something really serious happens that we cannot correct.

Maybe you can address that.

Mr. Parkinson. I think both the fiscal stimulus package and the Federal Reserve's monetary policy actions were taken because of the perception there were significant risks coming out of the turmoil in the financial markets to future economic growth.

We have taken both those monetary policy actions to try to insulate the macro economy from some of the things that are going on in the financial system.

As you were talking about circuit breakers, I was trying to think of what the analogy could be in this case, but I was struggling a bit. It seems to me that if firms are concerned about their inability to issue debt and raise funds in the debt markets, putting a floor on the prices of bonds is not going to be helpful to them. That would lead in effect to the same sort of phenomenons we are having in some of these auction rate securities markets where markets have been failing to clear because of the imposition of this kind of speed limit to the system.

So my preliminary analysis is that it is unlikely to be helpful and in fact, might be harmful in the present context.

Chairman Kanjorski. Is there anybody down there who has been thinking about positive things that could be done that we either do not have authority for or would take some time to legislate on that we should start thinking about, going through the process of legislation?

Mr. Sirri. I think there have been some examples of things that have been done recently. Within our own authority, we have been asked to consider certain changes to accounting rules or interpretations of accounting rules.

In this specific instance, it was to allow loans to be renegotiated. The determination we had to come to was the circumstance under which default would be reasonably foreseeable, working with the American Securitization Forum and the FASB, we were able to provide some clarity for that definition, that allowed loans to be renegotiated without having those trusts be brought back onto the balance sheets of the intermediaries, necessitating a large capital charge.

I think another example where we have been changing our policy slightly to accommodate the current environment has been in the area of money market mutual funds.

As you know, there have been some defaults and some impairments of short-term commercial paper, as the funds have held those papers, they have been circumstances where support was needed, where subsidies were needed of various kinds, and through our rulemaking and no action ability, we have been able to facilitate that, allowing the money market mutual funds to stay at a $1 NAB.

Chairman Kanjorski. Somebody raised the question the other day, that if the SEC just changed the rating on municipal bonds to reflect what the rating is on corporate bonds, that this would free up the two distinctions and many of the municipal bonds could move on without being forced for sale because they have maintained a Triple A. It is Rule 2a-7.

Could that be addressed? Could that simply be done by making that different distinction?

Mr. Sirri. I think what you are referring to is a portion of 2a-7 that provides that if a piece of a long-term paper held in a trust is rated below a certain level, in this case, AA, then the money market mutual fund would have to sell that paper.

I think the important thing to realize here is why a rule like that was put in place. Money market mutual funds are substitutes for cash. As such, the primary issue associated with them is one of liquidity.

The Rule 2a-7, which is a very complex definitional rule, is all about maintaining liquidity for that money market mutual fund. I think we hold that liquidity is paramount here. We would never want funds to be encouraged to hold instruments that are not very, very liquid. The reason is they could break $1.

Chairman Kanjorski. Let me understand. It is not that these municipal bonds have lost their value. It is that laws are driving them, because of ratings by rating agencies, to potentially be sold and they are being sold into a market lacking liquidity, and as a result, their prices are falling materially from what their real value is.

Is that not the problem?

Mr. Sirri. It is part of the problem, but I think you put your finger on it when you talked about liquidity. The thing that is important here is that the instrument be liquid.

It may be as you say that its value is still high, but the securities are only worth what you can sell it for at the moment, especially in the case of a money market mutual fund. We would never want them holding paper that they could not liquidate instantly at the value at which they were incurring it.

Chairman Kanjorski. Is not one of the potential remedies here if we have a freeze up in the marketplace and we have no buyers, that we potentially would have to authorize the Treasury to be the buyer of last resort, just to stabilize the market?

We would be expending a lot of money and putting the taxpayers' money at tremendous exposure, dollar for dollar exposure, as opposed to just recognizing that we may have a temporary situation that by adjusting the rating score to reflect something different than it does now for municipal bonds and just make them rated at the same way corporate bonds are rated, they would still carry a Triple A corporate rating. They would not be any more or any less at risk than they are today, but they would not have to be spun off by some of these institutions that are under compulsion by law not to hold these securities and to get rid of them.

Even if we did it for 30 or 90 days, it is somewhat analogous to me that at a point, say the subprime market goes into the prime market and rather than looking at 2 million foreclosures, we are going to look at 6 million foreclosures.

Is there any doubt that we would not think about declaring a moratorium on foreclosure at some point? We did it during the depression.

I would certainly be supportive if I saw a tremendous total collapse of the real estate market, which would be a total collapse of the financial market, why not go to a moratorium?

That is an extraordinary measure. We do not want to do it, but by doing some surgical repair, potentially, we could hold back that situation at no greater cost than if we have to move in and do moratoriums or other such remedies that are rather limited, and probably are too complicated for the Congress to participate in.

The time and effort that it would take to get this through and signed into law, I suppose we could do it, but if we got to the point where we could cooperate the way we did last week on the stimulus with the White House and the Congress, I have a feeling it would be a song of doomsday for the country. That is the extreme to which we would be driving. I do not see us coming together too often the way we did last week.

Are there measures that you can all take within the independent agencies and the Executive Branch that could alleviate some of this pressure even on a short term basis?

Mr. Dinallo. I think that the one thing that is important is in the long term, the Triple A rating, the wrap, is an important thing for lots of municipalities, for small municipalities, for the boards of schools and hospitals.

They cannot realistically go forward without a Triple A rating because of the depth of distribution of the money market account point. I think you could do it for a short period of time, but the concept of all these municipalities would sort of go without a Triple A rating is really a difficult world to conceive of when you are dealing with money market accounts and fidelity, etc.

Chairman Kanjorski. I just want to make a point to the Mayor. I know you have so many projects, Mayor, that are either going in or about to go in or are in development that could be affected by the failure of the bond market to provide the liquidity to continue. I hope that does not happen.

I want to tell you a story. When I come back to Wilkes-Barre and look around, I always look at the cranes and the number of cranes I can see indicates the relative success of the economy at the time.

That also applies down here in Washington. I sit in my office and I look out the window. If I can count something less than seven cranes, we still have a very healthy economy in Washington. When I see more than nine cranes, we are getting close to trouble. It has happened that way for 25 years.

It is very interesting how we tend to go to excess and then we get these jolts in the system.

What we are going to try to do for Wilkes-Barre and other medium sized communities is keep the crane count down to the right number so we do not have those disasters.

Now, Mr. Castle, if you will.

Mr. Castle. Thank you, Mr. Chairman. Let me just start by saying a couple of things. Mr. Bachus is at a meeting at the Capitol and could not be here. I also want to enter into the record pursuant to the conversation which he and Governor Spitzer had--there was confusion in that discussion. Governor Spitzer indicated that the blame for the bond insurance crisis lay with any of the regulators other than his department. His department was the only one directly responsible for most of the bond insurers.

He also politely denied there were any special dividends approved for a bond insurer during his administration. I would like to proffer for unanimous consent to enter into the record a Form 8-K filed by MBIA, Inc. with the Securities and Exchange Commission. The document says, ``In April 2007, MBIA Insurance Corporation received approval from the New York State Insurance Department to declare and pay a total of $500 million in special dividends to MBIA, Inc. in the second quarter of 2007.''

I would note further, for the record, that despite the recording of pre-tax net loss on its financial instruments in that report, the same company actually increased its dividends throughout the entire year of 2007. It also went through an additional $660 million in capital in what is perhaps an ill conceived stock repurchase program.

I would like to proffer for unanimous consent the Form 8-K from the Securities and Exchange Commission. Thank you.

Mr. Meeks. [presiding] Without objection.

Mr. Castle. Let me ask this of you, Mr. Parkinson. I have read about Warren Buffett's offer to reinsure the bond insurers' muni portfolio for a 50 percent fee above the unearned premiums. Nice that he can do that.

I am concerned about this. Would this not really just spin off all of their core good business? I have heard testimony from all of you a little bit today, from their bad business, leaving crippled run off companies, and while this might benefit New York and other municipal debtors, as well as clear the future muni market business for Buffett's new company, would it not be unfair to the holders of all the other bond insurers' other debts, such as banks and hedge funds that relied on the bond insurers' wrap based on their entire book of business, including the stable portions?

Mr. Parkinson. I guess as I understand his proposal, it is to reinsure the muni bond portion of the--

Mr. Castle. Just that portion; correct.

Mr. Parkinson. The trouble I have with that is that I don't see how that will solve their current difficulties, how that will improve their rating. To be sure, it would mean they have additional resources to bear any losses that might arise from the muni bond side, and therefore would free up some capital.

But that would come at the price reducing their revenues going forward. Consistent with that analysis, I have read in the press that it would not lead the rating agencies to feel any better about their current financial condition, and if that is the case, it seems to me that it does not solve the fundamental problem that they are facing, and therefore, does not reduce the likelihood that there would be adverse effects on the broader financial markets.

Mr. Castle. That was my impression, too. I appreciate your answer on that.

Mr. Sirri, the current crisis in our credit markets has been exacerbated by the overwhelming lack of transparency. For example, a lack of any price reporting mechanism for collateralized debt obligations or credit default swaps.

Do you believe it would be beneficial to our markets to allow investors to see the actual prices for these complex instruments? What steps could you take as a regulator to make that happen?

Mr. Sirri. The markets you are talking about are over-the-counter markets. They take place as trades between brokers and between dealers. They do not take place on exchanges.

You are quite right. Prices are not generally produced in those transactions that are available to the public.

If you want to consider whether it makes sense to make those prices public, I think it is a difficult analysis and one you have to undertake with care.

These markets are filled with what are known as bistro contracts. They are very customized contracts. They do not trade broadly. They are only held by a small number of people.

In such circumstances, you do not generally think of providing transparency to those markets. If we did come to a determination or if you all came to a determination that would be useful, there are mechanisms to do that.

There is, for example, in the over-the-counter markets for fixed income securities, a system called Trace that is operated by FINRA. It is a mechanism whereby corporate bond trades are reported to and then disseminated publicly within minutes of the trade.

If we thought it was useful to do so, that scheme could be broadened to incorporate other classes of securities. For example, right now things like agency securities and asset backed securities are not covered by Trace. It could be broadened to include those kinds of securities, including mortgage-backed securities, CDOs, and such.

Mr. Castle. I realize we have another panel. I do not want to take any longer. Just sitting through this today, your panel and the one before, and reading some of the testimonies to come later, it occurs to me that there are steps that if we all put our heads together, perhaps we could be taking them, in terms of clarification of regulations, for example. Perhaps the transparency issue and a few other issues, I am not saying it is at the heart of the credit problems right now.

I happen to think a lot of this lies in real estate issues and other areas. I believe we could have perhaps done a better job than we have, and hopefully, when it is all said and done, we can come to some sort of agreement to address all of these issues better.

With that, I yield back, Mr. Chairman.

