

CONGRESSIONAL OVERSIGHT PANEL

FEBRUARY OVERSIGHT REPORT \*

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VALUING TREASURY'S ACQUISITIONS



FEBRUARY 6, 2009.—Ordered to be printed

\*Submitted under Section 125(b)(1) of Title I of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343

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### EXECUTIVE SUMMARY

A central question surrounding the Troubled Asset Relief Program (TARP) is whether the U.S. Department of the Treasury's (Treasury) policy of injecting cash into financial institutions has resulted in a fair deal for taxpayers. The focus of this report is a financial valuation study of the terms of Treasury's program to invest capital in financial institutions. The report was commissioned as part of the Congressional Oversight Panel's continuing investigation into the terms of the TARP. The report was conducted for the Panel by its Advisory Committee on Finance and Valuation (Advisory Committee) and by the international valuation firm, Duff & Phelps Corporation; the Advisory Committee's report is attached to this report and the longer complete Duff & Phelps valuation report is posted on the Panel's website.<sup>1</sup> The valuation report was enhanced by an accompanying legal analysis of the terms of the TARP transactions, which is also attached to this report.

The valuation report concludes that Treasury paid substantially more for the assets it purchased under the TARP than their then-current market value. The use of a one-size-fits-all investment policy,<sup>2</sup> rather than the use of risk-based pricing more commonly used in market transactions, underlies the magnitude of the discount. A number of reasons for this result have been suggested. The Panel has not determined whether these reasons are valid or whether they justify the large subsidy that was created. In addition, the

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<sup>1</sup> Congressional Oversight Panel (online at [cop.senate.gov](http://cop.senate.gov)).

<sup>2</sup> That policy includes creation of a uniform capital infusion program, acceptance of a limit on the marketability of the securities Treasury received, and terms that encourage institutions to replenish their private capital.

Panel has not made judgments about whether the decision-making underlying these investments was sound. The rationale for the Treasury's approach and the impact of this disparity will be subjects for the Panel's continued study and consideration. It is important, however, for the public to understand that in many cases Treasury received far less value in stocks and warrants than the money it injected into financial institutions.

The legal analysis concludes that the documentation for the investments was standardized. The use of standardized documents likely contributed to Treasury's ability to obtain speed of execution and wide participation, but it meant Treasury could not address differences in credit quality among various capital infusion recipients through variations in contractual terms governing the investments or impose specific requirements on a particular recipient that might help insure stability and soundness.

The February report also provides an update on the Panel's previous work, as well as a review of the key actions and changes at Treasury regarding the TARP since the Panel's last report. In its initial report, on December 10, 2008, the Panel asked ten questions about the TARP and a series of sub-questions on the strategy, goals, methods, and operations of the program. In its next report, issued on January 9, 2009, the Panel analyzed Treasury's response to the Panel's questions and highlighted four specific areas where Treasury most needed to provide additional information:

(1) Bank Accountability. The Panel pressed Treasury to collect and disclose additional information about how TARP-recipient banks are using taxpayer funds and to establish reporting requirements, formal usage guidelines, or additional benchmarks for the conduct of TARP recipients as a condition of taxpayer support.

(2) Transparency and Asset Evaluation. The Panel emphasized the need for Treasury to ensure transparency both in the process of selecting TARP recipients and the relationship between an institution's receipt of TARP funds and the value of its assets in order to increase TARP accountability and confidence in the markets.

(3) Foreclosures. The Panel pressed Treasury to follow Congress's express mandate in §§ 109–110 of the Emergency Economic Stabilization Act of 2008 (EESA) to increase federal assistance to homeowners in danger of losing their homes and make further efforts to reduce foreclosures.

(4) Strategy. The Panel repeated its concern about Treasury's shifting explanations of its strategy for using TARP funds and called for Treasury to develop and follow a coherent strategy for the future use of TARP funds.

The Panel remains committed to its ongoing oversight role and will continue to seek answers to the questions presented in its previous reports. While the Panel recognizes that Treasury is in the midst of a transition of personnel and policies, it believes that the Panel's initial questions and areas of concern maintain their importance and will help Treasury as it reshapes its policies and continues to administer the TARP.

To that end, the Panel wrote a letter to Treasury on January 28, 2009, reiterating its requests for answers and asking for further re-

sponse by February 18, 2009.<sup>3</sup> The Panel expects to discuss Treasury's responses in its March report to Congress.

In addition to following the issues raised thus far, the Panel will focus on home mortgage foreclosures in its next report. We will continue to engage the public through hearings and a public participation and comment process, as well as required monthly reports.

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<sup>3</sup>See Appendix II, *infra*.

## VALUING TARP ACQUISITIONS

In October 2008, Treasury abandoned its original strategy of purchasing “troubled” mortgage and other assets from the nation’s financial institutions, deciding instead to invest money directly into those institutions.<sup>4</sup> The Panel made clear in its first report to Congress and the public, on December 10, 2008, that it wanted to know if “the public is receiving a fair deal” under the TARP in general and for those investments in particular. It explained that:

[A] critical aspect of [the Panel’s] mission is to determine whether the United States government has received assets comparable to its expenditures under the Emergency Economic Stabilization Act of 2008.

The Panel’s review of the ten largest TARP investments the Treasury made during 2008 raises substantial doubts about whether the government received assets comparable to its expenditures.<sup>5</sup> The Panel’s analysis does not explore whether these investments were the best means of achieving broader policy goals.

Valuation of the transactions is critical because then-Treasury Secretary Henry Paulson assured the public that the investments of TARP money were sound, given in return for full value: “This is an investment, not an expenditure, and there is no reason to expect this program will cost taxpayers anything.”<sup>6</sup> In December, he reiterated the point, “When measured on an accrual basis, the value of the preferred stock is at or near par.”<sup>7</sup> This means, in effect, that for every \$100 Treasury invested in these companies, it received stock and warrants valued at about \$100.

As discussed in greater detail in the remainder of this section, an extensive valuation analysis of the ten transactions that was commissioned by the Panel concluded that:

- In the eight transactions which were made under the investment program for healthy banks, for each \$100 spent, Treasury received assets worth approximately \$78.
- In the two transactions which were made under programs for riskier banks, for each \$100 spent, the Treasury received assets worth approximately \$41.
- Overall, in the ten transactions, for each \$100 spent, the Treasury received assets worth approximately \$66.
- Extrapolating these results using appropriate weighting to all capital purchases made in 2008 under TARP, Treasury paid \$254 billion, for which it received assets worth approximately \$176 billion, a shortfall of \$78 billion.

Three programs have been used by the Treasury to infuse capital directly into American financial institutions under TARP. The Cap-

<sup>4</sup>U.S. Department of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Actions to Protect the U.S. Economy (Oct. 14, 2008) (online at [www.treasury.gov/press/releases/hp1205.htm](http://www.treasury.gov/press/releases/hp1205.htm)).

<sup>5</sup>This valuation analysis does not include the approximately \$24 billion in loans to General Motors, Chrysler, Chrysler Financial, and GMAC made as part of the Automotive Industry Finance Program.

<sup>6</sup>U.S. Department of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Capital Purchase Program (Oct. 20, 2008) (online at [www.treas.gov/press/releases/hp1223.htm](http://www.treas.gov/press/releases/hp1223.htm)).

<sup>7</sup>U.S. Department of the Treasury, Responses to Questions of the First Report of the Congressional Oversight Panel for Economic Stabilization (Dec. 30, 2008).

ital Purchase Program (CPP), created in October 2008 has the most widespread bank participation.<sup>8</sup> This program was intended for healthy banks: those that are sound and not in need of government subsidization. While a total of 317 financial institutions have received a total of \$194 billion under the CPP as of January 23, 2009, eight large early investments represent \$124 billion, or 64 percent of the total. The eight were: Bank of America Corporation, Citigroup, Inc., JPMorgan Chase & Co., Morgan Stanley, Goldman Sachs Group, Inc., PNC Financial Services Group, U.S. Bancorp, and Wells Fargo & Company. In addition, the Systemically Significant Failing Institutions Program (SSFI Program), launched in November 2008,<sup>9</sup> and the Targeted Investment Program (TIP), launched in January 2009,<sup>10</sup> were created to deal with financial institutions that were in financial distress. Only American International Group (AIG) received money under the SSFI Program. After receiving money as a “healthy bank,” six weeks later Citigroup received a second infusion of TARP funds, an infusion that was ultimately included as part of the as yet uncreated TIP.<sup>11</sup>

Under these three programs, Treasury made cash investments in designated financial institutions in return for a combination of preferred stock<sup>12</sup> and warrants<sup>13</sup> to purchase common stock of those institutions. The terms differed for each of the three programs—CPP, SSFI, and TIP—but they all involved the purchase of portions of the institutions.

To determine whether the Treasury received its money’s worth in these transactions, the Panel commissioned a detailed valuation project in December 2008. The project and its methodology were designed by an Advisory Committee on Finance and Valuation, composed of Adam M. Blumenthal, a former First Deputy Comptroller of the City of New York, Professor William N. Goetzmann of Yale University and Professor Deborah J. Lucas of Northwestern Uni-

<sup>8</sup>U.S. Department of the Treasury, Treasury Announces TARP Capital Purchase Program Description (Oct. 14, 2008) (online at [www.treas.gov/press/releases/hp1207.htm](http://www.treas.gov/press/releases/hp1207.htm)).

<sup>9</sup>U.S. Department of the Treasury, Treasury to Invest in AIG Restructuring Under the Emergency Economic Stabilization Act (Nov. 10, 2008) (online at [www.treasury.gov/press/releases/hp1261.htm](http://www.treasury.gov/press/releases/hp1261.htm)).

<sup>10</sup>U.S. Department of the Treasury, Treasury Releases Guidelines for Targeted Investment Program (Jan. 2, 2009) (online at [www.treasury.gov/press/releases/hp1338.htm](http://www.treasury.gov/press/releases/hp1338.htm)).

<sup>11</sup>Id. Treasury made it clear retroactively when it announced the TIP guidelines that its November 23 investment in Citigroup fell under TIP. Id. See also U.S. Department of the Treasury, Joint Statement by Treasury, Federal Reserve and the FDIC on Citigroup (Nov. 23, 2008) (online at [www.treasury.gov/press/releases/hp1287.htm](http://www.treasury.gov/press/releases/hp1287.htm)). Treasury used TIP again in January 2009 to make additional investments in Bank of America. U.S. Department of the Treasury, Treasury, Federal Reserve and the FDIC Provide Assistance to Bank of America (Jan. 16, 2008) (online at [www.treas.gov/press/releases/hp1356.htm](http://www.treas.gov/press/releases/hp1356.htm)).

<sup>12</sup>The preferred stock in the CPP investments paid a dividend of 5 percent for five years and 9 percent thereafter; it was so-called “perpetual preferred” (that is, it did not have a fixed term), although it could be redeemed by the issuer under certain conditions. Preferred stock is a form of security that lies halfway between a corporation’s common stock and its formal debt. The preferred stock bears a fixed dividend rate that is payable out of earnings, it must receive its dividend before any dividends can be paid to common shareholders, and its dividend rights are often cumulative (as was the case with the Treasury investments), which means that if a dividend is missed, the holder of the preferred stock has a right to receive the missed dividend as part of its payment in future years. In a liquidation, the preferred shareholders must be paid before any amount can be paid to the common shareholders, but preferred shareholders themselves cannot receive any funds if there is not enough first to pay all of the corporation’s creditors.

<sup>13</sup>The warrants allowed the Treasury to buy common stock of each institution for an additional amount—called the “exercise price”—that was calculated so that Treasury benefit if the value of the common stock increased. The exercise price for the Treasury warrants is the average trading price of a share of the institution’s stock for the 20 days prior to the selection of the institution for the CPP, and the shares that could be purchased were set at 15 percent of the face value of the Treasury’s preferred stock investment. (So that if the Treasury made a \$100 billion investment, the warrants would permit it to purchase \$15 billion of common stock.) The warrant values differed for the other two programs, but the principle remained the same.

versity.<sup>14</sup> After a competitive bidding process, the Committee recommended the international valuation firm Duff & Phelps to work with it to implement the project design and to perform the actual valuation.

To reach a conclusion about each of Treasury's investments, it is necessary to compare the amount of the government investment with the value of the preferred stock and the warrants it received in return in each transaction. The task is made more difficult because none of the securities is publicly-traded. Instead, the valuation analysis assumed that "securities similar to those issued under the TARP were trading in the capital markets at fair values."<sup>15</sup> The valuations employed multiple approaches in order to cross-check and validate the results.<sup>16</sup> Value was estimated for each security as of the time immediately following the announcement by Treasury of its purchase. This valuation approach takes into account investors' perceptions about how the TARP investment and other government programs announced concurrently affected the value of the institutions. The valuation report itself was based solely on publicly available information.

