COMMITTEE ON SCIENCE AND TECHNOLOGY

SUBCOMMITTEE ON INVESTIGATIONS AND OVERSIGHT

U.S. HOUSE OF REPRESENTATIVES

HEARING CHARTER

The Science of Insolvency

Tuesday, May 19, 2009

10:00 a.m. to 12:00 p.m.

2318 Rayburn House Office Building

Purpose

On Tuesday, May 19, 2009 the Subcommittee on Investigations and Oversight of the Committee on Science and Technology will hold a hearing to focus on what it means for a financial institution to be "solvent" given the complexity of global financial markets. In order to do this, the Subcommittee will tap the insight of economists into how the tools of their discipline can be used in making determinations of current solvency and projections of future solvency on an objective, scientific basis.

Economics aspires to be a science. The insights of economics have been used to inform almost every aspect of domestic policy. The National Science Foundation is the major funding resource for economic research in the Federal government. What, then, do those whose perspectives are shaped by "the dismal science" have to say about the current financial morass?

Balance sheets of financial institutions have become far more difficult to understand as the percentage of the assets listed therein consisting of direct loans (which have a relatively straightforward valuation) has diminished and that of derivative instruments has grown. Even with regards to assets based on more common financial instruments (mortgages, for example) what has the turmoil in the real estate market meant for accurately valuing and accounting for those holdings? This complexity for valuing balance sheets has been particularly difficult for the large institutions at the center of the financial system. These are the firms which have traded increasingly in the complex instruments -- collateralized debt obligations (CDO), credit default swaps (CDS), and the like -- whose connection to the underlying assets from which their value is derived can be far from transparent. Compounding the transparency problem is the fact that such instruments, rather than being standardized, are often born of specific deals and thus do not lend themselves to conventional trading, by which the value of major equities and commodities are established.

Questions over the solvency of major financial institutions arose suddenly, on the heels of a boom period during which values seemed to spiral ever upward and, consequently, mechanisms of valuation went largely unchallenged. In retrospect, that growing value looks like the edge of an unsustainable bubble, driven largely by real estate. Valuation

has become even more complex owing to an April decision by the Financial Accounting Standards Board (FASB) tying valuations of financial assets less tightly to current market prices and thereby increasing firms' flexibility in assigning value to them.[1]

Earlier this month the Federal Reserve announced the results of the "stress test" performed on the 19 U.S.-owned banks whose assets exceeded $100 billion at the end of 2008. This test's design combined the Fed's choosing "two alternative assumed paths for the U.S. economy," having supervisors make "judgmental adjustments to the firms' loss and revenue estimates," and deciding on the assumptions of what the Fed chairman, Ben Bernanke, called "objective, model-based estimates for losses and revenues that could be applied on a consistent basis across firms."[2]

Such factors as FASB's decision and the Fed's methodology invite a discussion of the reliability and rigor of the modeling used in financial assessments, as well as what truly constitutes objective criteria. Can we find worthwhile data and reliable models to determine solvency at a time when markets are suddenly viewed as unreliable sources of information about value? Among the questions addressed in examining this issue will be:

- How can a financial instrument be assigned value in the absence of a market for it? What models and other techniques are available? Are new ones needed?
- Do objective standards for solvency exist? When it comes to determining a firm's solvency, does a financial institution constitute a special case as compared to, say, a retail or industrial firm?
- Was the stress test sufficiently rigorous? Was it fair? Did it look at appropriate factors and make valid assumptions?

Witnesses

The Subcommittee will take testimony from four prominent economists regarding these questions. We are looking for insights into how economists evaluate the current situation to give us a better sense of the state of the science, and the state of information that we rely on, to make legislative and policy choices.

Dr. Dean Baker, Co-Director, Center for Economic and Policy Research

Dr. Simon Johnson, Ronald A. Kurtz Professor of Entrepreneurship, MIT Sloan School of Management

Dr. Jeffrey Sachs, Director, The Earth Institute at Columbia University

Mr. David John, Senior Research Fellow, Heritage Foundation

[1] "Under New Accounting Rule, Toxic Assets May Be Revalued," Washington Post, April 3, 2009, p. A15.

[2] Speech, Federal Reserve Chairman Ben S. Bernanke, Jekyll Island, GA, May 11, 2009, available at www.federalreserve.gov/newsevents/speech/bernanke/20090511a.htm.