Mr. Meeks. Thank you. Let me start first with a question to my superintendent from the State Insurance, Mr. Dinallo.

What do you think the State regulators like yourself did right or wrong with respect to the bond insurers?

Mr. Dinallo. What I think we have done right is we identified an issue and immediately got on top of it, I think well before many other people were confronting the issue. We have done our best this year to highlight the issue and come up with solutions and particularly private side potential solutions in dealing with it.

If we were to criticize what we did wrong, as I said before, I think we emphasized solvency, which is what we are supposed to be doing, but here, it turns out that a Triple A rating is really important. I guess we could regulate more to the rating as opposed to the pure solvency question.

That is not something that historically we have done. I do not think frankly a Federal or State or other regulator would necessarily do that. Here where you have such interconnectivity, it is not just a claims paying question. It does turn out to be a rating question.

If I could just clarify something I said before, I can see we are starting to wind down, in responding to Chairman Kanjorski's question about what the Federal Government could do, and I know he was on CNBC today talking about sort of the FDIC-type backstop, I think we should first, of course, go for a private sector solution. We have been trying to facilitate that. That is what the entirety of my efforts have been about.

Failing that, one goes to sort of a good book/bad book scenario, and then you get to the Berkshire Hathaway question, which is who seeks to reinsure or buy that good side of the book. That is the point.

All I was saying was that if Congress wants to do that or even the States altogether, the municipalities could reinsure themselves technically, certainly Ajit Jain's offer is a very appreciated offer, although any experts will tell you it is a very profitable offer for Berkshire Hathaway, and there might be a better solution, a cheaper solution, to worry about the good side of the book if we cannot get to any other scenario, including what I hope is as we are speaking private side solutions.

Mr. Meeks. Mr. Mayor, I was listening to your testimony. As you stated, many cities, talking about infrastructure problems now, going into debt because of the foreclosures on homes, and they are limited in what their resources are and what their alternatives are, other than raising taxes, etc.

Off the beaten path just a little bit, but I know that the Senate is doing an investigation into solvent wealth funds, but in Indiana, for some infrastructure problems, they had utilized some solvent wealth funds to do roads and highways, etc., for infrastructure.

I just wanted to get your opinion. Would something like that, given the crisis we have, be an option for cities like yours to look into to try to offset some of the financial debt that the cities are currently in?

Mr. Leighton. We are always looking for different sources to help us with the debt. Just last month, I attended the Conference of Mayors here in Washington and listened to all the mayors talk about the infrastructure across this country, especially about the bridge that collapsed in Minnesota.

What it appears is that throughout the United States, the aging infrastructure is affecting not only smaller cities like Wilkes-Barre, but also bigger cities like Minneapolis. The problem we are having is there is insufficient revenue sources to fix the aging infrastructure. We are always looking for alternative ways of reducing our debt and increasing our revenue sources.

Mr. Meeks. My last question would be to Mr. Sirri. When we look at this crisis, the question of transparency is a big issue. I would like to know whether or not you think there is a role for a group like the New York Stock Exchange to play in the transparency issue, something they may be able to do in that regard.

Mr. Sirri. There could be conceivably a role for any number of entities that choose to collect and report, disseminate information.

I think the question you have to ask very carefully is to what extent would dissemination of information help the problem. Largely, in this space, one of the problems were there were simply no trades. In the space of CDOs, starting in early 2007, trades just did not occur. There were no prices.

I think here, although transparency is often helpful, I think it is a difficult analysis and it would take some additional work to determine to what extent that would help solve this exact problem.

I would note there are a number of mechanisms that are available to disseminate such information. The New York Stock Exchange, I think, might be one of them. The Trace system I mentioned earlier would be another. There may yet be some private sector solutions that would fulfill a need like that.

Mr. Meeks. Thank you. I want to thank all of you, and again, on behalf of the chairman, as he did, apologize for the delay. This panel is now dismissed.

We would like to welcome our third panel. I guess we will hear from Mr. William Ackman first, the managing member of Pershing Square Capital Management.

Mr. Ackman will present for 5 minutes.

STATEMENT OF WILLIAM A. ACKMAN, MANAGING MEMBER, PERSHING SQUARE CAPITAL MANAGEMENT, L.P.

Mr. Ackman. Mr. Chairman, and embers of the subcommittee, thank you for the opportunity to share my perspective on the bond insurance industry.

In my remarks, I will introduce my firm, Pershing Square Capital Management. I will explain how the bond insurance industry grew beyond its original roots to its current troubled state, share my views on recent attempts to bail out some of the insurers, and propose solutions to mitigate the potential for systemic risk due to a failure of some or all of the bond insurers.

Briefly, on Pershing Square, we are a registered investment advisor that manages $6 billion of capital, and we are principally value investors. We have large stakes in companies like Target, Barnes & Noble, and Sears. As a result, our success is highly dependent on the strength of the economy and the American consumer.

I am actually here today not to talk about our long investments. I am here to talk about a short position we have in the holding companies for the two largest bond insurers, MBIA and Ambac.

By way of explanation, the holding companies are the publicly traded owners of the regulated insurers, and the insurers are the companies that are the subject of the hearing today.

Just briefly on short selling, because I think it can be somewhat controversial and some people say you cannot rely on short sellers because they are biased. I think the point I would make is that you have to remember that management is also biased. Management owns stock and options, short stock and options. They are long. We are short. We both have, you could argue, a bias.

While our interests are actually adverse to the holding company executives, our interests actually align with the policyholders who are the beneficiaries of the guarantees from the insurer. We want the insurance subsidiaries to retain as much capital as possible so they have a higher probability of making good on their obligations to policyholders.

Just briefly on background on the industry, we have heard a lot about it today, so I will take you through it quickly. The industry began in the 1970's. For 20 years, it was principally a mutual bond insurer. The holding companies went public in the late 1980's/early 1990's. I think that is a significant event in the history of the companies, at which point the holding company executives began to be compensated based on the performance of the holding companies by getting stock options and restricted stock, and then the business became more competitive as there were more entrants, and a desire for greater profits led holding companies to push their subsidiaries into riskier lines of business.

Over time, the interests of the holding company executives, in our opinion, and the bond insurers themselves, diverged. Over the last decade, risk taking accelerated. Massive subprime and derivative exposures developed and we have heard a lot about that today.

Who is responsible for the industry's problems? In our view, the holding companies bear principal responsibility for poor risk management.

We think the rating agencies also share responsibility because they encourage the bond insurers to diversify and to structure finance. We think they understated the risk and overstated the ratings for that part of the business.

We think regulators overly relied on the rating agencies and the managements, and that contributed to the problem as well.

The problem today, of course, as we have heard, is losses from subprime exposures will likely in our view overwhelm the capital of the bond insurers, leaving policyholders at risk.

We have heard a lot from Superintendent Dinallo. I would like to say listening to what he has been working on over the last several months, I think he has actually done an excellent job managing a very difficult situation.

I think bringing in additional capital into the industry is a positive. We are very supportive of that development. Berkshire Hathaway is a true Triple A rated company. I think that is a very good development.

We do object. We do think it is not good for the capital markets for a bailout to take place where the bailout participants are the counterparty banks to these exposures.

What I mean by this is that if private equity wants to come into the bond insurance business, we think that is a wonderful thing. If a bank that has counterparty risk that they do not want to write down wants to take advantage of the fact that the bond insurers have lower capital requirements than banks, having lower rating agency standards than banks, and they can put a few billion in, to not take $30 or $40 billion of losses, we think that is actually bad for the capital markets because it reduces transparency.

There are some investors that might be hurt as a result of a downgrade to the bond insurers, about $1.5 or $1.6 trillion in mature muni bonds are at risk for downgrades.

We have heard about municipal money market funds that might be forced to sell securities if they get downgraded below the AA. You heard today in the front page headlines on muni auction selling.

Here is why I have an interesting solution that I think is worth considering. The good news, if I can call it that, is that the rating agencies have systematically under rated municipal bonds.

The simple example of that is a Triple B municipal bond has one-fourth the probability of default of a Triple A corporate. That is a stunning fact. It is a fact that is not that well known in the broader investment community.

I guess the best way I would explain it is if you look at all the municipalities in the country and you are in the business of giving ratings, and almost all of them are Triple A, in order to have a business, you have to grade them a little more harshly, so you have various levels that you can address.

There is something called the municipal rating scale, which I think Chairman Kanjorski was touching on, and the corporate rating scale.

We heard the Congressman from Massachusetts talking about the grade of his Massachusetts' community's debt. We think the same scale should be used for corporate ratings and all municipal ratings. What that will do is it will lead to a systematic upgrading of municipalities around the country, and we think--Moody's and S&P have more data on this than we do.

We think the vast majority of municipalities will be AA- or higher on the corporate rating scale, which means even in the event the bond insurers are downgraded, the underlying ratings will qualify for the Rule 2a-7 test and for many fiduciaries, like pension funds, that are only able to hold highly rated bonds.

I want to talk briefly about the Buffett proposal. I think the media has not gotten it quite right. I do think it is a very interesting proposal, if the goal here is to protect the municipal holders.

What Buffett is offering is a private sector solution. In my view, as an American, you do not go to the government for money if there is a private sector alternative. You want to protect bond holders.

Buffett is offering to reinsure the entire municipal books of three of the biggest bond insurers. What he is doing is he is putting the municipal holders at the front of the line, as he calls it.

The concern is that the structured finance risk will burn through the capital of the bond insurers and 5 years from now, there will be nothing left for municipal holders.

What he is doing is he is taking that risk away from them, he is giving them a Triple A rating, and he is charging what he thinks is a market price.

What I think is very interesting about it, if this turns out to be a wonderful deal for Mr. Buffett, he is giving a 30 day period of time where anyone else can put in a bid, so he is creating a ceiling on the maximum price the bond insurers have to pay for this insurance, and if AIG or GE or another well-capitalized company wants to come in and do it at a lower price, and they are free to do it at a lower price, and this is a very efficient way to establish an auction price to reinsure that book of business.

Systemic risk. The other big piece here, of course, from a systemic standpoint, is the structured finance part of the business. Here I am relying on Oppenheimer estimates.

There is $125 billion of CDOs where the banks are counterparties to the bond insurers. The estimates are there will be $35 to as much as $70 billion of losses here. These are exposures that the banks have reinsured with the bond insurers. If the bond insurers go away, the banks will be exposed to this risk, less whatever they collect in terms of claims.

Buffett describes it. He says look, it is poetic justice that the people who sold this kool-aid end up drinking it in the end, so there is a little poetic justice.

That said, we heard from the SEC just on the previous panel that the banks are positioned to absorb these write-downs if they have to. We think if there is going to be a loss and it turns out it hurts a bank, if a bank needs to be recapitalized, we think a bank should be recapitalized directly as opposed to through the mechanism of the bond insurers.

Mr. Meeks. Could I just ask you to start wrapping up, please?