The ten largest investment transactions made under the three programs through November 2008 are listed in the following table.<sup>17</sup>

#### SUMMARY OF ESTIMATED VALUE CONCLUSIONS

[Dollars in billions]

Purchase program participant	Valuation date	Face value	Total estimated value		
			Value	Subsidy	
				Percent	\$
<b>Capital Purchase Program:</b>					
Bank of America Corporation .....	10/14/08	\$15.0	\$12.5	17	\$2.6
Citigroup, Inc .....	10/14/08	25.0	15.5	38	9.5
JPMorgan Chase & Co .....	10/14/08	25.0	20.6	18	4.4
Morgan Stanley .....	10/14/08	10.0	5.8	42	4.2
The Goldman Sachs Group, Inc .....	10/14/08	10.0	7.5	25	2.5
The PNC Financial Services Group .....	10/24/08	7.6	5.5	27	2.1
U.S. Bancorp .....	11/03/08	6.6	6.3	5	0.3
Wells Fargo & Company .....	10/14/08	25.0	23.2	7	1.8
Subtotal .....		124.2	96.9	22	27.3
311 Other Transactions <sup>1</sup> .....		70.0	54.6	22	15.4
<b>SSFI &amp; TIP:</b>					
American International Group, Inc .....	11/10/08	40.0	14.8	63	25.2
Citigroup, Inc .....	11/24/08	20.0	10.0	50	10.0
Subtotal .....		60.0	24.8	59	35.2

<sup>14</sup>Mr. Blumenthal is now the Managing General Partner of Blue Wolf Capital Management in New York. Professor Goetzmann is Edwin J. Beinecke Professor of Finance and Management Studies and Director of the International Center for Finance at the Yale School of Management. Professor Lucas is Donald C. Clarke HSBC Professor of Consumer Finance at the Kellogg School of Management at Northwestern University. Both Professor Goetzmann and Professor Lucas are Research Associates of the National Bureau of Economic Research.

<sup>15</sup>Adam M. Blumenthal, William N. Goetzmann, and Deborah J. Lucas, Report to the Congressional Oversight Panel on the Emergency Economic Stabilization Act of 2008, at 7 (Feb. 4, 2009) (hereinafter "Advisory Committee Report"). The Advisory Committee Report is attached as Appendix III to this report.

<sup>16</sup>The valuation methods are summarized on pages 7–10 of the Advisory Committee Report. The complete valuation report conducted by Duff & Phelps, which runs to some 697 pages, has been posted on the Panel's web site, [www.cop.senate.gov](http://www.cop.senate.gov), and a link to the report is attached as Appendix V to this report.

<sup>17</sup>Advisory Committee Report, *supra* note 15, at 2.

## SUMMARY OF ESTIMATED VALUE CONCLUSIONS—Continued

[Dollars in billions]

Purchase program participant	Valuation date	Face value	Total estimated value		
			Value	Subsidy	
				Percent	\$
Total .....	.....	254.2	176.2	31	78.0

<sup>1</sup> Extrapolates 22% subsidy rate from 8 studied CPP investments. See discussion in Part II.

This valuation analysis bears some similarities to an earlier valuation by the Congressional Budget Office (CBO). The report, titled *The Troubled Asset Relief Program: Report on Transactions Through December 31, 2008*, was released in January 2009. The CBO report focused on utilizing procedures similar to the Federal Credit Reform Act (FCRA) to assess the budgetary impact of all TARP transactions on the federal debt and deficit, which can be interpreted as a cost and thus a subsidy rate. By comparison, the Duff & Phelps report provides extensive, detailed company-by-company information for all major CPP participants. While both reports conclude that the fair market value of the securities received by Treasury was less than what was paid, the much deeper focus in the Duff & Phelps report provides the detailed information necessary to inform the public policy debate surrounding the future of the TARP. The Duff & Phelps report includes multiple valuation methods, an evaluation of similar private transactions, and an exploration of some of the reasoning behind the varied subsidies, including between the different programs and even between CPP participants. While the report itself does not draw any conclusions as to the validity of Treasury's decisions or any particular goals, the information will be extremely valuable to policy makers in drawing their own conclusions.<sup>18</sup>

In addition to a direct investigation of the market value of the transactions, the Panel's earlier reports suggested that additional information about the value of the TARP transactions could be derived by comparing those transactions to three large transactions involving private sector investors that were undertaken in the same time period: the purchase by Berkshire Hathaway of an interest in Goldman Sachs, announced in September 2008, the investment by Mitsubishi in Morgan Stanley, also announced in September 2008, and an investment by Qatar Holding LLC and entities representing the beneficial interests of HH Sheik Mansour Bin Zayed Al Nahyan, a member of the Royal Family of Abu Dhabi (Abu Dhabi) in Barclays PLC, announced in late October 2008.<sup>19</sup> The Advisory Committee and Duff & Phelps concluded that these transactions could not be used to make a direct comparison with the TARP investments. But by applying the same methodology to three major investments by private investors in financial institutions which occurred near the same time as the Treasury investments (the \$5 billion investment by Berkshire Hathaway in Goldman Sachs, the \$9 billion investment by Mitsubishi in Morgan

<sup>18</sup> Like the Duff & Phelps report, the CBO report uses only publicly available information to value capital purchases. Advisory Committee Report, *supra* note 15, at 7–10; Congressional Budget Office, *The Troubled Asset Relief Program: Report on Transactions Through December 31, 2008*, at 4–5 (Jan. 16, 2009).

<sup>19</sup> Advisory Committee Report, *supra* note 15, at 10.

Stanley and the £7 billion investment by Qatar Holding and Abu Dhabi and in Barclays), the valuation report concludes that, unlike Treasury, private investors received securities with a fair market value as of the valuation dates of at least as much as they invested, and in some cases, worth substantially more.

- For each \$100 Berkshire Hathaway invested in Goldman Sachs, it received securities with a fair market value of \$110.
- For each \$100 Qatar Holding and Abu Dhabi invested in Barclays, they received securities with a fair market value of \$123.
- For each \$100 Mitsubishi invested in Morgan Stanley, it received securities with a fair market value of \$91.

The way Treasury structured the CPP, SSFI Program, and TIP transactions was certain to create significant subsidies. Treasury's emphasis on uniformity, marketability, and use of call options in structuring TARP investments helped produce a situation in which Treasury paid substantially more for its TARP investments than their then-current market value. The decision to model the far riskier investments under the TIP and SSFI Program closely on the CPP transactions also effectively guaranteed that a substantial subsidy would exist for these riskier institutions. Because Treasury decided to make all healthy bank purchases on precisely the same terms, stronger institutions received a smaller subsidy, while weaker institutions received more substantial subsidies.

Two other structural factors contributed to the discount factor. First, companies have the ability to call the preferred stock at par; this option, which is not typical of publicly traded preferreds, decreased the value of the securities received by Treasury, particularly in the stronger institutions; this call feature may have reflected an attempt to limit the amount of time taxpayer funds are outstanding.<sup>20</sup> In addition, while the preferred stock and warrants could be registered for resale at the Treasury's request, liquidating such a large position would entail substantial cost. The likely costs inherent in such a liquidation also contributed to the discount.

In addition, the legal analysis<sup>21</sup> prepared for the Panel noted that for the CPP transactions: (i) Treasury will receive no premium if the issuer optionally redeems the preferred shares, (ii) the warrants and common stock held by Treasury can be repurchased, albeit at their then-fair market value, if the preferred stock is either redeemed or transferred, and (iii) the number of warrants held by Treasury are subject to an automatic 50 percent reduction if the subject institution sells equity equal in amount to Treasury's investment and qualifying as Tier I capital. Treasury appears to have decided to be a passive investor in each of the institutions in which it invests, choosing not to receive either voting rights or seats on

<sup>20</sup>The ability of a recipient of TARP assistance to call at par the preferred stock it has issued to Treasury accounts for slightly less than one-third of the total subsidy involved in the TARP transactions valued and slightly less than one-half of the subsidy in the CPP transactions alone. The liquidation costs associated with the preferred stock and warrants Treasury received accounted for about 20 percent of the total subsidy, or about a quarter of the subsidy in the CPP transactions alone. Looking at the benchmark transactions, private sector investors were, in those cases, able to offset this discount through a combination of higher interest rate, by taking more shares, or by insisting on other terms that balanced the impact of the market overhang.

<sup>21</sup>The legal analysis was prepared by Timothy G. Massad, Esq., a New York City corporate lawyer with close to 25 years' experience, who took an unpaid leave of absence from his law firm to serve as special legal advisor to the Panel on a pro bono basis. Catherina Celosse, Esq. acted as counsel for the Panel in the development of the legal analysis.

an institution's board of directors if it converts its warrants to common stock, and with a few exceptions no special covenants are imposed on the institutions that receive capital infusions. This can be contrasted with the more activist approach taken by the U.K. government in its investments in banks. (The legal analysis does note that, in some respects, Treasury did obtain better terms than were reflected in the Berkshire Hathaway investment in Goldman Sachs, but that those more favorable terms did not affect value.)

Additional observations in the legal analysis are also important. The analysis notes that the standard terms of the investments used in the CPP were generally within the range of what would be customary in a commercial transaction between a large financial institution and a large investor. The terms of the documents include a number of provisions that appear to be designed to encourage replacement of the Treasury investment with private capital quickly. In addition, there were no provisions in the CPP investment that restricted operations or business practices of the recipients, restricted or required reporting of use of funds,<sup>22</sup> or were directed at specific public policy objectives of EESA.<sup>23</sup> (The CPP, SSFI Program, and TIP forms do contain a "highly unusual provision . . . favorable to Treasury" that allow Treasury unilaterally to amend any provision of the relevant agreements if necessary to comply with any new or amended federal statutes; the impact of this provision is not included in the valuations in any way and is, in any event, extremely difficult to assess.)<sup>24</sup>

By paying the same price, regardless of the financial condition of the bank, Treasury ensured that weaker institutions would necessarily be subsidized more heavily. It may have wished to avoid the risk that more stringent CPP terms for some institutions would signal Treasury knowledge of adverse circumstances at those institutions. It is also possible that Treasury wanted to avoid the risk that failure of a weak bank could bring down stronger banks. The Panel has not determined whether these objectives have been met or whether they justified the large subsidy that was created. The Panel expects to address these broader policy objectives in its future work.

Investments in AIG under the SSFI Program and the second Citigroup investment involved significantly larger subsidy levels than were seen in the CPP institutions. The reason is that, despite the higher risk, Treasury modeled these investments closely on the CPP investments that had been designed for healthy banks. In the AIG transaction, Treasury already held warrants for 79.9 percent of the equity of AIG as the result of a loan provided to AIG by the Federal Reserve Bank of New York earlier in 2008; the proceeds of the TARP investment in AIG were used to repay part of that loan. The multiple loans and investments by parts of the federal government in AIG have helped keep it out of bankruptcy. The Advisory Committee and Duff & Phelps looked only at the discount to face value that the Treasury took as a result of its TARP investment, although they recognize that that investment was part of a

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<sup>22</sup>The lack of such reporting requirements is especially hard to understand.

<sup>23</sup>Timothy G. Massad, Summary of the Legal Report to the Congressional Oversight Panel for Economic Stabilization Concerning the TARP Investments in Financial Institutions, at 8 (Feb. 4, 2009) (hereinafter "Legal Analysis"). The Legal Analysis is attached as Appendix IV to this report.

<sup>24</sup>Id. at 11.

broader strategy by the government to prop up the company. Even in the AIG case, however, the then-Treasury Secretary insisted that the transactions were accompanied by “significant taxpayer protections and conditions.”<sup>25</sup>

Similarly, while the first investment in Citigroup was made as part of the CPP for healthy banks, the second investment was made after the markets recognized that Citigroup was subject to a significantly increased level of risk. The second investment was originally made outside any particular TARP program, on a free-standing basis; when the TIP was subsequently created, on January 2, 2009, the second Citigroup investment was reclassified as part of the TIP, aimed at riskier institutions, in connection with other government interventions. The analysis in the valuation report and its appendices does not evaluate those other interventions (i.e., interventions other than the purchase of preferred stock and warrants). It focuses only on the value gap between the amount of capital provided by the Treasury in the second Citigroup investment, and the value of the securities the Treasury received in exchange.

It is possible that the value of the investments made by Treasury may someday be worth more than the amount Treasury paid. It is also possible that they may be worth much less. This assessment demonstrates that the value received—including the market’s estimate of its future worth—was considerably less at the time of the transaction than the amount paid by Treasury. It also demonstrates that the value on an institution-by-institution basis varied substantially.

Treasury may have determined that granting the subsidies described above to a group of banks, regardless of their condition, on essentially the same terms was necessary, for one or more reasons, to preserve the integrity of the financial system. Whether the subsidy provided by Treasury to financial institutions represents a fair deal for the taxpayers is a subject for policy debate and judgment, not one that can be answered in a purely quantitative way.

In its public statements about its TARP expenditures, Treasury did not describe the program in terms of subsidization, nor did it explain why some banks should be subsidized more than others. Instead, Treasury repeatedly described investments “at or near par.” The Panel recognizes that the prudence of spending taxpayer dollars in this way may be the subject of disagreement among both experts and the public, but the Panel believes that if TARP is to garner credibility and public support, a clear explanation of the economic transaction and the reasoning behind any such expenditure of funds must be made clear to the public.

The Panel will continue to investigate how Treasury spends taxpayer funds and whether these expenditures are helping the economy.

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<sup>25</sup> U.S. Department of the Treasury, Remarks by Secretary Henry M. Paulson, Jr. on Financial Rescue Package and Economic Update (Nov. 12, 2008) (online at [www.treas.gov/press/releases/hp1265.htm](http://www.treas.gov/press/releases/hp1265.htm)).