Mr. Ackman. Sure. These are my final remarks.

What should regulators do? We heard about special dividends. MBIA took out $1 billion in special dividends between December of 2006 and April of 2007.

The goal of holding companies is really to take out as much capital as possible so they can pay dividends and buy back stock.

We heard from Superintendent Dinallo that he can stop special dividends, but not ordinary dividends. That really comes down to the fact that the executives themselves determine the amount of statutory capital that an insurer has.

If there is policyholder surplus, they can take out ordinary dividends. What determines policyholder surplus is what the estimates management has for losses. The big debate here is what the losses are going to be.

Our suggestion is that the regulators, and Eliot Spitzer, the Governor, talked about some Federal assistance, I think the best place for Federal assistance here would be for the Federal Reserve, the Comptroller of the Currency, and the Treasury, to help the New York State Insurance Department and other insurance departments to value the exposures of the bond insurers, figure out whether they are adequately capitalized, whether the reserves are adequate, and if not, there is a very simple solution where the State Insurance Department can fix the problem.

We need transparency on what the losses are. We need an independent third party with the resources to evaluate it. I think we have it in the form of our banking regulators.

I thank you for the time.

[The prepared statement of Mr. Ackman can be found on page 86 of the appendix.]

Mr. Meeks. Thank you. Next we will hear from Mr. Keith Buckley, the group managing director and global head of insurance for Fitch Ratings.

STATEMENT OF KEITH M. BUCKLEY, GROUP MANAGING DIRECTOR AND GLOBAL HEAD OF INSURANCE, FITCH RATINGS

Mr. Buckley. I would like to thank you, Mr. Chairman, for the opportunity for Fitch Ratings to give our views on the bond insurance industry.

What I plan to discuss is Fitch's history of rating the bond insurance industry. I will provide a general overview of our rating methodology, and then I will discuss recent rating actions that we have taken, including downgrades of three of the Triple A bond insurers.

From a historical perspective, Fitch began rating the bond insurers in 1991. We currently rate eight bond insurers including each of the big four bond insurers that together make up about 83 percent of the gross insured power in the industry.

All but one of these eight companies was originally rated Triple A, and all of these companies maintained their original ratings until very recently.

Accordingly, our bond insurer ratings have exhibited high levels of historic stability.

Our methodology is consistent with that which we use for other types of insurance companies and financial institutions, also recognizing the unique attributes of bond insurance. We look at both qualitative and quantitative attributes, with qualitative including such things as management, corporate governance and franchise, and quantitative aspects including things such as capital adequacy, risk management, financial performance, and liquidity.

Although all of the quantitative factors are important, arguably the most important is capital adequacy. We assess that via a proprietary model that we developed earlier last year, where we analyze the relative risk of the municipal structure and infrastructure bonds that are insured by the bond insurers, and based on that analysis, come up with relative amounts of capital they need to maintain in order to meet a Triple A rating threshold.

Generally, the greater the risk in the portfolio, the higher the amount of capital that needs to be held.

A key input into our modeling are the underlying ratings on the deals that are insured by the bond insurers. We generally take into account our own rating, if it exists. If not, we use the lower of the Moody's and S&P ratings.

I think it is also important to note that the bond insurers themselves maintain their own underlying ratings and employ their own credit staffs. They do a lot of work beyond what the rating agencies do to assess their own risks.

The ratings that we assign to the bond insurers are called financial strength ratings. They are assigned at the insurance operating companies that are regulated at the State level.

It is the regulatory protections that in part allow us to assign Triple A ratings because those liabilities are protected by statute.

I think it is very important to recognize that IFS ratings indicate the likelihood that a bond insurer will fail and become insolvent. The ratings do not provide and were never intended to provide any indication as to the likelihood that a bond insurer may be downgraded.

In fact, with most financial institutions and insurance companies, downgrades are common during periods of financial stress and when it comes to the subprime markets that a lot of insurance companies and financial institutions deal with, we are in such a period of stress.

Our recent rating actions came in two phases. Back in the second quarter of 2007, we began to get worried that because of subprime issues, in underlying deals rated by the bond insurers, that there would be downgrades in underlying collateral which would lead to increases in capital requirements, which in turn could put pressure on bond insurers' ratings.

We first did a stress test of this analysis and published it in September of 2007. When things seemed to get worse with subprime, on November 5th, we announced a formal review of the industry.

At that point, we said when we completed our analysis, if companies were shown to have inadequate capital relative to our Triple A standard, we would give them a period of 4 to 6 weeks in order to raise new capital, and if they were unable to do that, we would downgrade their rating consistent with what their credit metrics implied.

We thought it was important to give a timeframe such as 4 to 6 weeks for 2 reasons. One is that we think that Triple A companies, including bond insurers, need to demonstrate financial flexibility during all periods, either stressful periods or good periods. It is important to judge that.

Also, bond insurers have made unflinching representations of their willingness to support their Triple A ratings, and we felt the willingness of management to act quickly to support Triple A ratings was a very important qualitative factor in maintaining their ratings.

At the conclusion of our analysis, two bond insurers did raise capital or had commitments that allowed us to affirm their ratings, but three companies did not, and those ratings were downgraded.

Two other companies did not have material subprime exposure and their ratings were affirmed and remained stable.

We then announced a second phase of analysis on February 5th, after additional studies were done based on new economic data looking at subprime, that indicated losses were growing even higher.

Based on indications from our residential mortgage-backed securities group, we increased our loss assumptions and that indicated that maybe additional capital would be needed.

Concurrent with that decision, we announced that the ratings of two bond insurers that were previously affirmed were now put on rating watch negative because the capital they raise may not be adequate to cover the shortfall.

That analysis is ongoing. We have not announced a timetable as to when we think that will be completed, but I do think it will be in the relatively near term.

We do think to the extent that additional capital is required and additional downgrades were to occur, we do think the companies would remain solidly in the investment grade category.

In conclusion, I think Fitch's outlook for the bond insurance industry is somewhat uncertain at this point. We think there is a possibility that some companies may decide to voluntarily exit the market if they cannot return to Triple A ratings and retain trading values.

We think it is also likely that other companies may consolidate and thus try to deal with their issues that way.

We also would expect new entrants, and I think Berkshire Hathaway has been spoken about several times.

One thing that is important is because of the escalating losses related to subprime and because we have noticed some companies did not raise capital within the timeframes we set and because there are declines in franchise value, we are not sure the capital raising alone is sufficient to allow downgraded companies to return to Triple A.

At this point, reforming our methodologies as far as what does it take for a downgraded company to come back to Triple A, as far as those parameters and timeframes, and we will clarify that for the market in the near term.

I think what is important to recognize, too, at this stage, consistent with our original Triple A ratings, we are not envisioning solvency problems for the bond insurers. Again, this is a rating downgrade issue, not a solvency issue. I think that is a very important consideration.

Thank you very much for inviting me to testify.

[The prepared statement of Mr. Buckley can be found on page 93 of the appendix.]

Mr. Meeks. Thank you, Mr. Buckley. Next we will hear from Mr. Richard P. Larkin, senior vice president of Herbert J. Sims & Co., Inc.

STATEMENT OF RICHARD P. LARKIN, SENIOR VICE PRESIDENT, HERBERT J. SIMS & CO., INC.

Mr. Larkin. I would like to thank the subcommittee for inviting me. I think it would help for you to know that I served 26 years at two major statistical rating agencies over my career.

I would like to spend 2 minutes to answer some questions that have come up several times during the committee.

I am going to talk about low municipal scale ratings. I am going to talk about high corporate equivalent ratings, but also why is there such as thing as bond insurance and why is it needed if there are very few defaults.

In 1971, Ambac was founded. In 1974, MBIA was founded. Both are bond insurance companies. It was a small business. Most people at the time thought it was a novelty. However, in 1975, New York City had their financial crisis which threatened to destroy credit markets across the world, or so people thought. It was a major financial crisis in 1975.

That was followed shortly by Yonkers' almost-bankruptcy, the insolvency of the school boards of Chicago and Philadelphia, and a meltdown in the City of Chicago.

In 1982, a large default by the Washington Public Power System, and in the middle of that, California, Proposition 13, where voters passed and basically eliminated half of the taxation of municipalities that had to pay debt in California.

In those 7 years, there were good reasons for municipal bond investors to worry whether or not their bonds were going to be paid, and a lot of the reason for why municipal bond ratings are as low as they are came out of the 1975 crisis, plus those 7 years where there was a lot of stress.

I would like to say that I believe it is clear that the bond insurance crisis is rating driven. While bond insurers take responsibility for extending their guarantees into volatile and increasingly risky sectors, they could not have maintained their Triple A ratings unless the rating agencies believed that exposure in this sector would not have weakened those ratings.

Any solutions to this crisis will require actions by the NRSROs or changes to the NRSRO system.

In the last week, the three agencies have announced reforms or proposed revisions to their rating process. Because of their newness, it is difficult to determine whether or not they will be able to prevent reoccurrence of a crisis as the one we are witnessing right now.

There have been studies by rating agencies that point out default rates on tax-backed and utility revenue bonds are lower than those for Triple A corporate rated debt. As more people are educated in the history of infrequent municipal bond defaults, I believe demand for municipal bond insurance may be less robust in the future than has been the case.

Despite these low default rates, the median ratings for tax-backed and water and sewer utility bonds are only in the single A category despite low default rates.

In March of 2007, Moody's said their municipal scale rating were not indicators of default and loss, like their other ratings. In the report, Moody's published a map to show that these bonds that I am talking about, which are rated as low as BAA-3 on their municipal scale, would be rated no lower than AA-3 on their global scale.

The default studies used by this March 2007 Moody's report all corroborate what finance professionals and academics have said for years, that municipal bonds are the second safest investment against default after U.S. Treasury obligations.

It is clear, however, that the more conservative municipal scale ratings with a median single A rating play a large part in the usage of municipal bond insurance.

It is my firm belief that ratings which truly reflect low municipal bond defaults, call them global scale or corporate scale type ratings, would allow significantly more debt to carry ratings of AA and Triple A consistent with Rule 2a-7 allowing those investments to be carried by municipal money market funds.

Using this scale for retroactive assignments of underlying ratings on uninsured debt would also allow more securities to be retained by money market funds in the event the bond insurer ratings are downgraded below the AA level.

Here I must disagree with Mr. Ackman in his testimony when he said nearly all municipal bonds would probably be upgraded by moving to this corporate scale.

There are classes of municipal bonds where there would probably be little or no increase in ratings even going to the higher scale. These classes include hospitals, long term care providers, nursing homes, toll roads, private colleges, ports, and airports. These issuers have the greatest need for a viable bond insurance industry and are likely to feel the impact of the bond insurance crisis the most.

To me, the current crisis is primarily bond rating driven. As a former bond rating executive, I would like to offer several ideas that could provide some immediate relief for issuers and investors affected by downgrades to the bond insurers.

One, there could be increased availability of underlying bond ratings for insured debt. Underlying ratings are not issued automatically. These are the ratings on the issuer itself, not including the insurance.

The issuer must separately request an underlying rating if the bond issuing is insured. If underlying ratings were assigned a standard procedure, there could be significantly more bonds that keep ratings of AA or higher after an insurer's downgrade.

This solution is not without its problems, because the issuer pay agency model assigns ratings only upon request, the rating agencies may not be permitted or even required to assign underlying ratings if the issuers want to keep those ratings suppressed.

In addition, it is unknown whether the rating agencies have adequate information on which to assign those accurate underlying ratings for every insured bond that is right now rated Triple A or AA.

Another suggestion would be rating agency adoption of those global scale or corporate equivalent ratings. As I said before, if this were in place, there would be a large increase in AA and Triple A rated securities eligible for investment by money market funds and could be retained if bond insurers were downgraded.

This, however, assumes that the raters were willing or able to increase the number of underlying ratings where they currently do not exist.

In addition, it is unclear as to whether S&P or Fitch believe there should be a different rating scale from the current system as Moody's does, or whether they are in a position to implement such a dramatic change if they thought it was right.

The chairman has mentioned House Bill 2091 for credit enhancement using Federal Home Loan Banks for a letter of credit. I would support that. I think that could give some quick and immediate relief to issuers that need credit enhancement in the face of downgrades by the bond insurers.

Finally, IRS re-issuance regulations. When a municipality materially changes the terms of a bond issue, tax regulations can trigger negative tax consequences for both issuers and investors.

Today, many States and localities face conditions where their bonds are carrying interest rates far in excess of reasonable rates due to problems with the bond insurers. Some States and localities are prevented by the IRS' re-issuance regulations from negotiating new terms with their bond holders. Market participants have been talking with Treasury and the IRS to address these problems and there may be some relief there.

I would like to thank the committee for the invitation to appear and I would be happy to answer any questions.

[The prepared statement of Mr. Larkin can be found on page 224 of the appendix.]

Mr. Meeks. Thank you, Mr. Larkin.

Next we will hear from Michael Callen, chairman and chief executive officer of Ambac Financial Group Inc.

STATEMENT OF MICHAEL CALLEN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, AMBAC FINANCIAL GROUP

Mr. Callen. Thank you, Mr. Chairman. I am the interim chief executive officer and chairman of the Ambac Financial Group, and I commend the subcommittee for these hearings and what is going to come out of them.

Ambac and other insurers have a vital but usually obscure corner of the modern financial system. We are crucial to financing of municipal governments, school districts, and other public sector entities, helping them to get capital they need at the lowest possible cost.

We play a similar role in consumer finance where Ambac insured bonds have lowered the cost of financing for homes, education, and automobiles.

Ambac has been in the financial guarantee industry for 35 years. Today, almost a quarter of the insured municipal bonds are guaranteed by Ambac.

Over the past 3\1/2\ decades, Ambac and the industry has successfully survived many cycles and challenges, including 9/11 and Hurricane Katrina, Orange County, and multiple recessions. No holder of an Ambac-insured security has ever missed a single payment of interest or principal.

Almost no one questions the ability of Ambac to make good on obligations to holders of our guaranteed debt.

Instead, our challenge is maintaining the stability of the ratings that have supported our business in the past. Ambac is committed to do everything we can to maintain our ratings and restore the market's confidence, including raising substantial additional capital.

If our goal is a strong and viable monoline industry, who are the beneficiaries? First, bond issuers, including States and municipal governments. They want and sometimes they need the bond insurers to continue to provide market access and lower borrowing costs.

Second, bond investors. Investors benefit from the credit analysis that Ambac does prior to closing a transaction. This includes on-site due diligence, documentation review, and numerical analysis, all performed in-house at Ambac.

After closing the transaction, Ambac's surveillance team monitors the transaction actively and in cases of financial stress, can facilitate a restructuring before a default occurs. These are functions that many investors cannot do themselves.

Lastly, the capital markets and the financial system as a whole benefit. One of the roots of the problems facing financial markets today is the proliferation of participants with no skin in the game. These financial intermediaries who have nothing to lose generated and sold low quality assets into the liquid markets of the prior years.

In contrast, Ambac has skin in the game and the proper incentives to strive to generate high quality financing products. Good incentives do not guarantee that mistakes will not be made.

Ambac has made mistakes. We guaranteed overly complex securities by the name of CDO squared's. Four transactions. The structure of these deals has ended up magnifying rather than minimizing the risks involved.

As a result, Ambac announced that we expect to pay $1.1 billion in claims in the future on three of these CDO squared's, and on one CDO. We are not happy about that.

With every mistake comes a silver lining of lessons learned. We will no longer guarantee CDOs or CDO squared's. We have strengthened internal risk controls. We have tightened credit standards and raised rating hurdles.

You may be surprised to hear that actual claim payments to date have been low. In 2007, in fact, we recovered more in past claims than we paid out.

This will change. We are after all in the business of insuring against credit risk. During periods of credit weakness, we should expect to pay claims.

Last year, we took $1.4 billion in reserves and credit impairment charges, which includes the $1.1 billion on the CDOs.

Ambac has claims paying resources of $14.5 billion, and we continue to grow this through earnings on our existing investment portfolio.

I would like to make an important point concerning liquidity. As you know, it is generally liquidity problems that drive failures in the financial industry. Ambac is not exposed to liquidity risk.

When an issuer of an Ambac-insured security defaults, we make their principal and interest payments under the original schedule. Because we pay out over the original life of the bonds and not at the time of default, we know our claim obligations well in advance.

We never have to settle the claims in a lump sum payment as do property, casualty, and life insurance companies.

Let me turn to the possibility that the credit rating agencies may downgrade Ambac. What would such a downgrade mean in practice? Contrary to some media accounts, it would not signify a high risk of default to investors and Ambac-insured securities. At a AA rating, Ambac would still be higher rated than most financial institutions in the United States.

Let me emphasize that our ability to meet capital requirements associated with a Triple A rating has little to do with whether we can handle expected claims. Triple A is not about meeting expected obligations. It is about the ability to weather the 100-year storm and emerge with excess capital.

In conclusion, Ambac's ability to meet our obligations is not in question. What we are striving for goes beyond this to the ongoing viability of this industry, an industry that we believe fulfills a vital public purpose.

Those who benefit from a viable monoline industry are a broad and diverse group. They include States, municipalities, the consumers, and your constituents.

We, therefore, are encouraged by your efforts to take the time to understand our business before taking action that could have unanticipated consequences.

We are grateful that the subcommittee is making this effort, and to Commissioner Dilweg in Wisconsin and New York State Insurance Department, particularly, Eric Dinallo, has been very energetic and knowledgeable in addressing the issues that we have today.

Thank you.

[The prepared statement of Mr. Callen can be found on page 102 of the appendix.]

Chairman Kanjorski. Thank you very much, Mr. Callen. I guess we move now to Mr. Chaplin, chief financial officer of MBIA Inc.

STATEMENT OF CHARLES CHAPLIN, CHIEF FINANCIAL OFFICER, MBIA INC.

Mr. Chaplin. Thank you. Chairman Kanjorski and members of the subcommittee, thank you for inviting me to address you today. I also want to thank you for your stamina, for hanging around until the very last witness.

I am Chuck Chaplin, the vice chair and chief financial officer of MBIA Insurance Corp., and I am pleased to be here on behalf of MBIA to discuss the issues currently facing our company and our industry, and the proactive steps we have taken to address them.

As background, MBIA is an industry leader in bond insurance. We have been in the business for 34 years and we were the first bond insurer to receive a Triple A credit rating.

We currently insure over $1 trillion of total debt service and employ 480 employees in our Armonk, New York, offices and 11 offices around the world.

We have the most claims paying resources in our industry at over $17 billion, and our capital position relative to any solvency measure is unquestioned, and we believe we have in excess of $1 billion of excess capital relative to rating agency current Triple A standards.

Our industry has roots in the public sector where bond insurance has helped finance some of the country's great public works projects, including bridges, ports, utilities, toll roads, and other essential infrastructure.

MBIA has guaranteed financings in all 50 States, and in all of the subcommittee members' districts from JFK Airport in Queens, New York, to the Wyoming Seminary Prep School in Pennsylvania, to the Children's Hospital of Los Angeles, which is a deal that we insured only 2 weeks ago.

Today, municipal finance and essential infrastructure account for about 65 percent of our insured portfolio.

When we insure a bond, we are said to ``wrap'' it. That simply means we guarantee the timely payment of interest and contracted principal in the event the bond defaults. Our guarantee lends our rating to that of the insured bond and the pool of potential investors for Triple A rated bonds is much larger than that for lower rated paper.

Also, interest rates are generally lower, so issuers save money by borrowing on an insured basis.

There are 87,000 municipal and State governments in the United States, and 50,000 of them have issued debt of which about $1.7 trillion is currently outstanding. About half of that is wrapped by bond insurers.

The motivations for local governments has been compelling. It saves the taxpayers money. For some smaller governments that are less frequent issuers, and we have heard from a couple today, bond insurance also ensures that they have access to cost effective funding that might not be available on an unwrapped basis.

We also provide a service to the investor and 5 million American households own municipal debt. Our guarantee eases the burden on them of needing to understand the idiosyncratic credit risk and jurisdictional issues associated with borrowers in transactions. In effect, the bond insurance commoditizes the municipal debt.

We also provide surveillance and of course, if there are problems, remediation services. In effect, investors have outsourced those analytic and management functions to the bond insurers and we give them a money back guarantee. This broadens the universe of potential investors which again tends to reduce interest costs.

In the early 1990's, MBIA expanded its business into structured finance. These transactions involve bonds backed by assets such as credit card receivables and mortgages. Today, our structured finance business makes up 35 percent of the insured portfolio.

The value proposition for many of our structured finance customers and investors is really much the same as that for the municipal issuers and investors, that is to reduce borrowing costs, provide greater liquidity, to commoditize the product, and to act on investors' behalf to mitigate losses if they occur.

Until 3 months ago, our industry attracted little attention outside of our small community of bankers, regulators, and rating agencies. Of course, that was fine with us. In our view, a good year at MBIA was kind of like a good airplane flight, nothing very exciting happens.

Over the years, we have operated quietly and efficiently, delivering our value proposition to investors and bond issuers, and delivering solid returns to our shareholders.

Of course, that was then. Like many other financial institutions, we have exposure to the deepening credit crisis through a relatively small part of our structured finance business. About 9 percent of our total insurance portfolio is related to the U.S. mortgage market.

We have significant exposure to prime second lien products like home equity loans and to mortgages that have been pooled in investment vehicles called ``collateralized debt obligations'' or CDOs.

The rapid deterioration of the underlying mortgage loan performance and its impact on mortgage-backed securities in the second half of 2007 created new expectations of loss that were a multiple of any previous market forecast.