## TREASURY DEPARTMENT UPDATES SINCE PRIOR REPORT

In the month since the Panel's last report, the second half of the TARP funds have been released, a new Administration has taken office, and a new Treasury Secretary, Timothy Geithner, has been sworn in. Since the new Administration began, Treasury has also extended additional assistance to financial institutions and announced new rules governing the conduct of recipients of TARP money.<sup>26</sup> The Panel will continue to evaluate the terms and conditions of the new programs and will provide updates on the effectiveness of these efforts.

- **Second Tranche of TARP Funds Released.** On January 15, 2009, Congress voted to approve the release of the second \$350 billion available from the October 2008 Emergency Economic Stabilization Act.<sup>27</sup> As such, Treasury now has access to the full \$700 billion spending authority contemplated in EESA.<sup>28</sup>

- **New Transparency Initiatives.** Treasury has announced new regulations governing disclosure and mitigation of conflicts of interest in its TARP contracting.<sup>29</sup> In addition, Treasury has made public assurances that it will “publish a detailed description” of its criteria and process for selecting TARP recipients.<sup>30</sup> Treasury has also issued new guidelines that restrict contact between lobbyists and the Treasury officials who decide how to allocate TARP funds.<sup>31</sup> Finally, Treasury has announced a new policy of publishing investment contracts within five to ten business days of all future TARP transactions,<sup>32</sup> in addition to publishing additional information about past TARP transactions with financial institutions.<sup>33</sup>

- **Changing TARP Strategy.** Secretary Geithner has indicated that future TARP strategy will incorporate additional conditions and an emphasis on homeowner assistance and unfreezing credit markets. New TARP funding will have “tough conditions to protect the taxpayer and the necessary transparency to allow the American people to see how and where their money is being spent and the

<sup>26</sup>The Panel appreciates the new administration's responsiveness to the concerns raised in its oversight reports as evidenced by National Economic Council Director Lawrence H. Summers' January 15, 2009 letter to the Congressional leadership, see Appendix I infra, and its recent TARP initiatives discussed in this report.

<sup>27</sup>Lori Montgomery and Paul Kane, *Senate Votes to Release Bailout Funds to Obama*, Washington Post (Jan. 16, 2009) (online at [www.washingtonpost.com/wp-dyn/content/article/2009/01/15/AR2009011504253.html](http://www.washingtonpost.com/wp-dyn/content/article/2009/01/15/AR2009011504253.html)).

<sup>28</sup>Emergency Economic Stabilization Act of 2008 (EESA), Pub. L. No. 110-343 at § 115(a).

<sup>29</sup>TARP Conflicts of Interest, Interim Rule, 74 Fed. Reg. 3431-3436 (Jan. 21, 2009) (codified at 31 C.F.R. §§ 31.200-31.218).

<sup>30</sup>Brady Dennis, *Treasury Moves to Restrict Lobbyists from Influencing Bailout Program*, Washington Post (Jan. 28, 2009) (online at [www.washingtonpost.com/wp-dyn/content/article/2009/01/27/AR2009012703500.html](http://www.washingtonpost.com/wp-dyn/content/article/2009/01/27/AR2009012703500.html)); U.S. Department of the Treasury, Treasury Secretary Opens Term with New Rules To Bolster Transparency, Limit Lobbyist Influence in Federal Investment Decisions (Jan. 27, 2009) (online at [www.ustreas.gov/press/releases/tg02.htm](http://www.ustreas.gov/press/releases/tg02.htm)).

<sup>31</sup>Id.

<sup>32</sup>U.S. Department of the Treasury, Treasury Announces New Policy to Increase Transparency in Financial Stability Program (Jan. 28, 2009) (online at [www.ustreas.gov/press/releases/tg04.htm](http://www.ustreas.gov/press/releases/tg04.htm)).

<sup>33</sup>See, e.g., David Enrich and Damian Paletta, *Agreement Boosts Citi Oversight*, Wall Street Journal (Jan. 29, 2009) (online at [online.wsj.com/article/SB123318955291026821.html](http://online.wsj.com/article/SB123318955291026821.html)).

results those investments are delivering.”<sup>34</sup> Furthermore, Treasury will increase its emphasis on preventing foreclosures and freeing up credit for homeowners and small businesses.<sup>35</sup>

- **Term Sheet for CPP investments in Subchapter S-Corporations.** On January 14, 2009, Treasury released a Summary of Terms under which S-Corporation financial institutions—generally small, private banks—can apply for TARP capital infusions.<sup>36</sup> Under these terms, Treasury limits dividend repayments and receives 7.7 percent interest for the first five years and then 13.8 percent interest for the next 25 years. In exchange for capital, Treasury will receive debt senior to any stock in the company.

- **Additional Executive Compensation Rules.** On January 16, 2009, Treasury issued interim final rules for reporting and record-keeping requirements under the executive compensation standards of the CPP.<sup>37</sup> Treasury originally published executive compensation standards for CPP in October 2008. The new rules require the CEOs of firms receiving funds under CPP to certify to TARP’s Chief Compliance Officer on a regular basis that the institutions are complying with the applicable TARP rules governing executive compensation. Financial institutions are also required to maintain records to substantiate these certifications for at least six years following each certification and provide these records to the TARP Chief Compliance Officer upon request. Treasury made similar revisions to the executive compensation guidelines applicable to financial institutions participating in the SSFI Program. On February 4, 2009, Treasury issued stringent new guidelines governing executive compensation for future TARP recipients.<sup>38</sup>

- **Investment in Chrysler Financial.** In addition to the \$22.4 billion already loaned out as part of TARP’s Automotive Industry Financing Program (AIFP) in December 2008, on January 16, 2009, Treasury announced a plan to make a \$1.5 billion loan under the AIFP to a special purpose entity created by Chrysler Financial.<sup>39</sup> The money will provide liquidity to Chrysler Financial’s program to extend new consumer auto loans to Chrysler customers. The five-year loan will require Chrysler to pay Treasury interest equal to one month LIBOR plus 100 basis points in the first year, and then one month LIBOR plus 150 basis points in years two to five. The loan will be secured by a senior secured interest in a pool of newly

<sup>34</sup> Senate Committee on Finance, Testimony of Timothy F. Geithner, Hearing To Consider the Nomination of Timothy F. Geithner To Be Secretary of the Treasury, 111th Cong. (Jan. 21, 2009) (online at [finance.senate.gov/hearings/testimony/2009test/012109tgtest.pdf](http://finance.senate.gov/hearings/testimony/2009test/012109tgtest.pdf)).

<sup>35</sup> Id. See also Rebecca Christie, Summers Says TARP To Be ‘Very Different’ Under Obama, Bloomberg (Jan. 25, 2009) (online at [www.bloomberg.com/apps/news?pid=20601068&sid=ayehJsUpnfGg](http://www.bloomberg.com/apps/news?pid=20601068&sid=ayehJsUpnfGg)); Andrew Ross Sorkin, Geithner Says TARP Would Force Banks To Lend More (Jan. 23, 2009) (online at [dealbook.blogs.nytimes.com/2009/01/23/geithner-says-tarp-will-force-banks-to-lend-more/](http://dealbook.blogs.nytimes.com/2009/01/23/geithner-says-tarp-will-force-banks-to-lend-more/)).

<sup>36</sup> U.S. Department of the Treasury, TARP Capital Purchase Program (Jan. 14, 2009) (online at [www.treas.gov/initiatives/eesa/docs/scorp-term-sheet.pdf](http://www.treas.gov/initiatives/eesa/docs/scorp-term-sheet.pdf)).

<sup>37</sup> U.S. Department of the Treasury, Treasury Issues Additional Executive Compensation Rules Under TARP (Jan. 16, 2009) (online at [www.treas.gov/press/releases/hp1364.htm](http://www.treas.gov/press/releases/hp1364.htm)).

<sup>38</sup> U.S. Department of the Treasury, Treasury Announces New Restrictions On Executive Compensation (Feb. 4, 2009) (online at <http://www.ustreas.gov/press/releases/tg15.htm>).

<sup>39</sup> U.S. Department of the Treasury, Treasury Announces TARP Investments in Chrysler Financial (Jan. 16, 2009) (online at [www.treas.gov/press/releases/hp1362.htm](http://www.treas.gov/press/releases/hp1362.htm)); U.S. Department of the Treasury, Treasury Announces TARP Investment in GMAC (Dec. 29, 2008) (online at [www.treas.gov/press/releases/hp1335.htm](http://www.treas.gov/press/releases/hp1335.htm)); U.S. Department of the Treasury, Indicative Summary of Terms for Secured Term Loan Facility (Dec. 19, 2008) (Chrysler Term Sheet); U.S. Department of the Treasury, Indicative Summary of Terms for Secured Term Loan Facility (Dec. 19, 2008) (GM Term Sheet).

originated consumer auto loans, and Chrysler Holding will serve as a guarantor for certain covenants of Chrysler Financial.

- **Finalized Terms of Citigroup Guarantee Agreement.** On January 16, 2009, Treasury, in conjunction with the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC), finalized the terms of a guarantee agreement with Citigroup.<sup>40</sup> The guarantee agreement was initially announced by Treasury on November 23, 2008. The agreement guarantees Citigroup against unusually large losses on an asset pool of \$301 billion of loans and securities backed by residential and commercial real estate assets, which will remain on Citigroup's balance sheet.

The guarantee is in place for ten years for residential assets and five years for nonresidential assets.<sup>41</sup> Should there be losses on the pool, Citigroup will be responsible for up to the first \$29 billion. Any additional losses will be split between Citigroup and the government, with Citigroup bearing 10 percent of the losses and the government bearing 90 percent.

- **Additional Assistance to Bank of America.** On January 16, 2009, Treasury announced an agreement to provide Bank of America with a package of assistance in the form of guarantees, liquidity access, and capital under the TARP.<sup>42</sup> Treasury and FDIC agreed to provide Bank of America protection against the possibility of unusually large losses on an asset pool of approximately \$118 billion primarily composed of securities backed by residential and commercial real estate loans. The majority of these assets, which will remain on Bank of America's balance sheet, were acquired as the result of its merger with Merrill Lynch.

In addition, Treasury announced it will invest \$20 billion in Bank of America under the TIP. TIP was created to maintain investor confidence in financial institutions at risk of a loss due to market volatility. In exchange for its investment, Bank of America will issue Treasury preferred shares with an 8 percent dividend.

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<sup>40</sup> U.S. Department of the Treasury, U.S. Government Finalizes Terms of Citi Guarantee Announced in November (Jan. 16, 2009) (online at [www.treas.gov/press/releases/hp1358.htm](http://www.treas.gov/press/releases/hp1358.htm)).

<sup>41</sup> U.S. Department of the Treasury, Summary of Terms, (Nov. 23, 2008) (online at [www.treasury.gov/press/releases/reports/cititermsheet\\_112308.pdf](http://www.treasury.gov/press/releases/reports/cititermsheet_112308.pdf)).

<sup>42</sup> U.S. Department of the Treasury, Treasury, Federal Reserve and the FDIC Provide Assistance to Bank of America (Jan. 16, 2009) (online at [www.treas.gov/press/releases/hp1356.htm](http://www.treas.gov/press/releases/hp1356.htm)).

### OVERSIGHT ACTIVITIES

The Congressional Oversight Panel was established as part of EESA and formed on November 26, 2008. Since its establishment, the Panel has issued two oversight reports, as well as its Special Report on Regulatory Reform, which was issued on January 29, 2009.

Since the release of the Panel's January oversight report, the following developments pertaining to the Panel's oversight of the TARP took place:

- In late January, the Panel received reports from experts it engaged to estimate the fair market value of the securities purchased by Treasury in its eight largest purchases under the CPP, and its investments in AIG and Citigroup outside the CPP. This report includes a discussion of their findings above and a more detailed summary in Appendix III and on the Panel's website.
- On January 28, 2009, Elizabeth Warren, Chair of the Panel, sent a letter to newly sworn-in Treasury Secretary Timothy Geithner requesting more complete answers to the questions the Panel posed regarding Treasury's TARP strategy and implementation.
- The Panel has received and reviewed more than 3,500 messages with stories, comments, or suggestions through [cop.senate.gov](http://cop.senate.gov).

## **FUTURE OVERSIGHT ACTIVITIES**

### **PUBLIC HEARINGS**

Following two successful public hearings, one in Clark County, Nevada in December on the housing crisis and one in Washington, DC in January on regulatory reform, the Panel will continue to hold hearings to shine light on the causes of the financial crisis, the administration of TARP, and the anxieties and challenges of ordinary Americans.

### **UPCOMING REPORTS**

In March 2009, the Panel will release its fourth TARP oversight report. The EESA aimed to stabilize the economy both through direct support of financial institutions and through encouraging foreclosure mitigation efforts. In the March report, the Panel will examine existing foreclosure mitigation efforts. The report will consider key areas including: the need for more detailed and comprehensive information about mortgage loan performance and loss mitigation efforts; the primary drivers in loan default, including affordability, negative equity and mortgage fraud; impediments to successful foreclosure mitigation efforts; and existing foreclosure programs and alternative approaches.

That report will also update the public on the status of its TARP oversight activities. The Panel will continue to release oversight reports every 30 days.