Today, analysts are projecting losses on mortgage collateral that have not been seen since the Great Depression.

S&P reported that actual loss rates on subprime securities in December 2007 were 1.4 percent. However, projections of eventual losses are now on the order of 20 percent. I note that these are projected losses, not actual losses.

In the fourth quarter of 2007, when MBIA recognized future claim payments of approximately $1 billion, we had paid net claims equal to $44 million, or far less than 1 percent of our total exposure.

Based on the change in projected losses, we began an aggressive plan to raise capital even before the rating agencies communicated their increased capital requirements to the company.

In less than 8 weeks, we increased our capital position by over $3.1 billion. This level exceeds all worse case stress loss scenarios put forth to date by the rating agencies. Today, our claims paying resources stand at over $17 billion, the highest in the industry.

During our capital raise, our financial reports are risk reports and portfolio details were reviewed in great depth by highly sophisticated investors such as Warburg Pincus, who after doing their analysis, agreed to invest $800 million in our company.

This information was also thoroughly reviewed by the underwriters of our debt and equity security offerings. That is these independent parties got comfortable enough after scrutinizing every detail of our mortgage exposure to invest billions of dollars in our company.

What did go wrong with our portfolio? How did we, along with so many other financial institutions and market participants, miss the warning signs of these losses?

The generally benign credit environment between 2003 and early 2007 lowered the appreciation of and the pricing for credit risk across all of the credit markets.

The environment fostered an erosion of underwriting standards at all levels across the fixed income market. Because of the historically low loss levels and stable performance of mortgage products, we also missed this evolution.

Today, we are paying the price for that. However, we do not believe that any kind of a bailout plan is necessary for our company. There is not one shred of evidence that MBIA is at risk of failing to fully satisfy any and all policyholder claims, and private investors have shown a willingness to capitalize our company for the long haul. They understand the fundamental strengths of our business model and that we are focused on learning from this experience.

We will review our risk management standards and due diligence processes to make sure that we do not make this mistake again.

As we look forward, we see more need than ever for bond insurance. Formal estimates include $1.6 trillion in U.S. infrastructure needs alone over the next 5 years. The needs outside the United States are even larger.

The demand we expect will also be strong for structured finance and the structured finance products will continue to be important in lowering the costs and creating access to credit for consumers and businesses, just as municipal bond insurance does for cities, States, and authorities.

We have been working closely with our primary regulatory, the New York State Insurance Department, to review these lessons learned, to discuss new guidelines on acceptable products and portfolio guidelines.

The Department has been very proactive in support of our effort as Superintendent Dinallo referenced a little bit earlier.

Further, we believe that the Insurance Department is well-suited to continue to provide this oversight and to create and implement any new regulations.

We appreciate and commend Superintendent Dinallo's efforts to date because they will help to ensure the stability of this industry's participants.

In the meantime, we will work to re-build the trust that we have spent decades earning with the hope of restoring order and stability to the vital bond insurance marketplace.

Thank you again for your time and I look forward to responding to your questions.

[The prepared statement of Mr. Chaplin can be found on page 111 of the appendix.]

Chairman Kanjorski. Thank you very much, Mr. Chaplin.

I guess you get razzed because of your famous name.

Mr. Chaplin. Occasionally, it comes up.

[Laughter]

Chairman Kanjorski. I am old enough to remember that name, but most of the audience is too young to remember.

We probably have bored the rest of the committee to death, but if you do not mind, I am going to bore you a little bit longer.

I spent several days in New York over the last month, month-and-a-half, trying to get briefed on what is happening. It has been interesting. Each time I go up and get briefed, it appears that things are a little more severe, a little more dangerous, and a little more widely distributed in the credit market in particular.

I always ask a couple of questions when I have gone into the investment banking houses, the insurance companies and others: What do they feel caused this credit crunch? I would be interested to know if anybody here wants to volunteer their response, and most particularly, I think I can anticipate what Mr. Ackman's answer will be, but the insurance companies, I really would enjoy hearing whether or not you see any viable responsibility for any of this yourselves.

Mr. Chaplin. The short answer is ``yes.'' What we witnessed was a period of benign credit conditions that went on for quite a while, from 2003 through really almost the first half of 2007.

Chairman Kanjorski. On that point, you were licensed by the State of New York to do monoline insurance?

Mr. Chaplin. Correct.

Chairman Kanjorski. Maybe you can spell out, what does that really mean, ``monoline insurance?'' I think I know. It is different from what you do; is that correct?

Mr. Chaplin. We are in the business of insuring bonds, so it is a monoline in that sense. We insure only fixed-income securities, and we insure fixed-income securities that are issued both by municipalities as well as by structured finance vehicles.

Chairman Kanjorski. Were you always in the structured finance vehicle line?

Mr. Chaplin. MBIA started insuring structured finance vehicles in the early 1990's. We did not insure structured finance--

Chairman Kanjorski. At that point, you should have been a multi-line business; right?

Mr. Chaplin. I am sorry?

Chairman Kanjorski. It would be a mistake to call you a monoline at that point when you started to do the insurance of other vehicles. You should have been a multi-line.

Mr. Chaplin. I think that is a fair point. The term ``monoline,'' I believe, was coined to refer to the fact that we insured bonds only.

Chairman Kanjorski. Singular targeted business that you were rather expert at. In my other life as a practicing attorney, I had the occasion to use some of your companies with some of my clients when we would be doing projects and issuing bonds.

Do you think the difficulty you find yourself in today has any relationship to the fact that you enlarged or grew your business into other lines of exposure?

Mr. Chaplin. It certainly has to do with some poor underwriting judgments that we have made of late.

Chairman Kanjorski. That is easily said that way. How about if you had never gotten into underwriting any other line but municipalities? Would we have a problem today?

Mr. Chaplin. We would have no exposure to the home mortgage market.

Chairman Kanjorski. Would we have a problem today? It is not a hard question. I am going to try to insist on it because I am trying to drag out of you culpability here.

Mr. Chaplin. I am totally willing to agree that we are culpable and that we did in fact expand our business over time.

Chairman Kanjorski. And is that the reason that you have a difficulty now?

Mr. Chaplin. The fact that we have engaged in wrapping the bonds that we have, particularly in the mortgage sector, has resulted in the problems that we are enduring right now.

Chairman Kanjorski. If you had stayed in your regular course of business that you were licensed to do by the State of New York for 30 years, we probably would not have even have had this hearing today on the threat to municipal bonds; is that correct?

Mr. Chaplin. Certainly not over home mortgage exposures; no.

Chairman Kanjorski. You would not be in it. You would be the strongest insurance company in the world because you would be getting all this premium and insuring things like municipal bonds. I understand some of the testimony today that municipal bonds never fail; is that right?

Mr. Chaplin. Mr. Chairman, we believe that our insurance company today is actually very, very strong from a capital and liquidity perspective, and to the extent that we were focused on the municipal bond business itself, as has come up a couple of times today, the general obligation in the municipal bond business, where you really do have a low incidence of defaults--

Chairman Kanjorski. Mr. Chaplin, I am pressing you because we will not get to a situation where we can really get to the fundamentals here and the corrections that have to be made unless we are sort of straightforward and truthful with ourselves and truthful with the causes.

It is like arguing that something is not your fault because you do not want it to be your fault. I understand that.

The reality here is, I think, can you accept that if you stayed in insuring municipal bonds, wrapping your Triple A rating around municipal bonds, there would be no need for a hearing at all, there would not be a risk to the municipal market at this point?

Mr. Chaplin. We certainly would not have this problem. I agree.

Chairman Kanjorski. Right. When I was in New York, I asked some of the people there, how did these insurance companies that were monoline insurance companies, how did they get in trouble?

I could never get any of them to admit that anybody in New York encouraged them to do this. I have to assume none of the investment houses or anything encouraged your company in an earlier time to expand their business and make some more friends, basically. Make more profits. Make more revenues.

Did that happen or did it not happen?

Mr. Chaplin. I actually was not a part of our company at the time, but I am confident that the decision to start wrapping other than municipal bonds was motivated by the desire to expand our revenue and earnings base by using the skills that we had developed in other areas.

Chairman Kanjorski. Right. Do you think that decision was an internal decision of the board of directors or the people who ran your company, or did they periodically go to New York and meet with the investment banking houses and have some of them say hey, you are writing this monoline business.

It is boring. There are not going to be big profits in it. Look down here at these people who are putting securitization together and they are making fortunes, why do you not get into that business?

Do you not think that may have happened?

Mr. Chaplin. I believe that all the decisions about the expansion into the structured finance business were made at MBIA by MBIA management and the Board of Directors.

Chairman Kanjorski. And they had no outside influence?

Mr. Chaplin. It would not be fair to say that people at MBIA do not interact every day with all other participants in the capital markets, the banks, the broker-dealers, the regulators, and the rating agencies.

There is a very active dialogue there. It would not be fair to say that out of those dialogues, it did not generate ideas.

Chairman Kanjorski. You know what I am trying to get you to say is that the problem in some of our bond markets and credit markets today is as a result of greed.

Mr. Chaplin. Yes, but--

Chairman Kanjorski. Do you think so?

Mr. Chaplin. You are not going to get me to say the devil made me do it.

[Laughter]

Mr. Chaplin. It is true. We are in business to make money.

Chairman Kanjorski. It is better if the devil made you do it than nobody.

[Laughter]

Mr. Chaplin. I am afraid we have no one to blame but ourselves. We are a profit-making institution. We exist for the purpose of trying to deliver returns to our shareholders, and the fact is the way we deliver returns to the shareholders is--

Chairman Kanjorski. We are working on a Federal charter, an optional Federal charter right now. Would you recommend that when we issue a charter to an insurance company, we do not allow them to do any other business except if they are specifically authorized by the Commissioner of Insurance, the Federal Insurance Commissioner, or by their license adjustment? That we just are not going to allow it, based on the experience we are having now.

Mr. Chaplin. We have been having just those kinds of conversations with Superintendent Dinallo.

Chairman Kanjorski. Had he considered restricting your license or calling you back to practice under the original issuance of your license?

Mr. Chaplin. We have had conversations with the superintendent and the department about changing the base of business that the bond insurers engage in.

Chairman Kanjorski. That would mean you would be back in a boring business. It would be a safe business.

Did you all give any consideration to the cascading effect or the whirlpool effect that the credit failure has in affecting much larger pools of money and creating much greater risk out there, or had that not dawned on you?

Mr. Chaplin. The fact that the companies are today insurers of a very large portfolio of bonds, over $2 trillion across the bond insurance industry, it does make us an integral part of the capital markets. It does mean we have a responsibility, we believe, to manage the companies in a prudent manner.

The fact is we did make a mistake. There is no two ways about it. We did insure some bonds that we wished we had not insured, because we are taking substantial losses on those bonds.