The Panel notes with great interest the release by the Government Accountability Office (GAO), on January 30, 2009, of a report titled *Troubled Asset Relief Program: Status of Effort to Address Transparency and Accountability Issues*. Independently agreeing with the Panel's unresolved concerns, GAO highlighted Treasury's continued need for action both to improve transparency and accountability in the TARP and to articulate and communicate a coherent overall strategy. The Panel intends to pursue these issues closely and to address them in future reports.

The Panel also notes with approval the efforts of TARP Special Inspector General (SIG) Neil Barofsky to prompt TARP recipients to account for their use of taxpayer funds and satisfy the conditions and reporting requirements already in place. The Panel strongly calls on Treasury and the Office of Management and Budget to aid, rather than hinder, SIG Barofsky's investigation.

### **PUBLIC PARTICIPATION AND COMMENT PROCESS**

The Panel encourages members of the public to visit its website at [cop.senate.gov](http://cop.senate.gov). The website provides information about the Panel and the text of the Panel's reports. In addition, concerned citizens can share their stories, concerns, and suggestions with the Panel through the website's comment feature. To date, the Panel has received more than 3,500 comments, and the Panel looks forward to hearing more from the American people. By engaging in this dialogue, the Panel aims to enhance the quality of its ideas and advocacy.

### **ABOUT THE CONGRESSIONAL OVERSIGHT PANEL**

In response to the escalating crisis, on October 3, 2008, Congress provided the U.S. Department of the Treasury with the authority to spend \$700 billion to stabilize the U.S. economy, preserve home ownership, and promote economic growth. Congress created the Office of Financial Stabilization (OFS) within Treasury to implement a Troubled Asset Relief Program. At the same time, Congress created the Congressional Oversight Panel to “review the current state of financial markets and the regulatory system.” The Panel is empowered to hold hearings, review official data, and write reports on actions taken by Treasury and financial institutions and their effect on the economy. Through regular reports, the Panel must oversee Treasury’s actions, assess the impact of spending to stabilize the economy, evaluate market transparency, ensure effective foreclosure mitigation efforts, and guarantee that Treasury’s actions are in the best interests of the American people. In addition, Congress has instructed the Panel to produce a special report on regulatory reform that will analyze “the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers.”

On November 14, 2008, Senate Majority Leader Harry Reid and the Speaker of the House Nancy Pelosi appointed Richard H. Neiman, Superintendent of Banks for the State of New York, Damon Silvers, Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations (AFL–CIO), and Elizabeth Warren, Leo Gottlieb Professor of Law at Harvard Law School to the Panel. With the appointment on November 19 of Congressman Jeb Hensarling to the Panel by House Minority Leader John Boehner, the Panel had a quorum and met for the first time on November 26, 2008, electing Professor Warren as its chair. On December 16, 2008, Senate Minority Leader Mitch McConnell named Senator John E. Sununu to the Panel, completing the Panel’s membership.

In the production of this report, the Panel owes special thanks to our Advisory Committee of Adam M. Blumenthal, Professor William N. Goetzmann, and Professor Deborah J. Lucas, to Tim Massad and Catherina Celosse for their legal analysis, as well as to the hardworking staff at Duff & Phelps. The Panel also thanks Ting Yeh for his careful research support on this report.

**APPENDIX I: LETTER FROM MR. LAWRENCE SUMMERS  
TO CONGRESSIONAL LEADERSHIP, DATED JANUARY  
15, 2009**



THE OFFICE  
PRESIDENT  
ELECT

January 15, 2009

The Honorable Nancy Pelosi  
Speaker  
United States House of Representatives

The Honorable Harry Reid  
Majority Leader  
United States Senate

The Honorable John Boehner  
Republican Leader  
United States House of Representatives

The Honorable Mitch McConnell  
Republican Leader  
United States Senate

Dear Madam Speaker, Leader Boehner, Leader Reid and Leader McConnell:

Thank you for the extraordinary efforts you have made this week to work with President-Elect Obama in implementing the Emergency Economic Stabilization Act of 2008. In addition to the commitments I made in my letter of January 12, 2009, the President-Elect asked me to respond to a number of valuable recommendations made by members of the House and Senate as well as the Congressional Oversight Panel. We completely agree that this program must promote the stability of the financial system and increase lending, preserve home ownership, promote jobs and economic recovery, safeguard taxpayer interests, and have the maximum degree of accountability and transparency possible.

As part of that approach, no substantial new investments will be made under this program unless President elect Obama has reviewed the recommendation and agreed that it should proceed. If the President elect concludes that a substantial new commitment of funds is necessary to forestall a serious economic dislocation, he will certify that decision to Congress before any final action is taken.

As the Obama Administration carries out the Emergency Economic Stabilization Act, our actions will reflect the Act's original purpose of preventing systemic consequences in the financial and housing markets. The incoming Obama Administration has no intention of using any funds to implement an industrial policy.

The Obama Administration will commit substantial resources of \$50-100B to a sweeping effort to address the foreclosure crisis. We will implement smart, aggressive policies to reduce the number of preventable foreclosures by helping to reduce mortgage payments for economically stressed but responsible homeowners, while also reforming our bankruptcy laws and strengthening existing housing initiatives like Hope for

OBAMA-BIDEN PRESIDENTIAL TRANSITION PROJECT

CO-CHAIRS

VALERIE B. JARRETT · JOHN D. PODESTA · PETER M. ROUSE

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Homeowners. Banks receiving support under the Emergency Economic Stabilization Act will be required to implement mortgage foreclosure mitigation programs. In addition to this action, the Federal Reserve has announced a \$500B program of support, which is already having a significant beneficial impact in reducing the cost of new conforming mortgages. Together these efforts will constitute a major effort to address this critical problem.

In addition to these commitments, I would like to summarize some of the additional reforms we will be implementing.

**1. Provide a Clear and Transparent Explanation for Investments:**

- For each investment, the Treasury will make public the amount of assistance provided, the value of the investment, the quantity and strike price of warrants received, and the schedule of required payments to the government.
- For each investment, the Treasury will report on the terms or pricing of that investment compared to recent market transactions.
- The above information will be posted as quickly as possible on the Treasury's website so that the American people readily can monitor the status of each investment.

**2. Measure, Monitor and Track the Impact on Lending:**

- As a condition of federal assistance, healthy banks without major capital shortfalls will increase lending above baseline levels.
- The Treasury will require detailed and timely information from recipients of government investments on their lending patterns broken down by category. Public companies will report this information quarterly in conjunction with the release of their 10Q reports.
- The Treasury will report quarterly on overall lending activity and on the terms and availability of credit in the economy.

**3. Impose Clear Conditions on Firms Receiving Government Support:**

- Require that executive compensation above a specified threshold amount be paid in restricted stock or similar form that cannot be liquidated or sold until the government has been repaid.
- Prevent shareholders from being unduly rewarded at taxpayer expense. Payment of dividends by firms receiving support must be approved by their primary federal

regulator. For firms receiving exceptional assistance, quarterly dividend payments will be restricted to \$0.01 until the government has been repaid.

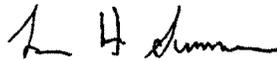
- Preclude use of government funds to purchase healthy firms rather than to boost lending.
- Ensure terms of investments are appropriately designed to promote early repayment and to encourage private capital to replace public investments as soon as economic conditions permit. Public assistance to the financial system will be temporary, not permanent.

**4. Focus Support on Increasing the Flow of Credit:**

- The President will certify to Congress that any substantial new initiative under this program will contribute to forestalling a significant economic dislocation.
- Implement a sweeping foreclosure mitigation plan for responsible families including helping to reduce mortgage payment for economically stressed but responsible homeowners, reforming our bankruptcy laws, and strengthening existing housing initiatives like Hope for Homeowners.
- Undertake special efforts to restart lending to the small businesses responsible for over two-thirds of recent job creation.
- Ensure the soundness of community banks throughout the country.
- Limit assistance under the EESA to financial institutions eligible under that Act. Firms in the auto industry, which were provided assistance under the EESA, will only receive additional assistance in the context of a comprehensive restructuring designed to achieve long-term viability.

The incoming Obama Administration is committed to these undertakings. With these safeguards, it should be possible to improve the effectiveness of our financial stabilization efforts. As I stressed in my letter the other day, we must act with urgency to stabilize and repair the financial system and maintain the flow of credit to families and businesses to restore economic growth. While progress will take time, we are confident that, working closely with the Congress, we can secure America's future.

Sincerely,



Lawrence H. Summers  
Director-Designate  
National Economic Council

**APPENDIX II: LETTER FROM CONGRESSIONAL OVERSIGHT PANEL CHAIR ELIZABETH WARREN TO TREASURY SECRETARY MR. TIMOTHY GEITHNER, DATED JANUARY 28, 2009**

**Congressional Oversight Panel**

732 North Capitol Street, NW  
Rooms C-320 and C-617  
Mailstop: COP  
Washington, DC 20401

January 28, 2009

Mr. Timothy F. Geithner  
Secretary of the Treasury  
U. S. Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

Dear Secretary Geithner:

Congratulations on your successful confirmation as Treasury Secretary. I am writing as Chair of the Congressional Oversight Panel to affirm the Panel's commitment to working with you as we carry out the duties assigned to us by Congress in Section 125 of the Emergency Economic Stabilization Act of 2008, Public Law 110-343.

In your opening statement to the Senate Finance Committee during your confirmation hearing on January 21, 2009, you committed to ensuring that Troubled Asset Relief Program (TARP) funding be allocated "with tough conditions to protect the taxpayer and the necessary transparency to allow the American people to see how and where their money is being spent and the results those investments are delivering." The Panel was encouraged by this statement and by your emphasis on transparency and accountability in your answers to the written follow-up questions you received from the Finance Committee after the hearing. Many of your proposed changes to TARP reflect the concerns we have expressed in both of our oversight reports.

In our first oversight report, we sent your predecessor ten questions consisting of forty-six sub-questions, seeking more information on behalf of the American public on Treasury's strategy, the selection process for TARP recipients, the uses to which this funding is being put, Treasury's plan to help families through this crisis, and any metrics Treasury may have as evidence of TARP's effectiveness. Your predecessor replied, but twenty-six of those sub-questions had no response. Among the nineteen remaining sub-questions, some open questions remain as well.

Our second report addressed your predecessor's response to our original questions, and identified four key areas of critical concern for Treasury to implement TARP in accordance with the will of Congress. We focus particularly on: 1) more bank accountability for the use of funds, 2) increased transparency, 3) a plan for foreclosure mitigation, and 4) the articulation of a clear overall strategy.

While we understand that this is a time of transition for your department, economic events are unfolding rapidly. We ask that you address these key areas of concern by Wednesday,

Mr. Timothy F. Geithner  
January 28, 2009  
Page 2

February 18, 2009. We also urge you to keep the American public informed on the uses and effects of TARP money and the steps being taken to safeguard the taxpayers' investments in financial institutions.

We look forward to working with you to meet the challenges posed by this crisis. If I can be of any assistance, please do not hesitate to contact me or have a member of your staff contact the Panel's Executive Director, Naomi Baum, at [REDACTED] or [REDACTED].

Sincerely,



Elizabeth Warren  
Chair  
Congressional Oversight Panel

cc: Rep. Jeb Hensarling  
Sen. John E. Sununu  
Mr. Richard H. Neiman  
Mr. Damon A. Silvers

**APPENDIX III: REPORT OF THE ADVISORY COMMITTEE  
ON FINANCE AND VALUATION TO THE CONGRES-  
SIONAL OVERSIGHT PANEL**

Report to Congressional Oversight Panel on the Emergency  
Economic Stabilization Act of 2008

Adam M. Blumenthal, Managing General Partner, Blue Wolf Capital Management.

William N. Goetzmann, Edwin J. Beinecke, Professor of Finance and Management Studies and Director of the International Center for Finance at the Yale School of Management, and Research Associate of the National Bureau of Economic Research.

Deborah J. Lucas, Donald C. Clarke, HSBC Professor of Consumer Finance at the Kellogg School of Management at Northwestern University, and Research Associate of the National Bureau of Economic Research.

SUMMARY

A key question posed by the Congressional Oversight Panel for the Emergency Economic Stabilization Act of 2008 (“EESA”) is whether or not the investments in financial institutions made by the U.S. Department of the Treasury (“Treasury”) under the Troubled Asset Relief Program (“TARP”) represent a fair deal to taxpayers. To provide insight into that question, we compared the price paid by Treasury for these securities with the values implied by the open market for some of the largest investments made under the TARP.<sup>1</sup>

SUMMARY OF ESTIMATED VALUE CONCLUSIONS

[Dollars in billions]

Purchase program participant	Valuation date	Face value	Total estimated value		
			Value	Subsidy	
				Percent	\$
<b>Capital Purchase Program:</b>					
Bank of America Corporation .....	10/14/08	\$15.0	\$12.5	17	\$2.6
Citigroup, Inc .....	10/14/08	25.0	15.5	38	9.5
JPMorgan Chase & Co .....	10/14/08	25.0	20.6	18	4.4
Morgan Stanley .....	10/14/08	10.0	5.8	42	4.2
The Goldman Sachs Group, Inc .....	10/14/08	10.0	7.5	25	2.5
The PNC Financial Services Group .....	10/24/08	7.6	5.5	27	2.1
U.S. Bancorp .....	11/03/08	6.6	6.3	5	0.3
Wells Fargo & Company .....	10/14/08	25.0	23.2	7	1.8
Subtotal .....		124.2	96.9	22	27.3
311 Other Transactions* .....		70.0	54.6	22	15.4
<b>SSFI &amp; TIP:</b>					
American International Group, Inc .....	11/10/08	40.0	14.8	63	25.2
Citigroup, Inc .....	11/24/08	20.0	10.0	50	10.0
Subtotal .....		60.0	24.8	59	35.2
<b>Total .....</b>		<b>254.2</b>	<b>176.2</b>	<b>31</b>	<b>78.0</b>

\* Extrapolates 22 subsidy rate from 8 studied CPP investments. See discussion below.

<sup>1</sup> The investments chosen represent the largest investments made in non-automotive financial institutions other than the second and third investments in Bank of America (of \$10 billion and \$20 billion) which occurred in January 2009, too recently to be included.

- Of the \$184 billion of TARP funds analyzed, we estimate the securities received would have a fair market value of approximately \$122 billion when Treasury announced its agreement to buy them.

- The eight purchases made under the TARP Capital Purchase Program, aimed at healthier banks, had a subsidy rate to those banks of 22%. The securities subsequently purchased from AIG and Citigroup under the Systemically Significant Failing Institutions Program and the Targeted Investment Program had a significantly higher subsidy rate of 59%.

- If one takes this discount for the investments made under the CPP and applies it to the entire \$194 billion committed to capital purchases in financial institutions participating in that program, the total subsidy under the CPP would be approximately \$43 billion.<sup>2</sup> When added to the \$35 billion discount on \$60 billion invested in AIG and in Citigroup outside of the CPP, we estimate that of the \$254 billion invested to date in securities of non-automotive financial institutions, and exclusive of the most recent Bank of America investment, the amount that represents a subsidy to those institutions is \$78 billion.

A value was estimated for each security as of the time immediately following the announcement by Treasury of its purchase. This valuation approach takes into account investors' perceptions about how the TARP investment itself, and other government programs announced concurrently, affected value.

Whether the subsidy provided by Treasury to financial institutions represents a fair deal for the taxpayers is a question for policy debate and judgment, not one that can be answered in a purely quantitative way. The Treasury Department has pointed out that the loss of wealth and diminution in asset values that would accompany failure of one or more major financial institutions could represent a far larger sum.

A substantial portion of the subsidy under the CPP program can be attributed to the decision by Treasury to provide capital on the same terms to all participants. Treasury chose to offer "one size fits all" pricing in order to encourage all institutions to participate, and in so doing disregarded apparent differences in their financial condition. A consequence is that Treasury effectively offered weaker participants greater subsidies than it offered to stronger participants. For example, the analysis in the report suggests that Treasury received securities from Wells Fargo worth an estimated \$23.2 billion as of the valuation date for its investment of \$25.0 billion, or 93% of face value, while from Morgan Stanley, it received securities worth an estimated \$5.8 billion as of the valuation date for its investment of \$10.0 billion, or 58% of face value.

The TIP and SSFI programs were intended to assist institutions under more stress than those participating in the CPP. Under these programs AIG and Citigroup received funds on terms that were only slightly more stringent than those offered to CPP participants, and the resulting subsidy rates were much higher in these

<sup>2</sup>Treasury's subsequent investments under the CPP were to institutions that differed from those analyzed by Duff & Phelps in several important respects such as size and scope of activities, and the transactions took place under different market conditions. In extrapolating the costs, we did not attempt to evaluate the effect of these differences.

two transactions. It is worth noting that at the time of these two investments, there were numerous government commitments to these institutions; we focused only on the value of the TARP investments.

By applying the same methodology to three major investments by private investors in financial institutions which occurred in the same time frame as the Treasury investments (the \$5 billion investment by Berkshire Hathaway in The Goldman Sachs Group, the \$9 billion investment by Mitsubishi in Morgan Stanley and the £7 billion investment by Abu Dhabi and Qatar Holding in Barclays plc), it was estimated that the private investors received securities with a fair market value as of the valuation dates of at least as much as they invested, and in some cases worth substantially more. (Berkshire Hathaway received Goldman Sachs securities with a fair market value of 110% of the amount paid, Abu Dhabi and Qatar Holding received securities with a fair market value of 123% of the amount paid, and Mitsubishi received securities with a fair market value of 91% of the amount paid.)

Such comparisons are offered only as a benchmark. The question of whether Treasury could have negotiated investments that had comparable pricing and satisfied its public policy objectives at the same time is not one that the report can answer.

#### *A. Introduction*

The U.S. Department of the Treasury (“Treasury”) used almost all of the \$350 billion of taxpayer dollars provided to it to in the first installment of the the Troubled Asset Relief Program (“TARP”) created by the Emergency Economic Stabilization Act of 2008 (“EESA”). Of this amount, Treasury has spent, or committed to spend, approximately \$310 billion to purchase preferred stock and warrants of financial institutions.

Most of these purchases were made pursuant to a program developed by Treasury called the Capital Purchase Program (“CPP”). In addition, outside of the CPP, Treasury had invested an additional \$60 billion in two financial institutions, Citigroup and AIG, through other programs as of the date of our study (an additional investment in Bank of America has since been announced, but we did not review it). The CPP, announced on October 14, 2008, was implemented through a series of Treasury cash investments in exchange for preferred shares and warrants from a broad range of financial companies. All participating institutions obtained essentially the same terms on the preferred shares (a 5% dividend, increasing to 9% after five years) and warrants to purchase common stock equal to 15% of the face value of the preferred investment, with the companies having the right to cancel half of these warrants under certain circumstances. Terms differed somewhat for non-publicly traded institutions and for the investments outside of the CPP.

Treasury allocated \$250 billion of the funds under EESA to CPP. To date, it has spent or committed to spend \$194 billion of that amount to purchase preferred stock and warrants of 319 financial institutions under this program.

In this report, we focus on the value of Treasury’s investments in a set of the largest participants in the CPP program, and the value of Treasury’s investments in Citigroup and AIG made under

related programs. In order to provide information helpful in assessing whether the public is receiving a fair deal under the TARP program, we asked two questions in particular: (i) what was the fair market value of the preferred stock and warrants Treasury received in exchange for these cash infusions to financial institutions and (ii) how do these values compare to what was received in several privately negotiated transactions, including the earlier investment made by Warren Buffett's Berkshire Hathaway Inc. ("Berkshire Hathaway") in The Goldman Sachs Group ("Goldman") and the investment made by Mitsubishi UFJ Financial Group ("Mitsubishi") in Morgan Stanley, two of the institutions that received TARP funds, and by Qatar Holdings and other middle eastern entities in Barclays plc ("Barclays") at the end of October 2008.

To answer these questions, on the Panel's behalf, we designed the scope and methodology for a valuation project and selected Duff & Phelps ("D&P"), one of the largest valuation firms in the world, to conduct a rigorous valuation study implementing that plan. D&P frequently conducts arm's-length, independent valuations of securities like the TARP investments for which no active trading market exists. We directed D&P to provide an analysis of the likely fair market value of the securities received by Treasury in the ten largest investments made under the TARP. Given the particular details of Treasury's investments and the desire to comprehensively review how they relate to publicly traded securities as well as to comparable private investments, we judged that the professional experience and judgment of a major firm such as D&P would most effectively interpret market information and yield reliable, quantitative answers. In the sections that follow, we describe the scope, methodology and conditions of the D&P analysis, and summarize their basic findings. We then apply the estimates made by D&P to the question posed by the Panel.

#### *B. Process*

Immediately after the Congressional Oversight Panel was formed, the Panel created an Advisory Committee on Finance and Valuation to create a valuation study. The members of the Advisory Committee are: Adam M. Blumenthal, Managing General Partner of Blue Wolf Capital Management and Former First Deputy Comptroller of the City of New York; Professor William N. Goetzmann, Edwin J. Beinecke Professor of Finance and Management Studies and Director of the International Center for Finance at the Yale School of Management, and Research Associate of the National Bureau of Economic Research; and Professor Deborah J. Lucas, Donald C. Clarke HSBC Professor of Consumer Finance at the Kellogg School of Management at Northwestern University, and Research Associate of the National Bureau of Economic Research, and the former Chief Economist of the Congressional Budget Office.

Members of the Advisory Committee created a detailed scope for the valuation project, and identified and interviewed or had discussions with five firms who were considered as candidates to perform the valuation work. The Advisory Committee recommended the selection of Duff & Phelps, LLC (D&P), one of the largest valuation firms in the world, based on a number of factors. D&P and the Advisory Committee then designed a methodology to be used to imple-

ment the project design. The Advisory Committee periodically reviewed with D&P their application of the valuation methodologies and the assumptions underlying them.

### *C. Scope*

The valuation project was designed to provide an estimate of the fair market value of the securities purchased by Treasury in its eight largest purchases under the CPP, and its investments in AIG and Citigroup outside the CPP. The Panel focused on these investments because they were among the largest commitments made under the TARP.<sup>3</sup> Collectively, they represent a total expenditure of \$184 billion, or 53% of the first \$350 billion authorized by Congress for the TARP.

The scope called for D&P to take into account in its analysis only information that was publicly available. They were asked what an arm's-length investor would pay for the securities. This presupposed that an investor would not have access to material non-public information, but would have comprehensive access to public filings, analyst reports, and trading information on all of the publicly traded securities issued by the companies. Importantly, by basing estimates on the market price immediately following the announcement by Treasury of a purchase, the valuation takes into account investors' perceptions about how the intervention itself affects value going forward.

The scope also called for the firm to take into account major privately negotiated investments that occurred around the same time as the TARP investments under consideration, in particular, investments by Warren Buffet's Berkshire Hathaway in Goldman Sachs, by Mitsubishi in Morgan Stanley, and by Qatar Holding and Abu Dhabi in Barclays, all of which occurred in September and October of 2008.

The scope specifically excludes any effort to place a value on the policy objectives of Treasury in making these investments, apart from those reflected directly in security prices. It also excludes consideration of any indirect effects of the purchases on other governmental or private interests. For instance, interdependencies between institutions may mean that helping one enhances the value of others, as was thought to be important with AIG. Those objectives, as well as the broader implications for the financial system and the economy, obviously must be considered in the policy debate on whether the TARP investments were a good use of public funds, but they are outside the scope of the valuation analysis, which addresses only the subsidies to the institutions as measured by the difference between the prices paid for the securities and estimated fair market values.

We do not attempt to value other broad financial interventions which Treasury, the Federal Reserve Bank, the FDIC, or other government affiliated entities made in the financial markets, in some cases simultaneously or in close proximity to the TARP investments. We also do not value other government investments in the same companies. For example, at the time of the TARP investment, Treasury already owned 79.9% of AIG, as the result of a prior loan

<sup>3</sup>The additional \$20 billion investment in Bank of America on January 16, 2009 occurred too late to be included in the valuation report.

to AIG by the Federal Reserve Bank of New York, and the proceeds of the AIG loan were used to repay part of the Fed's loan to AIG. In this case, we valued the TARP securities, not the Fed's loan, or the government's pre-existing equity interest in AIG.

The scope includes only the value of the securities at the time of the announcement of the investment. As such, it does not consider their current market value, which may be considerably different than the values reported.

Finally, the scope provides for an estimate of the subsidy received by each institution as a whole, but it does not cover how the subsidy will be divided among different classes of stakeholders (e.g., stock holders, bond holders, employees, suppliers and customers).

#### *D. Methodology*

The methodology used in the valuation report is discussed below and is described at much greater length in D&P's report. The Advisory Committee and D&P developed a general approach, which was to evaluate the preferred shares and the warrants obtained by Treasury separately, company by company. Recognizing that any single valuation approach might provide a limited perspective on the factors influencing the value of the securities, the Advisory Committee asked D&P to consider multiple methods that offered a means to cross-validate their estimates. All of these approaches rely on some basic assumptions, the most important of which is that the prices for securities similar to those issued under the TARP were trading in the capital markets at fair values, which as defined by D&P is "the price at which they would change hands between a willing buyer and a willing seller when neither is acting under compulsion and when both have a reasonable knowledge of the relevant facts." Despite the turmoil in the capital markets, the Advisory Committee believes, and D&P confirmed through analysis, that there was sufficient liquidity and market volume in the trading of securities at that time to rely on market pricing for analysis. D&P was not asked to consider whether these market prices were consistent with other notions of fundamental economic value. D&P's results are provided as a range of values. The midpoints of those ranges were selected as representative values for this report.

#### *E. Preferred stock valuation*

Preferred shares are legally a type of equity, but they have several characteristics that are similar to bonds. They are senior in priority to the common shares of a company, but junior to the debt of the firm. The preferred shares issued under CPP are non-voting securities which provide for a 5% dividend for a five-year period and a 9% dividend in perpetuity thereafter. A company can choose not to pay a preferred dividend without declaring bankruptcy, but the dividends on the preferred shares issued by bank holding companies under CPP are cumulative, meaning that any missed dividends must be paid in full before common stockholders can receive dividends. The preferred shares are callable under certain conditions described in full in D&P's report.

As a check on the robustness of the estimates, D&P used several methodologies to value the preferred stock issued in the investments: two based on the market values of different types of com-

parable publicly traded securities and one using a contingent claims analysis approach.