I want to be clear, those losses do not come anywhere close to threatening the solvency or the very high credit quality.

Chairman Kanjorski. I understand. We do not want to get into that. I know you have to answer to your stockholders and the public. There is no reason for us to compromise the market. I do not want to do that. We are going to assume that you are going to work yourself through this and that you can.

I am interested, however, in finding some of the root causes, not only for the municipal bond problems that we are having, but others, and getting to the subprime.

Two years ago, I authored a subprime mortgage act that to some extent would have limited what has now happened, if we had passed that act. It was not the best act in the world. There were a lot of compromises in it because we are dealing with 50 States that have different practices.

At least we would have had an organized effort to get our arms around that, and we did not do it as a Congress. Unfortunately, there was this tremendous compulsion in the last 2 or 3 years to package anything that walked and even some things that did not walk. Astounding how the thirst for profit and money will drive people to do extraordinary things.

I think that is sort of what happened. Do you not agree with me, in the subprime market? When people tell me they were surprised in August, I am astounded.

I am going back now to some of my conversations in New York. People said until late July or early August, they had no idea of this problem. I am thinking, man, if only they had known about me because I must be some kind of financial genius. I have been worrying about this for 3 or 4 years. All these Ph.D.'s and accomplished economists and what not, it did not dawn on them until July or August of last year.

I do not think they could be that myopic, but maybe they are. A lot of us have been worried about what ultimately has happened. Now, what we are worried about is what do we not know that may still be out there and how do we get our arms around that, and what do we do about it.

I did not have the occasion to be here, Mr. Ackman, when you testified. I had another problem I had to attend to, which was successful, but it was another occurence that happens in the course of our lives. It has been a tough day for me.

People have been pounding me all day today and yesterday about why people are allowed to sell short and distort the market. I do not know a lot about your business. I do not profess to. I thought that is what capitalism was all about, you could take any side of the transaction in any way you wanted to, and if you were smarter than most of the other guys, you made money and if you were not smarter than the other guys, you got cleaned.

Is that not what capitalism is about or did I miss the point somewhere?

Mr. Ackman. I think that is right.

Chairman Kanjorski. You would be surprised how many people want to cut you out of doing business.

[Laughter]

Mr. Ackman. Actually, I am principally a long investor. If I may, I would love to address the question you asked. I have an answer that may or may not be correct but I think it might interesting. May I?

Chairman Kanjorski. Yes.

Mr. Ackman. I think if you go back to the mortgage lending in the Jimmy Stewart era, which actually carried up right through to the beginning of securitization, you had a local S&L that had a guy who kept a deposit in the bank. The bank manager knew him, knew his wife, knew where he lived, and knew what his job was.

One day he decided to buy a home. He came into the bank for a mortgage and he applied. Character was considered. How he treated other people. There were other factors that went into whether he was a creditworthy borrower.

The mortgage loan was made, secured by the home. It was a pretty simple thing. Maybe 80 percent of the value of the home, the guy put down a substantial downpayment. Over a 30-year life of the mortgage, he hoped to pay it down, some day have a mortgage burning party. That was the old way of doing it.

What happened really in the last 4 to 5 years is the incentives changed a fair amount. What would happen is you would have mortgage brokers who would get paid a fee for finding a borrower and placing a mortgage.

Then you would have seller servicers, and what they would do is they would get a warehouse line of credit from a bank and they would originate as many mortgages as they could, and to make things efficient, you would call them up on the telephone.

You would dial 1-800-MORTGAGE or you would go to mortgage.com. You would give them your Social Security number, your name. They would run a scoring methodology on you. They would approve you for a loan.

The seller servicer would hold the loan for about 60 days until he got a big enough pool of loans in that warehouse that he could then sell them in securitization. You would have the bank that provided the warehouse line of credit would do a securitization.

The mortgage broker would get his fee. The seller servicer would get their fee when they sold the mortgage to the securitization. The banker, the investment bank, would get his fee when he sold the paper from the securitization to the holders.

The problem developed where they had trouble selling some of the lower rated but still investment graded pieces of the securitization, the so-called ``Triple B'' pieces and sometimes the single A pieces.

They created something. You know, when Wall Street has a problem, they come up with a solution. The solution was a CDO, which was a place where you could sell things you could not otherwise sell.

Every step along the way, a profit was made and risk was being transferred, but there was not a huge incentive to worry about how the loan was going to perform more than 30 to 60 days, a relatively short period of time.

Then the CDO would be originated by the bank and the bank would sell the pieces to whoever could sell the pieces, then the super senior piece, a lot of those pieces were sold to bond insurers.

What enabled this process to take place all along the way was really the rating agencies. The rating agencies, their traditional business, and it is not dissimilar to what happened to the bond insurers, they started out in the business of really rating corporate obligations.

How are GM's bonds going to perform. They went into a business of rating fairly complex securities where there was very little in the way of actuarial data because it was a relatively new industry, and they used models and they made projections and they were aggressive.

The rating agencies got fees every time there was a securitization done. They did not get their fee unless they gave it a Triple A rating.

I just think human nature is such that if you get $25,000 if you do not do the deal for the work you do or you get $600,000 if you give the Triple A tranche a Triple A rating in a CDO, and incentives fuel a machine where people make money all along the way.

I think that, I would say, is the cause for where we are today. It is just human nature, incentives. I do not know about greed, but people are profit oriented.

I would submit that is the story.

Chairman Kanjorski. You call it ``profit'' and not ``greed?''

Mr. Ackman. They are similar, I would say.

Chairman Kanjorski. Profit, everybody is entitled to profit for a function that they perform. Excessive profit starts to move toward greed.

In looking at some of these transactions, and I have talked to some of the people who have recently gone into creating these pools, they just could not keep their eyes off the fees and the returns for little or no effort, and no skin in the game. They dumped the risk very quickly.

Mr. Ackman. I agree.

Chairman Kanjorski. To catch them, it had to be catastrophic in timing to get caught. Other than that, they were out of the game and made millions on just some pools.

Mr. Ackman. That is right.

Chairman Kanjorski. One other thing I have associated with this is what you would call the perfect storm in a capitalist system. A capitalist system is supposed to have advocates on both sides of the transaction to protect themselves, to get down to what is the right and fair price. They watch each other.

That is why government does not have to become a regulator. We do not have to get in play because these cats in the private market, they will scratch their eyes out. All we can do is threaten them with jail. They can kill and they will for a dollar, and that is good. That keeps the market healthy.

Unfortunately, when you study these transactions, as you described it, everybody is on the one side of profit of the transaction. Nobody is on the other side, nobody except the last guy down there who bought these things. Only he did not buy them. He had a money market manager buy them, making a profit by acquiring them. Everybody, even his fiduciary who was buying for him, made a profit, by getting him into a bad deal and keeping it a secret until the whole line of action is over.

My question to you is, is there something that can be constructed to get back to self regulation? If we do that, are they going to distort the market again with the intention of making profits, and moving toward greed?

Are they going to find a way to distort it again, and if they are, how can we prevent it from happening except by doing something that has always been thought of as being anti-capitalistic in this system, and that is requiring everybody at every line to keep exposure or ``skin'' in the game?

If everybody had to keep an exposure of 5, 10, or 15 percent going down that line, I would have to think human nature would have said, you know, I do not want this thing to come back to me.

When you are out, the way you describe it, you go on line, you sell a bunch of these packages and in 60 days, you are out. It is awfully tempting to do that and continue to do that.

I cannot understand honestly. How do these people get involved in no doc loans? These are people who did not have a job, did not have any prayer in the world of paying this thing back, and they used them as tools to defraud the system basically.

It did not dawn on anybody? There was not any check or balance in all these institutions and an internal auditing process to find out what we are doing out there?

I can begin to believe that there may not have been when I read about how some trader could handle $7 billion in a bank and nobody seems to run a check on what he is doing. That is astounding to me.

But then again, in government, we do the same thing. What is our budget, $3.2 trillion? We do not have a lot of checks on us, either. Maybe I should not be as surprised.

What do we do about it? That is really the ultimate question.

Mr. Ackman. Sure.

Chairman Kanjorski. I feel a little put out because I have been one of these anti-Democrats in terms of regulation. I have been a firm believer that if the marketplace can be balanced and there are checks and balances, you really do not need a regulator.

Now, suddenly, when you look at the rate-making field, the easy way to solve that would be to put them under stringent Federal control and have all kinds of regulators involved or the ultimate rating agency could be a Federal agency, a stamp of approval.

There are some complications with First Amendment rights. Everyone I have talked to says that this can be avoided if we craft it correctly.

The problem is that the average taxpayer does not have skin in the game if he does not have one of these mortgages. That is only 2 or 3 percent of the population that has skin in the game from that side.

What is going to happen if we have a collapsed economic system either in the country or in the world? Then everybody in the world has skin in the game and they had nothing to do with it. They did not even know it was happening.

When you talk to them about it, they are astounded. They are literally astounded that there was such irresponsibility out there.

Does anybody have any idea what we should do? What is the role? It is easy for us to say, well, we can step aside and let this be handled by the private market. A lot of people are urging a private solution.

I tend to agree with them, except what happens if the contagion continues and we have a continued frozen market, and 60 or 90 days from now, we cannot float bonds to the extent of financing operating funds for corporations, very sound corporations? General Motors wants to build another car and they need money to pay their employees for 90 days and they cannot float bonds, and they have to close down.

What do we do?

Mr. Ackman. I think what is creating the credit crisis is a lack of transparency. Banks do not want to lend banks to other banks because they do not know what exposures are on their balance sheets.

We and others have concern about bond insurers because we do not know what credit exposures they have. The bond insurers have not provided transparency on which asset-backed securitization deals they have guaranteed, which CDOs they have guaranteed.

Investors have to rely on either the rating agencies or the management of the bond insurer to determine their capital adequacy.

I think the problem came about because people outsourced their due diligence to rating agencies. You can just look at the stock price of Moody's and see what has happened to the reputational equity of that company.

What I think has to happen is companies need to come clean. Banks need to disclose what their exposures are, not just we have ``X'' dollars of subprime exposure. The markets will work when people provide transparency.

If you look at what is going on in the municipal market right now, one of the big problems is transparency. I am frankly interested in investing in municipal bonds right now because it seems like an interesting--if I can get 20 percent lending to the guy that collects my toll when I cross the G.W., that seems like a pretty good interest rate.

The problem is it is very hard to get documentation on what does the balance sheet of the toll road look like.

Chairman Kanjorski. For transparency, should we require a repository of inventory on these types of securities that they are recorded and available to the public?

Mr. Ackman. Yes. It is an easy solution. You have an EDGAR system, which was one of the most powerful things we did for the capital markets, making on the Internet, companies have to make quarterly filings. You get them instantaneously. They are free and available to everyone.

There is no reason why the same thing could not be available for CDOs, for asset backed securitizations, and for municipal bonds.