*(i) Discounted Cash Flow Analysis Using Market Yields  
("Yield-Based Discounted Cash Flow Approach")*

This approach involves estimating the future expected cash flows (dividend payments and return of principal) on the preferred securities, and discounting those projected cash flows at a market yield derived from the prices of comparable securities. Finding the appropriate discount rate involved analyzing the yields of the publicly traded preferred stock and debt securities of each institution based on transaction prices in the days following Treasury's announcement of the investments. In those instances where sufficiently liquid preferred securities were available for comparison, D&P used them as the primary basis for determining a discount rate. In either case, D&P then systematically adjusted yields to take into account the differences between the terms of the CPP preferred shares and the terms of the publicly traded securities. Adjustments were made for the call options, the cumulative dividend, and other factors.

*(ii) Discounted Cash Flow Analysis Using Risk Adjusted Survival Probabilities Derived from CDS Spreads ("CDS-Based Discounted Cash Flow Approach")*

Like the yield-based method, this approach is based on future contractual cash flows adjusted for expected losses, a risk premium, and the time value of money. In this case, the adjustments are based on information about default and the price of credit risk implied by the premiums charged on credit default swaps ("CDS"). Values estimated in this manner were compared to those derived from the Yield-Based Discounted Cash Flow Approach. An advantage of the CDS prices is that they are generally determined in a more liquid market, and thus they may better capture the market assessment of risk. However, CDS prices reflect the market's required return on debt securities, not on preferred shares, and thus valuation requires an adjustment for the differences between the two types of securities. Because of the difficulty of determining the appropriate adjustment, this method was used primarily as a check on whether the other two approaches were generating reasonable estimates of value.

*(iii) Contingent Claims Analysis*

This methodology is distinctly different from the yield-based approaches. It relies on a probabilistic model of how the firm's asset value, and therefore, its ability to pay claimants, evolves over time. The model is calibrated using data on stock prices and their volatility, and on the book value of debt. Preferred shares are assumed to receive dividend payments as long as the solvency condition is satisfied, but to recover little or nothing in bankruptcy. Default occurs when assets drop below a trigger point based on debt outstanding. The value of the preferred shares is based on the discounted present value of dividends and any return of principal, averaged over simulations of a large number of possible time paths of a firm's asset value.

This mathematical framework is used in the private sector for credit risk modeling and has also been used in a government context for the valuation of government guarantees. This approach allows for sensitivity analysis of the quantitative importance of various assumptions. The results of the contingent claims analysis are consistent with the yield-based approaches, and in addition, make apparent the sensitivity of estimated value to assumptions about the volatility of the firm's underlying assets and the events that trigger bankruptcy.

#### *F. Warrant valuation*

A warrant confers the right to acquire a share of stock from a company within a specified time period for a predetermined price, called the exercise price. Warrants allow an investor to participate in potential stock price increases since they generate a gain whenever share prices rise above the exercise price of the warrant.

Treasury required each publicly held institution receiving an investment to issue warrants at an exercise price equal to the average trading price for the 20 days prior to the day of Treasury's approval of the institution's participation in the CPP. The number of common shares to be acquired was set at a number which, when multiplied by the exercise price, was equal to 15% of the total amount of Treasury's investment in the preferred shares. Thus, if Treasury invested \$10 billion in the institution, Treasury would receive warrants for \$1.5 billion of common stock. If the exercise price of the warrants was \$15 per share, then Treasury would receive warrants for 100 million shares. The warrants are subject to a reduction feature whereby half of the warrants may be cancelled by the issuing institution if it meets certain conditions involving sale of common stock to investors in private sector transactions prior to year-end 2009, a feature which should reduce the upside to Treasury. These warrants have a value independent of the preferred shares themselves. D&P valued the warrants using a widely used option pricing methodology, a Monte Carlo model, which allowed them to take into account the conditions of the warrant contract.

Warrant values depend on a number of inputs, including the current stock price, the exercise price, the risk free rate of return, the expected future volatility of the stock price, the dividend yield on common stock, and the number of warrants issued in relation to the outstanding shares of stock and other features specific to the TARP offerings. The D&P valuation used the stock price of the company on the chosen date of valuation, a forward-looking set of short-term discount rates based upon the current Treasury yield curve, an estimation of volatility drawn from historical stock price fluctuations, as well as a comparison to volatilities implied by prevailing market prices of long-dated equity options and the appropriate ratio of exercised warrants to outstanding shares.

In most instances, the value of the warrants was small relative to the value of the preferred stock itself.

#### *G. Reduced marketability discount*

Under all of the methodologies, and for both preferred stocks and warrants, D&P applied a "reduced marketability discount factor" to reflect the fact that the large size of Treasury positions made them

potentially costly to liquidate and hence less valuable. Based on academic and industry studies, they estimated this factor to be between 5% and 10% for the preferred stocks and between 5% and 20% for the warrants.

#### *H. Comparable transactions*

Utilizing similar methodologies, D&P also analyzed three transactions which were concluded around the time of the TARP investments: the \$5 billion Berkshire Hathaway investment in Goldman Sachs announced on September 23, 2008 and closed on October 1, 2008; the \$9 billion Mitsubishi investment in Morgan Stanley, which was announced on September 22, 2008, amended, and then closed on October 13, 2008; and the £7 billion investment by Abu Dhabi and Qatar Holding in Barclays plc which was announced on October 31, 2008 and completed on November 27, 2008. D&P estimated that Berkshire Hathaway received securities with a fair market value between 108% and 112% of the actual amount paid, based on prevailing market prices for similar securities; that Mitsubishi received securities with a fair market value between 88% to 94% of the amount paid; and that Qatar Holdings and Abu Dhabi received securities with a fair market value of between 122% to 125% of the amount paid.

Stated differently, Berkshire Hathaway, Qatar Holding and Abu Dhabi paid less for their securities than what one would expect other investors to pay; all of the private investors received relatively more valuable securities for their investments than did Treasury.

D&P concluded that this broad range of outcomes reflects unique circumstances at individual financial institutions, and in some cases contractual terms that severely limited marketability. In addition, there may also be some value accruing from Warren Buffett's reputation as a canny investor which enabled him sufficient leverage to purchase securities in Goldman Sachs at a significant discount to the prevailing market value of similar securities. Because of such special circumstances, they concluded that the individual transactions should not be taken as a benchmark for valuation of the TARP securities but rather as an indicator of the potential for investors to extract price concessions below prevailing market values in certain circumstances.

The issue of whether the government could have obtained similar discounts from prevailing market values on similar securities remains a question for Treasury. The question also remains of whether, even if it could have negotiated a transaction benchmarked to these transactions, such a deal would have met policy objectives, but this question is outside of the scope of the valuation report. As a result, the D&P analysis uses public market trading data that assumes no positive strategic advantage that might accrue to a large shareholder. The analysis of comparable transactions does, however, provide information about the relative discounts that accrued to some other major private actors so that the Panel may understand their magnitude.

*I. Conclusions of the valuation analysis*

The table below lists the TARP investments reviewed in the valuation showing institution, amount, date announced and the Treasury program under which the investment was made.

[Dollars in billions]

Purchase program participant	Date	Amount
<b>Capital Purchase Program:</b>		
Bank of America Corporation .....	10/14/08	\$15.0
Citigroup, Inc .....	10/14/08	25.0
JPMorgan Chase & Co .....	10/14/08	25.0
Morgan Stanley .....	10/14/08	10.0
The Goldman Sachs Group, Inc .....	10/14/08	10.0
The PNC Financial Services Group .....	10/24/08	7.6
U.S. Bancorp .....	11/03/08	6.6
Wells Fargo & Company .....	10/14/08	25.0
Subtotal .....		124.2
<b>SSFI &amp; TIP:</b>		
American International Group, Inc .....	11/10/08	40.0
Citigroup, Inc .....	11/24/08	20.0
Subtotal .....		60.0
Total .....		184.2

The next table shows D&P's estimates of the fair market value of each of the investments, in each case as of the respective dates the investments were announced. Taken as a whole, D&P concluded that the fair market value of the investments as of such dates, in the aggregate, was between \$112 and \$132 billion, or between 61% and 71% of the amount Treasury paid for them. Thus, of the total \$184 billion invested in these transactions, between \$53 and \$73 billion represented overpayment relative to the estimated fair market value of the securities.

(a) In the case of two of the eight largest investments under the CPP, U.S. Bancorp and Wells Fargo & Company, which the market deemed least risky, and for which Treasury paid \$31.6 billion in the aggregate, D&P concluded that the fair market value of the investments was at or somewhat below the amount paid for them by Treasury, with a range of 87% to 99% of Treasury's cost. That is, D&P believes that a third party buyer would have paid between \$27.6 billion and \$31.3 billion for securities for which Treasury paid \$31.6 billion.

(b) In the case of the other six CPP investments, in Bank of America, JP Morgan Chase & Co., Goldman Sachs, the PNC Financial Services Group, Citigroup, and Morgan Stanley, which the market deemed riskier, D&P concluded that the fair market value of the investments was significantly below the price paid by Treasury, with a value range of 47% to 68% of face for Morgan Stanley, which bore the greatest discount, to 77% to 89% of face at Bank of America. In the aggregate for these six investments, for which Treasury paid \$92.6 billion, D&P estimated a value range of \$61.6 to \$73.2 billion.

(c) In the case of the \$60 billion in investments outside the CPP program, consisting of the November investments in AIG under the SSFI program and in Citigroup under the TIP, D&P concluded that

the government received value equal to between \$22.5 and \$27.1 billion, or 37% to 45% of the amount invested.

#### SUMMARY OF ESTIMATED VALUE CONCLUSIONS

[Dollars in billions. All values are after applicable discounts due to reduced marketability]

Purchase program participant	Valuation date	Face value	Midpoint	Total estimated value*		Duff & Phelps value range				
				Discount to face		Values		Percent of face		
				Percent	\$	Low	High	Low	High	
<b>Capital Purchase Program:</b>										
Bank of America Corporation .....	10/14/08	\$15.0	12.5	17	\$2.6	\$11.6	\$13.3	77	89	
Citigroup, Inc .....	10/14/08	25.0	15.5	38	9.5	14.2	16.8	57	67	
JPMorgan Chase & Co .....	10/14/08	25.0	20.6	18	4.4	19.0	22.2	76	89	
Morgan Stanley .....	10/14/08	10.0	5.8	42	4.2	4.7	6.8	47	68	
The Goldman Sachs Group, Inc .....	10/14/08	10.0	7.5	25	2.5	6.8	8.2	68	82	
The PNC Financial Services Group .....	10/24/08	7.6	5.5	27	2.1	5.2	5.8	69	77	
U.S. Bancorp .....	11/03/08	6.6	6.3	5	0.3	5.9	6.7	89	102	
Wells Fargo & Company ....	10/14/08	25.0	23.2	7	1.8	21.7	24.6	87	99	
Subtotal .....		124.2	96.9	22	27.3	89.2	104.5	72	84	
<b>SSFI &amp; TIP:</b>										
American International Group, Inc .....	11/10/08	40.0	14.8	63	25.2	14.2	15.4	36	38	
Citigroup, Inc .....	11/24/08	20.0	10.0	50	10.0	8.3	11.7	41	59	
Subtotal .....		60.0	24.8	59	35.2	22.5	27.1	37	45	
Total .....		184.2	121.6	34	62.6	111.7	131.6	61	71	

\* As of the respective valuation dates. Midpoint is midpoint of Duff & Phelps range.

#### J. Discussion

There were significant differences in the risk of the institutions that received funds under the TARP, as evidenced by the very different yields on their securities that investors demanded in the capital markets and documented by D&P. In financial institutions which the markets judged to be relatively less risky, Treasury received securities with values slightly below what was paid for them. In institutions which the market viewed to have greater risk, the value of securities received by Treasury was further below fair market value.

The Advisory Committee believes that this result is a consequence of the policy decision by Treasury to offer uniform terms under the CPP to all financial institutions irrespective of their relative financial condition. For firms with a relatively high probability of default, the 5% dividend rate on the preferred shares was substantially below their market cost of capital, whereas for the healthier firms, it offered a smaller advantage over market rates. Further, the option for an institution to extend the financing beyond the fifth year at a 9% rate only had substantial value to the weaker institutions.

A further benchmark for understanding the results of the valuation exercise is that the CPP facility was structured to be voluntary. To induce the relatively healthy financial institutions to participate, the terms for them had to be set so that they did not surrender more value than they received. The decision by Treasury to treat everyone equally led to the best institutions more or less

breaking even and weaker entities benefiting from receiving financing on the same terms as their stronger peers.

A potential reason to refrain from discriminating among TARP borrowers is the potential adverse effect on public expectations about particular institutions. Put simply, if the public thinks that Treasury knows something about a bank that the public does not know, the markets may interpret any signal from Treasury as a positive or negative indication about the health of the firm. Avoiding this type of signaling may have been a concern in crafting the program. On the other hand, as the report illustrates, the market was aware of the differential risk profile of these banks at the time the investments were made. To the extent that adverse signaling was a concern, risk-based pricing based only on public information may have been possible. However, proposing alternative mechanisms *ex post* is outside of the scope of this report.