We have tiny little companies that no one has ever heard of that you can pull up a 10-K and an 8-K and a proxy and you can do the work. We have microcap companies with $12 million market caps that can trade efficiently because people can do the work, whereas in the municipal bond market, you have a town that is miles away. You cannot do any work on it, so therefore, you need to have bond insurance or you need to have a rating agency.

You do not need those things. It is much better for investors to do their own due diligence, their own analysis.

Chairman Kanjorski. You are referring to the bond market. How about all the other securities that are out there that with risk involved?

Mr. Ackman. No. I think there is no reason not to provide--no competitive reason why you cannot disclose all of the prospectuses for every CDO transaction on the EDGAR system. There is no reason for not having it. Then investors can do the home work.

Chairman Kanjorski. Let me find out from the rest of the panel. What do you think?

Mr. Larkin. Mr. Chairman, I want to pick up on something that Mr. Ackman said about outsourcing the credit decisions to the rating agencies. Let me throw out a radical idea.

Perhaps there are too many regulations that write the rating agencies into investment making decisions.

Chairman Kanjorski. I am sorry. I am going to ask your indulgence for a moment. I have a call from the President. If you will just hold where you are and I will be right back.

[Recess]

Chairman Kanjorski. Thank you for the indulgence. I have to tell you that you have staff assistants out in the anteroom, some of the staff are starting to rebel. I just heard them say that it is Valentines Day, and it is 6:30, so you better get your act together and get out of here or there is going to be a revolt.

[Laughter]

Chairman Kanjorski. I could stay here all day, quite frankly. I think it is a vitally important issue. I am looking to panels like this to give us the insight on what to do.

Mr. Larkin. Mr. Chairman, could I finish the thought?

Chairman Kanjorski. Yes.

Mr. Larkin. As Mr. Ackman said, there has been an awful lot of outsourcing of the credit decisions to the rating agencies. You can start with Rule 2a-7 of the Act of 1940. It basically says the rating agencies decide what money market funds can hold and what they cannot hold.

There are things written into bond documents that say if this is rated A but an issuer wants to make a change to a document, it cannot be done without the bond rating agency's approval, otherwise the rating could be downgraded.

Ultimately is the point I made before, the bond insurers, Triple A, they can only do whatever the rating agencies would have allowed them to do to be able to maintain the Triple A. The bond insurers could not have gotten into this without the rating agencies saying it is okay.

Perhaps we do not need more regulation on the raters or the bond insurers. Maybe we have just written the rating agencies into too much regulation, to give them this much power.

Chairman Kanjorski. We have been looking into that. You cannot imagine the number of statutes and regulations that they are in. It would take us several years to pull the peel off and find out what is there.

I tend to agree. I think some quick action could be taken to allow municipal bonds to be treated like corporate bonds are on a temporary basis. That would solve all the pressure of forcing trustees to sell when there is really no threat to the asset.

I am firmly convinced that this is not a problem of real liquidity. It is a problem of trust and faith. The people in the market have lost faith in the market. We have to get them back.

Once they get a comfort level, just like after you have your first accident, and once you get behind the wheel and you drive again, it all comes back to you. If you stay away from it and you do not drive, you are never going to drive.

If we are going to get investors back into the marketplace, we have to first show them good product. They have to have the transparency to see that product. I think we have to take the effort to make sure that happens and then let them ride with it for 3, 6, or 9 months, and ultimately the market will solve its own problem and be back.

Mr. Larkin. I think a few people have brought up changes to transparency, at least within the municipal bond industry, the municipal EDGAR system. It is basically providing information and providing disclosure so investors can make those decisions.

Right now, it is very hit or miss as to whether you can get disclosure in the municipal market. The more you can improve things like that, the more you will be able to have investors able to make decisions. I would even go so far as to say maybe you would even have real rating agency competition in the municipal area, because right now, you could not start a rating agency unless you get the cooperation of the issuers because the information is just not readily available.

Chairman Kanjorski. Right.

Mr. Larkin. Without the issuers agreeing, and that is why the rating agencies only rate upon request, because without the issuers' cooperation, you cannot rate it.

As more transparency comes into the market, maybe we will get more rating agency competition.

Mr. Buckley. Mr. Chairman, I think Fitch would certainly strongly endorse and support the concept of greater transparency of all the types of transactions we rate.

There is very good disclosure on corporations via Forms 10-K, 10-Q, etc. Certainly, we get much more information than the investing public on structured finance transactions and on municipalities.

We think it would be better for the capital markets if the information that we received was also made available to the general investing public by the issuers and structurer's, because we do not want to necessarily be the only ones looking at the data.

We think transparency is good and healthy and that it allows investors to better understand our ratings and interpret our research and talk to us and understand our process.

Chairman Kanjorski. What would be the difficulty of actually defining what has to be transparent? It is so simple for various entities, whether they be hedge funds or equity funds, to create new constructs that do not quite fall in the definition of a bond or a share.

How do we force that every financial instrument gets recorded and is part of the inventory?

Mr. Buckley. It certainly would be a process, but if you look at the disclosure requirements for corporations currently, not perfect, but good, robust. If you look at that as sort of a starting point and can think of a structured finance or municipal finance or other types of instruments that are being created, can you bring them to a standard that seems reasonably consistent with what corporations need to disclose, given their own unique needs.

I think that might be at least a starting point. That seems to have worked reasonably well and can we bring other types of instruments to that level playing field.

Chairman Kanjorski. Normally, for an inventory of that sort, we would have considered putting that in the exchanges. Now that they have gone for profit, where can we find some non-profit entity to hold that inventory?

Mr. Ackman. I think it is as straightforward as putting it on the Internet.

Chairman Kanjorski. Somebody has to be responsible for it. Somebody has to tend to it.

Mr. Ackman. There is a fee that comes out of every bond issue of a basis point or less or some small fee, $1,000, that goes towards a national repository of information for the benefit of investors. It will help issuers reduce their issuance costs. I think they would be more than happy to pay such a fee.

It is like a registration fee you pay to the SEC for an equity offering.

In that we are in a hearing about bond insurers, on the transparency side, one very simple thing that could happen immediately and one of the things that we actually did, wrote a letter to Chairman Bernanke and suggested that this would be a good thing for the transparency in the bond insurance industry, is why do not the bond insurers provide on their Web site a list of all their exposures, the underlying ratings for those exposures, and then in particular, they have what they call classified lists, which are lists of credits where there are potential problems. They have different classified, seriously classified or medium classified or just barely classified.

If investors got to see all the riskiest parts that the bond insurers have exposure to, if they had a list of all the CDOs' transactions and all the asset backed securities that they have guaranteed, then investors could do their own due diligence. They would not have to rely on the rating agencies' Triple A.

I find it like a little bit like Alice in Wonderland that we are sitting at a hearing talking about a group of entities that are struggling to raise capital and almost all of them still have Triple A ratings.

Investors clearly do not trust the Triple A, and what would create trust would be transparency from just the bond insurers coming clean, show us all your exposures.

Chairman Kanjorski. How long would it take to have those disclosures?

Mr. Ackman. Maybe we can ask Mr. Chaplin. They have this information at the tip of their fingertips. I am sure they have it in electronic form. They could make it public tomorrow if they chose to.

Chairman Kanjorski. Is that correct?

Mr. Callen. Mr. Chairman, I usually disagree with Mr. Ackman, but on the issue of incentives that he described, I fully agree. I think this was an issue of incentives.

On transparency, I have been the CEO of Ambac for all of a month. You cannot find a better expert. The issue is every time that I have gone to our chief financial officer to ask him a detailed question, he snaps at me to look at our Web site.

Let me make an exception to this. We have it all on the Web site, every municipal exposure. It is one of the most transparent businesses there is.

When you get into something, and here I am talking about in our case, four transactions, CDO squared's, there are several layers.

What I recommended at one point is that we actually publish the QSIPs. The people that know this technically much better than I do came and surrounded me with knives and said are you crazy. If you put the QSIPs on there, you are providing information that can be used very successfully against you. Are there no competitive protections any more?

I would argue and I would point anybody to the Ambac Web site and show me a more transparent Web site anywhere.

I wanted to do this for our major investors who were very injured and very upset and came and pounded on me. The first 3 weeks in the job, I was talking to investors, apologizing for what has happened to them.

I said to them, some of the most professional investors in the world, well, all right, we will put all our QSIPs on, don't go that far because that gives--I agree with you on short sellers. I think they are every bit as much capitalists as the rest of us and there should be short sellers.

Their point is that will give the short sellers the opportunity to go out and take advantage, which I do not think we have the time to go into detail here, but I learned how that could happen.

There is a little bit perhaps, just a distant possibility of self serving in this conversation, but it would have to be examined very carefully.

I am all for transparency. All the rating agencies know everything of ours and they run it through their models.

The last point I would make is we are really talking here--let me give you a view of my own of what is happening in the market now.

When you build an airplane, you build it to the 6th sigma. You design for 100 people. You build it to withstand 400 people. Deterministic.

When you trade in markets, it is probabilistic. You have some probability of loss every time you trade. The markets right now are locked up because they are working to the 6th sigma.

When we talk to Moody's, which we did for 2 hours yesterday about how we are solving the problem they perceive, they are saying we want per our model to give you 99.99 percent confidence level that the worse thing can happen to you, and unless you can do that and then multiply it by 1.3 times, that is the amount of capital we want you to have. If you go to AA, it is 1.2 times that extreme scenario.

Let me leave you with one more thought. I have a theory. Let us see if I am right. You call a hearing again in 3 months, and here is what I believe you are going to find. You are going to find that the mortgage losses we are experiencing today are a pig in a python. Here is what I mean by that. We had very loose underwriting standards in 2006 and 2007, some at the end of 2005. Very loose. All the reasons that have been described. Bill Ackman is absolutely correct on that.

There was a lot of fraud and there were a lot of investor unoccupied buildings that were financed through mortgages. Those, especially the fraud, and the investor transactions, when housing prices started to decline, are the first ones to default.

This is a surreal experience for me and I have been in the financial industry for 45 years. I have been through the LDC stuff, the commercial real estate stuff across the country, Orange County. It was all about the world coming to an end at the time we were dealing with it.

This is the first time I have ever experienced a situation where it is not how much capital you have, it is not how much liquidity you have, it is not what your earnings are, it is what you are projecting to happen. It has not happened yet. It may never happen.

If I am right about the pig in the python, it is not going to happen.

That is a real possibility. I think we have to stay tuned and see how these loss curves might trend down. Thank you.

Chairman Kanjorski. Does anyone else on the panel have anything to add so we can make friends with your wives and significant others?

Mr. Ackman. Can I make one more romantic interjection?

[Laughter]

Mr. Ackman. With all due respect to Mr. Callen, I think if providing transparency gives a short seller more information to make his argument, then maybe the information is not so bullish for the company, and maybe that is why investors are concerned.