#### *K. Conclusion*

Our report concludes, based on analysis set forth in great detail in D&P's report, that the fair market value of the securities received was, in most cases, significantly less than what Treasury paid; and we identify the structural reasons in the program that led this to be true. We are not attempting in this report to answer the question of whether the investments were good or bad from a policy perspective, or whether Treasury will eventually recover its investment or even come out ahead. Whether they were of positive benefit to the nation requires an assessment of their effects on the functioning of the U.S. economy. Consequently, this involves a policy debate and requires an assessment as to whether these investments are part of a coherent strategy to achieve the objectives of EESA. The fundamental question is whether the actions taken by Treasury are working to stabilize financial markets and institutions and helping American families. This report provides information on the value conveyed to these institutions at the time of the intervention, which should be a useful input into a broader cost-benefit analysis of the TARP. We hope that by quantifying the cost of the initial largest investments made to date, we have made a contribution to that debate.

**APPENDIX IV: SUMMARY OF THE LEGAL REPORT TO  
THE CONGRESSIONAL OVERSIGHT PANEL FOR ECO-  
NOMIC STABILIZATION CONCERNING THE TARP IN-  
VESTMENTS IN FINANCIAL INSTITUTIONS**

TIMOTHY G. MASSAD

*A. Scope and methodology of legal report*

The Panel asked Timothy G. Massad, a corporate lawyer with a New York-based law firm for almost 25 years, including 17 as a partner, to prepare a legal analysis of the TARP investments. He specializes in corporate finance. Mr. Massad took a leave of absence from his firm in late December in order to serve as special legal advisor to the Panel on a pro bono basis and to prepare the report. Catherina Celosse acted as counsel for the Panel in the development of the legal report.

The legal analysis focuses on the Capital Purchase Program (“CPP”) created by Treasury as a whole and the largest investments thereunder, as well as the AIG, second Citigroup and most recent Bank of America investment made outside of the CPP. The CPP was for healthy banks. The AIG investment in November 2008 was made under the Systemically Significant Failing Institutions (“SSFI”) program and the Citigroup and Bank of America investments were made under the Targeted Investment Program (“TIP”), which were programs for institutions in greater difficulty or at risk of failure.

The legal analysis provides an explanation of the structure and terms of these investments. It also considers whether the terms received by Treasury were customary and consistent with market practice from a legal (but not a valuation) standpoint. There is a wide range of market practice, and terms vary depending on many factors including in particular the credit-worthiness of the issuer, the relative strength of the parties and the preferences of investors. Opinions also vary as to what is customary, and the analysis cannot be reduced to a quantitative assessment as with the valuation analysis. While the legal analysis reviews the material terms of the agreements individually, an investment decision by a private investor to purchase securities of this type is usually made on the basis of the terms as a whole, and an investor’s willingness to agree to a particular set of non-economic terms usually is greatly influenced by the attractiveness of the economic terms.

In examining whether the terms were consistent with market practice, the analysis considers in particular the terms of a set of recent transactions agreed upon with the Panel. These include the investments by Berkshire Hathaway Inc. in The Goldman Sachs Group, Inc. (“Goldman Sachs”) and by Mitsubishi UFJ Financial Group (“Mitsubishi”) in Morgan Stanley in the fall of 2008, as well as four other investments in Citigroup, Merrill Lynch and Morgan Stanley that were made between late 2007 and the fall of 2008 (the “U.S. comparative transactions”). In addition, these transactions include the investments by the government of the United Kingdom in Royal Bank of Scotland and Lloyds TSB—HBOS in October 2008 (the “U.K. government investments”) and the investment in Barclays Bank PLC by Qatar Holdings and Sheikh Mansour of Abu Dhabi.

The scope and methodology of the report was agreed upon with the Panel, including that the report would be based solely on review of publicly available information concerning the investments.

As with the valuation analysis, the legal analysis does not address whether the investments were good or bad investments. Because they were investments by the government seeking to fulfill certain public policy purposes, that conclusion requires not only a consideration of the terms of the investments but also an evaluation of the public policy objectives and whether the investments contributed to achieving those objectives, matters which are beyond the scope of the legal report. The assessment of whether the terms were consistent with market practice is only intended to provide a benchmark. It is not intended to judge whether Treasury made the right public policy choices or suggest that public policy objectives should not influence those terms.

The legal report does not consider the other actions that were taken by the U.S. government in response to the financial crisis concurrently with the making of these investments, including specific arrangements made with particular institutions that received TARP funds. Although these actions are relevant to evaluating the effectiveness of the investments from a policy standpoint, they are beyond the scope of the report.

### *B. Findings*

The summary below highlights some of the findings of the legal report.

(i) *Documentation of TARP Investments—Use of Standard Forms.* Treasury created standard documentation for the CPP investments. In the transactions reviewed, there were no variations in terms from the standard forms other than those contemplated by the forms themselves, such as those related to size of the investment, number of shares issued and strike price of the warrants.

Treasury created two sets of forms, one for publicly held qualified financial institutions or “QFIs” (the Public QFI forms) and one for non-publicly held qualified financial institutions excluding S corporations and mutual organizations (the Non-Public QFI forms). Of the total \$194.2 billion invested as of January 23, 2009, approximately \$1.7 billion has been invested in 90 institutions that are privately held or are community development institutions.

*Similarity to Berkshire Hathaway Papers.* The CPP standard forms are quite similar to, and appear to have been based on, the papers used by Berkshire Hathaway for its investment in Goldman Sachs. The pricing-related terms (such as dividend rate, number and exercise price of warrants (including the warrant reduction feature discussed below) and optional redemption premium) of the Treasury agreements are not nearly as favorable to Treasury as the terms that Berkshire Hathaway received, as discussed in the valuation report. In most other areas the terms obtained by Treasury are as good as, and in some cases better than, those in the Berkshire Hathaway agreements (such as voting rights of the preferred stock, restrictions on dividends and stock repurchases, warrant anti-dilution protection and exercise period, transfer restrictions, representations and warranties and amendments), although such other provisions generally are not as important to the average investor. One other area where the terms obtained by Treasury are

not as good, though it could be thought of as a pricing-related term, is the issuer's right to repurchase the warrants and underlying common shares at fair market value following redemption or transfer by Treasury of the preferred.

*Incentives to Replace Treasury Investment.* In order to meet regulatory requirements, Treasury could not require the issuer to redeem the securities (that is, repay Treasury) at a fixed date. However, Treasury included a number of provisions, as discussed below, that appear to be designed to encourage the QFI to replace the Treasury investment with private capital, which was presumably one of Treasury's objectives. These include the dividend step-up provision, the lack of a premium on optional redemption and (in the Public QFI form) the QFI's right to reduce the number of warrants in certain circumstances and to repurchase the warrants and underlying common shares at fair market value once the preferred stock is redeemed or transferred. (The common stock dividend restrictions may also encourage replacement of the Treasury investment.) Some of these provisions have a negative impact on valuation as indicated by the valuation report; that is, they make the security less attractive to an average investor.

*Passive Investor Philosophy.* The contracts generally provide for Treasury to be a passive investor. This is evidenced by providing for only limited voting rights, not having any board seats or board observers, agreeing not to exercise voting rights on common shares acquired under the warrants and (in the CPP investments) not imposing any covenants other than those that are customary for passive preferred stock investments. There are, for example, few covenants that restrict operations or that are directed at the public policy objectives of EESA. This approach can be contrasted with the more activist approach of the U.K. government as well as the approach taken by Treasury in the TARP loans made to the automotive companies, as discussed in the report.

*Consequences of Using Standard Forms.* The legal analysis also considered the implications of Treasury's decision to structure the program by creating standard forms that were used for all transactions, which implications are relevant to the debate as to whether the investments were good policy choices. First, the design of the program enabled Treasury to avoid having to negotiate any of the terms with any institution, which would have required substantially more Treasury resources and many policy or credit choices. That would have made it difficult to complete as many transactions as quickly as Treasury did. The program design also may have contributed to a perception that the program was fair at least as among financial institutions that were deemed eligible. That may have encouraged participation. Speed of execution and wide participation were important Treasury objectives in October 2008 when the program was launched. The absence of individually negotiated terms meant also that completed transactions did not suggest to the marketplace that, because of the inclusion of more restrictive terms in one case versus another, Treasury had determined that one institution was weaker than another; such signals could have in turn affected confidence in, or market prices of the securities of, particular institutions. Treasury also avoided subjecting itself to criticism for why it required or did not require particular terms for an institution. On the other hand, the program design meant that

Treasury could not address differences in credit quality or risk among institutions, or in their need for capital, by varying the terms of each investment.<sup>1</sup> Insofar as the standard terms were set for strong institutions, they may have been too lenient for weaker institutions. The program design also meant that Treasury could not impose specific requirements on a recipient to take certain actions that it deemed necessary for the stability or soundness of an institution (The Treasury view may have been that the government could use its power as a regulator to do so). It meant Treasury's only choice was to decide whether an institution was eligible and what the size of the investment would be within the range of 1–3% of risk-weighted assets. A determination that an institution was not eligible had potentially harsh consequences for the institution.

A major question for the policy debate is therefore whether the basic design of the program—provide capital to a large number of institutions by using standard terms designed for “healthy” banks—made sense, because so many issues follow from the answer to that question.

*TIP/SSFI Investments.* Treasury used the CPP forms with modifications for the TIP/SSFI investments. The CPP was a voluntary program for healthy banks; TIP and SSFI are for institutions experiencing more difficulty or at risk of failure. The two institutions funded under the TIP also received funds under CPP, and the TIP program was not created until months after the first investment now grouped under that program was announced. The Panel may wish to consider whether these various programs fit together into a coherent overall strategy.

(ii) *Basic Structure of the Investments.* Treasury acquired preferred stock and warrants. In the CPP investments, Treasury purchased senior preferred stock in an amount equal to 1–3% of risk weighted assets of the institution but not more than \$25 billion. Risk-weighted assets are the total assets weighted for credit risk and are a measure used to determine adequacy of capital. The preferred stock qualified as Tier 1 capital, which is a core measure of capital for a financial institution, as a result of a contemporaneous regulatory change by the Federal Reserve Board. The structure of the investment was consistent with Treasury's goal of bolstering the capital of institutions, which had been depleted by, among other things, losses on mortgage-related assets.

*Priority of Preferred Stock.* Preferred stock provides Treasury with priority over common stock as to payment of dividends and in liquidation. The TARP preferred stock pays dividends at a fixed rate, and the dividends are cumulative (except for banks that are not subsidiaries of bank holding companies), which means the dividends, even if not declared by the board of directors in a particular period, continue to accrue, thus enhancing the investor's return. Unpaid cumulative dividends also compound at the dividend rate then in effect, which is favorable to the investor. The preferred

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<sup>1</sup> In customary market practice, there are often differences in pricing-related terms as well as non-economic terms depending on the credit-worthiness of the issuer. In theory, Treasury could have incorporated a customized, risk-based approach to setting the dividend rate at least for large public companies, for example by reference to the yields on other publicly traded securities or credit default swap rates (or perhaps they could have varied the number of warrants taken), and still have maintained the general standardized terms of the documents. But this would have left the question of how to price the securities for less widely-traded institutions, and its effects on speed of execution and participation rates are impossible to know.

stock is senior, which insures that no other preferred stock can have a higher priority as to payment of dividends or in liquidation.

*Blank Check Preferred.* Another reason preferred stock may have been attractive to Treasury and to the financial institutions seeking CPP funds is that many public corporations have what is known as “blank-check preferred” which allows the board of directors to issue preferred stock having the desired terms without having to obtain approval (in most cases) from common stockholders, thus facilitating a quick transaction.

Stockholder approval can nevertheless be necessary pursuant to the rules of the national securities exchanges if the common shares underlying the warrants equal 20% or more of the total outstanding common shares. Treasury provided that in this case, the institution was not only required to get approval, but the exercise price of the warrants would decline if approval was not obtained quickly.

*Warrants—Basic Terms.* In the CPP investments, Treasury received warrants to acquire common shares equal to 15% of the value of the preferred investment, which give it an opportunity to realize upside, without giving up its fixed return, if the common stock price of the institution increases. The exercise or strike price of the warrants was set at the current market price of the common stock. Sometimes, warrant exercise prices are set at a premium to current market price of the common stock, which would be less favorable to Treasury as it would require greater price appreciation in order to realize a gain. The warrants were immediately exercisable (subject to a reduction feature) and had a term of ten years, which potentially gives Treasury a long time to realize any gain.

The Non-Public QFI form for the CPP program differs in that Treasury acquires a warrant for a preferred stock that pays a 9% dividend, which it exercises immediately. There is no provision for reduction of warrants.

*Warrant Reduction.* One unusual feature of the Public QFI forms is that the issuer is entitled to reduce the number of common shares which may be acquired on exercise of the warrants by 50% if it sells equity that qualifies as Tier 1 capital in an amount equal to Treasury’s investment before December 31, 2009. This feature could eliminate much of Treasury’s upside with respect to the warrants. However, it may serve a public policy goal of creating an incentive for the issuer to raise capital which could be used to replace the Treasury investment (although actual redemption of the preferred is not required in order to reduce the warrants).

*Structure of TIP/SSFI Investments.* The basic structures of the TIP/SSFI investments were similar to the CPP forms—Treasury acquired nonconvertible senior preferred stock paying cumulative dividends as well as warrants. There were differences in pricing-related terms (such as dividend rates, numbers and exercise prices of warrants and absence of the warrant reduction feature found in the CPP investments) as well as in non-pricing terms as described below. Treasury has the unilateral power to change the dividend rate in the AIG transaction, which is highly unusual.

*Structures of Comparative Transactions.* The basic structure of the CPP investments was quite similar to the Berkshire Hathaway investment in Goldman Sachs. Berkshire Hathaway purchased cumulative perpetual preferred stock paying a fixed dividend, plus

warrants to acquire common stock that were exercisable for five years. The structures used in the other U.S. comparative transactions were somewhat different. Mitsubishi purchased noncumulative convertible preferred stock. Noncumulative dividends do not accrue if not paid. However, noncumulative perpetual preferred stock can be treated as Tier 1 capital without limit. Convertible preferred stock gives the holder the right to convert into common stock at a price (and thus realize an upside that is tied to common stock price appreciation as with the warrant), although it must give up the fixed return of the preferred stock to do so. Two of the other U.S. comparative transactions also involved purchases of noncumulative convertible preferred stock. The other two U.S. comparative transactions involved sales of units in which the investor acquired common stock and trust preferred securities. These latter two investments are more complex transactions that have certain tax advantages for the issuers, although they also involve acquiring a combination of a fixed return and a potential to realize upside in the common stock price.

The U.K. government transactions are quite different in structure. The U.K. banks made open offers to their existing shareholders to purchase ordinary shares (the equivalent of common shares), and the U.K. government agreed to purchase the ordinary shares to the extent existing shareholders did not take them up, and to buy preference shares that pay noncumulative dividends. Because few shareholders took up the offers, the U.K. government purchased almost all the ordinary shares offered. As a result, it owns 57.9% of one of the banks and 43.4% of the other. The Barclays transaction involved the sale of three securities: perpetual reserve capital instruments which pay a fixed return in cash or common shares, warrants for common stock and mandatorily convertible notes.

(iii) *Dividends.* The dividend rate on the CPP investments increases from 5% to 9% per annum after five years. This creates the potential for higher returns, and it may also create an incentive for the issuer to redeem the preferred stock. The dividend rates in the TIP/SSFIs investments are higher to begin with and do not increase.

(iv) *Redemption and Repurchase.* In order for the preferred stock to be treated as Tier 1 capital for regulatory purposes, it must be perpetual; the issuer cannot be required to redeem it (that is, repay Treasury) at a fixed date or upon the occurrence of certain events. However, the CPP forms provide for redemption at the option of the issuer in the first three years if the issuer receives proceeds from a qualified equity offering (essentially a sale of equity securities constituting Tier 1 capital for cash) equaling at least 25% of the investment price. After three years, the issuer can redeem at any time. Redemption is at par (without a premium). The absence of a premium, and the fact that the issuer can redeem so early, is not advantageous to an investor who wishes to lock in a rate of return (and negatively impacts the valuation of the securities), but it may serve a public policy objective of encouraging institutions to replace Treasury investment with private capital.

The CPP forms also give the issuer the right to repurchase the warrants and any common shares acquired upon exercise of the warrants at fair market value once the preferred shares are re-

deemed or transferred by Treasury. (Fair market value is determined initially by the issuer's board of directors but is subject to an appraisal process if Treasury disagrees.) This provision is very unusual and again negatively affects valuation, but it may serve the public policy objective of encouraging replacement of the Treasury investment. It may also reflect past experience in U.S. government bailouts, such as in the Chrysler bailout when, after Chrysler recovered and paid off the government loans, there was debate over whether the government should realize a profit on the warrants it received or give them back to Chrysler. The repurchase right sets up a procedure that may avoid a similar controversy.

The TIP/SSF I investments contain redemption provisions at par and a repurchase right that are similar to the CPP forms.

(v) *Covenants.* The Panel requested that the legal analysis review the covenants included in the TARP investments from the standpoint of not only what was found in the comparative transactions, but also from the standpoint of whether there were provisions that addressed the public policy purposes of the investments. The analysis noted that there is a wide range of market practice in commercial transactions when it comes to covenants. Wellknown, seasoned investment grade issuers generally face lighter covenants when raising funds in normal circumstances than do less credit-worthy companies. Covenants may also vary depending on, among other things, the form of the investment, the context of the transaction and the leverage of the investor. There are generally fewer covenants in purchase agreements for equity securities as compared to loans and other debt financing arrangements, in part because there is a more practical remedy for a covenant violation in a debt financing (the investor can call a default and accelerate the debt) than in an equity investment.

The analysis summarized the covenants in the TARP investments as follows. Whether the covenants in any particular area, including those pertaining to dividends, executive compensation, lending and use of proceeds, are appropriate or adequate is a matter for the policy debate. That debate should consider in particular whether covenants should be more restrictive if the economics of the investments provide less than fair value to Treasury, and whether the use of standard forms created an inherent risk of covenants that were too lenient for some, as discussed earlier.

(a) *Dividend Restrictions and Stock Repurchases.* The TARP investments include restrictions which insure the priority of dividends on the preferred stock that are similar to those in the comparative transactions. This is a standard covenant in a preferred stock transaction. They also include a covenant that prohibits increases in the dividends on common stock, which is not as common (none of the U.S. comparative transactions or the Barclays transaction has such a restriction). By contrast, the U.K. government transactions and the TARP investments in the automotive companies prohibit all dividends on common shares. The TARP investments also restrict repurchases of common stock, which can be thought of as economically equivalent to a dividend payment in terms of the interests of the preferred stock investor. These covenants are subject to exceptions. The covenants regarding dividends and stock repurchases are more restrictive in the TIP/SSF I

investments than in the CPP forms, in that dividends are prohibited in AIG's case for five years and limited to \$0.01 per share per quarter for up to three years in the case of Bank of America and Citigroup.

(b) *Executive Compensation.* The CPP forms contain a covenant implementing the executive compensation provisions of EESA but do not contain more detailed restrictions or any reporting requirements, though Treasury has recently published rules to require certain reports and certifications. The TIP/SSFI investments contain slightly more restrictive executive compensation covenants (which apply to a larger group of executives and cover more payments) and related reporting requirements.

(c) *Lending/Foreclosure Mitigation/Use of Proceeds.* Because the TARP investments were made with public funds to achieve certain policy objectives, one must consider whether there were covenants directed at those policy objectives. The CPP forms contain recitals—introductory language—that state that the QFI “agrees to expand the flow of credit to U.S. consumers and businesses” and agrees to work to “modify the terms of residential mortgages to strengthen the health of the U.S. housing market.” However, no specific covenants concerning these issues were included in the CPP investments. There are also no covenants in the CPP investments restricting use of the proceeds nor any requirements to report how the funds are used. There are no covenants requiring the issuer to take actions with respect to the problems that may have led to the need for the Treasury investment, such as covenants to develop a restructuring plan (as in the U.K. transactions and the automotive investments), to sell certain assets, to not engage in or limit particular types of business, etc.

Except for the other matters noted below, there were generally no other covenants or provisions in the CPP investments that imposed restrictions on, or required changes to, operations or business practices or that were directed at the specific public policy objectives cited by Treasury for making the investments. The legal report notes that the use of standard forms meant Treasury could not include customized covenants that required particular institutions to take particular actions that Treasury felt were desirable to improve strength and stability. The legal report also speculates as to why Treasury chose not to include general covenants directed at policy objectives, which may have been because Treasury believed that it was more important to get large numbers of institutions to participate in the program and such covenants would have discouraged participation. It could also be because Treasury wished to be a passive investor and exercise its authority as a regulator rather than an investor (which passive approach, as noted earlier, was also evidenced by having only limited voting rights, not voting the warrant shares, and not having board seats or board observers). It could also be that Treasury believed contractual covenants cannot address the policy objectives effectively.

The TIP/SSFI investments contain a few more restrictions. In the case of the AIG investment, the proceeds were applied directly to pay down loans provided by the Federal Reserve Board of New York. In the case of the second Citigroup and third Bank of America investments, there are no restrictions on use of the proceeds but

there are reporting requirements concerning use of the proceeds. Citigroup also agreed to implement the FDIC's mortgage modification program with respect to certain assets. All three TIP/SSFIs investments contain covenants that pertain to policies on lobbying, governmental ethics, political activity and corporate expenses. There are no covenants on lending. Although there are no other significant restrictions, the analysis noted that the credit agreement between the Federal Reserve Bank of New York and AIG imposes more restrictive covenants on AIG with respect to operation of its business. In addition, a trust for the benefit of Treasury holds almost 80% of the voting equity of AIG, which gives the trust the ability to direct management.

The approach taken by Treasury can be contrasted with that taken by the U.K. government. The U.K. banks are required to maintain lending to the mortgage market and to small and medium enterprises at their respective 2007 levels, although this is subject to a caveat that appears to relieve them of any obligation to engage in uncommercial practices. The U.K. banks are also required to submit restructuring plans.

Treasury's approach can also be contrasted with what Treasury did in the case of the loans to the automotive companies, where extensive covenants restricting the companies were included. These included prohibitions on all dividends, restrictions on executive compensation, restrictions on material transactions outside the ordinary course of business, a requirement to divest corporate aircraft, reporting requirements, and a requirement to develop a restructuring plan meeting certain public policy objectives.

While it is more common to see restrictions of this sort in debt financings than in preferred stock investments, one could take the view that the use of preferred stock for the banking institution investments was driven by the need to satisfy capital requirements, not to realize higher equity returns, and should not dictate the covenant package. The differences between the covenants in the automotive loans (and AIG credit facility) on the one hand versus the banking institution investments on the other may have been driven more by the overall design of the program—that is, it was a voluntary program intended for large numbers of “healthy” banks, not a rescue of a single institution, and it was for institutions which the government already regulates.

(d) *Other*. The CPP forms contain a limited right of access to information that relies on the information received by the U.S. government in its capacity as regulator. The Non-Public QFI forms contain restrictions on affiliate transactions.

(vi) *Voting and Control Rights*. All the investments provide that the holders of the preferred stock have the right to vote on amendments to the charter and certain material transactions if their interests could be adversely affected. These are customary voting rights for preferred stock, and are contained in the four U.S. comparative transactions in which preferred stock was issued as well as in the U.K. government investments. In addition, the investments provide that if dividends are not paid for six quarterly periods (in the case of the CPP) or four quarterly periods (in the case of the TIP/SSFI investments), the holders of preferred stock have the right to elect two directors. This is a provision that is very fre-

quently, but not always, included in preferred stock investments. For example, Mitsubishi obtained such right but Berkshire Hathaway did not, and it was included in one of the other two U.S. comparative transactions in which preferred stock was issued. In the U.K. government transactions, the preference shares also obtained additional voting rights upon a failure to pay dividends.

Treasury agreed not to exercise voting rights with respect to any common shares acquired on exercise of the warrants. This is a very unusual term. However, it does not apply to any person to whom Treasury transfers the warrants (or underlying shares) and thus does not affect resale value of the warrants or underlying shares.

In the U.K. government transactions, the government obtained the contractual right to designate two or three directors. Because the U.K. government ended up acquiring 58% and 43% of the common equity of the two banks in the open offers, it has the practical ability to designate the entire board of directors without the benefit of these contractual provisions. In one of the U.S. comparative transactions the investor acquired the right to designate a director.

The legal analysis notes that although the voting rights obtained by Treasury in the TARP investments are customary for preferred stock investments, the issue of what type of voting rights, or influence over management, Treasury should have in an investment made with taxpayer funds raises public policy concerns that the Panel may wish to consider. Treasury may not have sought greater contractual rights of influence because of a view that the government should exercise influence as a regulator but not as a shareholder.

(vii) *Transfer Restrictions.* Treasury did not agree to any contractual restrictions on its ability to transfer the preferred stock or the warrants, other than agreeing not to transfer more than 50% of the warrants during the warrant reduction period. There were transfer restrictions in all the U.S. comparative transactions, including a five year restriction in the case of the Berkshire Hathaway investment in Goldman Sachs. Treasury also received registration rights for public QFIs, which facilitates its ability to resell the securities because such rights enable it to do so in a public offering, and it can require the issuer to list the preferred stock on a national securities exchange. Registration rights were granted in only three of the U.S. comparative transactions.

(viii) *Representations and Warranties and Conditions to Closing.* Treasury required the issuers to make far more extensive representations and warranties in the purchase agreements than was the case in the Berkshire Hathaway deal or the other U.S. comparative transactions. (Representations and warranties assist the parties to a transaction in performing due diligence and in allocating risk. If an inaccuracy is discovered prior to closing, Treasury would have a right not to purchase the securities; once the securities are purchased, Treasury may have a claim for damages but the value of this is limited since it would reduce the value of the issuer.) The Treasury forms also impose conditions to closing including receipt of legal opinions and officers certificates. Although these are not unusual and should not be difficult to meet, they are not always obtained by an investor and were not included in the Goldman-Berkshire Hathaway transaction, for example.

(ix) *Other*. The CPP forms provide that Treasury has the unilateral right to amend any provision of the purchase agreement to the extent required to comply with any changes after the signing date in federal statutes. This is a highly unusual provision that is favorable to Treasury and could be used, for example, to remedy deficiencies in reporting requirements. It is also included in the TIP/SSFI investments.

**APPENDIX V: LINK TO VALUATION REPORT OF DUFF & PHELPS TO THE CONGRESSIONAL OVERSIGHT PANEL**

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