If a company is not willing to be transparent and to provide the QSIPs so investors can do their own assessment, if it were my company and I thought the losses were only $2 billion and the world was saying $12 billion, I would say open kimono, here is every one of my exposures. Here is every one of my troubled exposures.

You go do the work. I can prove to you I am not going to lose money. When you do not disclose anything and you say, look, the rating agencies say we are Triple A. Our models say we are Triple A. We are just not going to tell you what the exposures are, that is when investors lose confidence because frankly when a stock is down 80 percent, the market is telling you something.

The solution to the problem is simply transparency. If providing transparency gives the short sellers more arguments, then perhaps the story is not as good as management has been letting on.

I love short sellers. You would not ask Microsoft to publish all of its code. That would be a little silly. When a new structure for Morgan Stanley comes out that is fairly unique and innovative, you would not ask them to show it all.

I love short sellers. I think they are an important part of the market, but I have to remind people that a year ago, Ambac stock was at $96. It closed today at about $12 or $13. We were as transparent back then when everybody loved it as we are today, and the difference is that the housing market, for reasons we could talk about all day, has taken a turn.

We made a big mistake--``correlation.'' We thought if we had mortgages in California and mortgages in Maine, they would not both go down together. We were wrong.

Chairman Kanjorski. This is one of the few national markets at this point. It has always been a moving market.

I think I have gained a lot of information. I am not prepared to confess everything that we have learned.

Would the panel be available in the future either on a personal basis when we need additional information or if collectively, we call you back? Would you be interested in participating?

Mr. Chaplin. Absolutely.

Mr. Callen. Of course.

Mr. Larkin. Absolutely.

Mr. Buckley. Absolutely.

Mr. Ackman. Absolutely.

Chairman Kanjorski. I appreciate that.

I have to say that the Chair notes that some members may have additional questions for today's witnesses, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to any of today's witnesses, and to place their responses in the record.

Before we adjourn, the following documents will be made a part of the record: The letters that the chairman wrote to the Federal and State regulators and their responses; the written statements of the Association of Financial Guarantee Insurers and the Pennsylvania Higher Educational Facilities Authority; a letter from 35 Pennsylvania bankers; and a letter from the Illinois Finance Authority.

Without objection, it is so ordered.

At this point, the panel is dismissed and this hearing is adjourned. Thank you very much, gentlemen.

[Whereupon, at 6:53 p.m., the hearing was adjourned.]

A P P E N D I X

February 14, 2008

[GRAPHIC(S) NOT AVAILABLE IN TIFF FORMAT]

EXHIBIT 87

FINANCIAL TIMES

Last updated: February 15, 2008 11:46 am

Monolines explained

By Paul J Davis, Cynthia O'Murchu, Steve Bernard and Ingram Pin

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Monolines, companies that insure against the risk of a bond or other security defaulting, have in the past weeks come under fire from ratings agencies, after concerns grew over their ability to meet the obligations to the bond issuers they insure.

Some, such as ACA, Ambac and SCA, were recently downgraded, raising fears of a domino effect resulting in further downgrades and market losses for the securities they – and other monolines – guarantee.

In late January New York insurance regulator, Eric Dinallo, urged major banks to provide up to $15bn (£7.6bn) to support the monoline industry in an effort to stem the threat of additional losses for banks and other financial institutions with exposure to some of the over $2,400bn of debt guaranteed by bond insurers.

FT.com's interactive graphic explains how monolines work and what the threat to their triple-A ratings from the credit agencies could mean for investors, banks, municipal bond issuers and the monolines themselves.

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EXHIBIT 88

FTAlphaville

All that's missing at BarCap is a little clarity

Helen Thomas Author alerts Feb 19 2008 09:31

The house that was built on structured credit appears to have weathered the storm – or at least better than many.

It hasn't of course come out unscathed. Amid Barclays' remarkably resilient year-end results, the juggernaut that was Barclays Capital has been brought almost to a halt.
In the heady days of the first half of last year, BarCap, headed by Bob Diamond, outshone the UK retail and business banking operations, posting pre-tax profit of £1.7bn, way ahead of UK banking's £1.4bn.

In the second half of the year, it was reined in, ending the year with profit of £2.3bn, against the UK's £2.7bn. In other words, BarCap added just £675m of profit in the second half of the year. But even that, after credit market losses of £1.64bn, is probably considered something of a triumph – a 5 per cent gain for BarCap across the year.

Of a total of £1.64bn in credit losses in 2007, only £795m has gone through the income statement, and that £1.64bn is net of £658m of "gains arising from the fair valuation of notes issued by Barclays Capital."

So it sounds like BarCap raised debt sometime before the credit squall really got going, and is now being helped out by the widening spreads, and declining carrying value, on that issuance.

Counter-intuitive, perhaps – but there you go.

In terms of what has actually gone into that £1.64bn, it's all a tad unclear. Even with the benefit of note 18, which starts down on page 61.

There's £846m, which includes £722m of losses against ABS CDO super senior exposure, £60m of other credit market exposure and £58m on committed leveraged finance positions. We'd note that £58m, on drawn leverage finance positions of £7.4bn looks a little puny.

Barclays' monoline exposure, which Bob Diamond on Tuesday professed himself "not uncomfortable" with, rose by a factor of 10, from £140m at the half year stage to £1.4bn by the end of December. Barclays' has £1.3bn of hedges against its £6bn gross ABS CDO super senior exposure, none of which is with monolines – which rather begs the question of who it is with.

Elsewhere writedowns of £823m net come on other US subprime and Alt-A exposure, and its exposure to the monolines and CMBS. But we can't see what write-downs, if any, Barclays has taken on its ballooning exposure to assets backed by a monoline guarantee – or indeed on its £5bn exposure to subprime or £4.9bn exposure to Alt-A.

As analysts at KBW put it, "bears will continue to muse over the near term outlook for Barcap revenues, while questioning the prudence of current writedowns." And Credit Suisse's difficulties in making its numbers add up only provides additional bearish angst.

Related links
Barclays chief hails 'resilient' performance – FT.com

This entry was posted by Helen Thomas on Tuesday February 19th, 2008 09:31. Tagged with barcap, Barclays, Capital Markets.

EXHIBIT 89

ASSEMBLY STANDING COMMITTEE ON INSURANCE

NOTICE OF PUBLIC HEARING

SUBJECT: The State of the Bond Insurance Industry

PURPOSE: The purpose of this hearing is to examine the current state of the Bond Insurance Industry, including past decisions and policies that have led to the present crisis.

Friday--March 14, 2008
10:00 AM
250 Broadway
Assembly Hearing Room
Room 1923, 19th Floor
New York, NY

Bond insurance is purchased to guarantee the payment of principal and interest to holders of municipal bonds. Over the past several years, many bond insurers have extended coverage to insure different financial services products, including products backed by subprime mortgages. The recent decline in the worth of the subprime mortgage market has led credit rating agencies to downgrade or threaten to downgrade the credit ratings of bond insurance companies, which in turn has caused a dangerous drop in consumer confidence. The result of this drop in consumer confidence has already led to stock market volatility, a reduced ability to offer auction rate securities, a reduced ability to finance student loans, a decrease in the value of bank holdings and insurance company reserves, and an increased cost of and reduced availability of bond insurance. The availability and affordability of bond insurance will impact municipalities, which use municipal bonds to finance key projects relating to education, transportation infrastructure, and construction. If municipalities are unable to afford bond insurance, they may be forced to abandon or delay important and necessary projects.

This hearing will examine the need for increased regulatory reform and transparency of the bond insurance industry in order to mitigate the current crisis facing the industry, prevent future crises in the market, and ensure the strength and resiliency of New York's economy, which is tied so closely to the financial markets.

Please see the reverse side for a list of subjects to which witnesses may direct their testimony. Persons wishing to present pertinent testimony to the Committee at the above hearing should complete and return the enclosed reply form as soon as possible. It is important that the reply form be fully completed and returned so that persons may be notified in the event of emergency postponement or cancellation.

Oral testimony will be limited to ten minutes in duration. In preparing the order of witnesses, the Committee will attempt to accommodate individual requests to speak at particular times in view of special circumstances. These requests should be made on the attached reply form or communicated to Committee staff as early as possible.

Ten copies of any prepared testimony should be submitted at the hearing registration desk. The Committee would appreciate advance receipt of prepared statements.

In order to further publicize these hearings, please inform interested parties and organizations of the Committee's interest in hearing testimony from all sources.

In order to meet the needs of those who may have a disability, the Assembly, in accordance with its policy of non-discrimination on the basis of disability, as well as the 1990 Americans with Disabilities Act (ADA), has made its facilities and services available to all individuals with disabilities. For individuals with disabilities, accommodations will be provided, upon reasonable request, to afford such individuals access and admission to Assembly facilities and activities.

Hon. Joseph Morelle
Member of Assembly
Chairman,
Committee on Insurance

SELECTED ISSUES TO WHICH WITNESSES MAY DIRECT THEIR TESTIMONY:

1. What has caused the current crisis in the bond insurance market and what role did the regulator play in contributing to such crisis?
2. If bond insurer credit-ratings are downgraded, how will the New York market be impacted?
3. What could be done to mitigate the current crisis and to provide stability to the marketplace?
4. What will the effect be if bond insurers split their book of business into good and bad risks?
5. How would the proposed $10 million deficiency appropriation for legal and financial contractual services be used to provide a reliable solution to the current problems facing the bond insurance market?
6. What statutory or regulatory reforms should be enacted to strengthen the bond insurance industry?
7. What role, if any, should the rating agencies have played in approving AAA ratings for securities?
8. What is the short term and long term impact of the crisis on bond auctions?

PUBLIC HEARING REPLY FORM

Persons wishing to present testimony at the public hearing on The State of the Bond Insurance Industry are requested to complete this reply form as soon as possible and mail or fax it to:

Lishone Bowsky
Senior Committee Assistant
Assembly Committee on Insurance
23 Floor - Alfred E. Smith Office Building
80 South Swan Street
Albany, New York 12248
E-mail: Bowskyl@assembly.state.ny.us
Phone: (518) 455-4311
Fax: (518) 455-7095

I plan to attend the following public hearing on The State of the Bond Insurance Industry to be

☐ conducted by the Assembly Committee on Insurance on March 14, 2008.

☐ I plan to make a public statement at the hearing. My statement will be limited to 10 minutes, and I will answer any questions which may arise. I will provide 10 copies of my prepared statement.

☐ I will address my remarks to the following subjects:

☐ I do not plan to attend the above hearing.

☐ I would like to be added to the Committee mailing list for notices and reports.

☐ I would like to be removed from the Committee mailing list.

☐ I will require assistance and/or handicapped accessibility information. **Please specify the type of assistance required:**

NAME:

TITLE:

ORGANIZATION:

ADDRESS:

E-MAIL:

TELEPHONE:

FAX TELEPHONE:

***** Click here for printable form *****

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