CONGRESSIONAL OVERSIGHT PANEL

AUGUST OVERSIGHT REPORT *

THE CONTINUED RISK OF TROUBLED ASSETS

AUGUST 11, 2009.—Ordered to be printed

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

In the fall of 2008, the American economy was facing a crisis stemming from steep losses in the financial sector, and frozen credit markets. Then-Secretary of the Treasury Henry Paulson and Federal Reserve Board Chairman Ben Bernanke argued that a program of unprecedented scope was necessary to remove hundreds of billions of dollars in so-called toxic assets from banks’ balance sheets in order to restore the flow of credit.

By the time the law creating the Troubled Asset Relief Program (TARP) was signed only a few weeks later, however, the Secretary had decided, due to a rapid deterioration in conditions, to use another, more direct, strategy permitted under TARP to rescue the financial system, by providing immediate capital infusions to banks to offset the impact of troubled assets. Now, ten months after its creation, TARP has not yet been used to purchase troubled assets from banks, although the capital infusions have provided breathing space for banks to write-down many of these assets and to build loss reserves against future write-downs and losses. This report discusses the implications of the retention of billions of dollars of troubled assets on bank balance sheets.

In the run-up to the financial crisis, banks and other lenders made millions of loans to homeowners across America, expecting that their money would eventually be paid back. It is now clear that many of these loans will never be repaid.

In some cases, financial institutions packaged these mortgage loans together and sold pieces of them into the market place as mortgage-backed securities. In other cases they held the mortgages

*The Panel adopted this report with a 4–1 vote on August 10, 2009. Rep. Jeb Hensarling voted against the report. Additional views are available in Section Two of this report.
as “whole loans” on their own books. In either case, these mortgages, and the securities based on them, are now said to be “troubled assets.” They are no longer expected to be paid off in full, and they are very difficult to sell. There is no doubt that the banks holding these assets expect substantial losses, but the scale of those losses is far from clear.

As just noted, Treasury’s choice to pursue direct capital purchases resulted in a notable stabilization of the financial system, and it allowed the write-down of billions of dollars of troubled assets and reserve building. But, it is likely that an overwhelming portion of the troubled assets from last October remain on bank balance sheets today.

If the troubled assets held by banks prove to be worth less than their balance sheets currently indicate, the banks may be required to raise more capital. If the losses are severe enough, some financial institutions may be forced to cease operations. This means that the future performance of the economy and the performance of the underlying loans, as well as the method of valuation of the assets, are critical to the continued operation of the banks.

For many years, banks were required to mark their assets to market, meaning they listed the value for many assets based on what those assets would fetch in the marketplace. In response to the crisis, banks have been allowed greater flexibility in the way they value these assets. In most cases we would expect the new rules to have permitted banks to value assets at a higher level than before. So long as they do not sell or write-down those assets, they are not forced to recognize losses on them.

The uncertainty created by the financial crisis, including the uncertainty attributable to the troubled assets on bank balance sheets, caused banks to protect themselves by building up their capital reserves, including devoting TARP assistance to that end. One byproduct of devoting capital to absorbing losses was a reduction in funds for lending and a hesitation to lend even to borrowers who were formerly regarded as credit-worthy.

The recently conducted stress tests weighed the ability of the nation’s 19 largest bank holding companies’ to weather further losses from the troubled assets and assessed how much additional capital would be needed. However, the adequacy of the stress tests and the resulting adequacy of the capital buffer required for future financial stability depend heavily on the economic assumptions used in the tests. As more banks exit the TARP program, reliance on stress-testing for the economic stability of the banking system increases. The Panel’s June report evaluated the adequacy of the stress tests.

Treasury’s program to remove troubled assets from banks’ balance sheets is the Public Private Investment Program (PPIP). It has two parts, a troubled securities initiative, administered by Treasury, and a troubled loans initiative, administered by the Federal Deposit Insurance Corporation (FDIC). Treasury is now moving forward with the troubled securities program. The FDIC has postponed the troubled loans program, stating that the banks’ recently demonstrated ability to access the capital markets has made a program to deal with troubled whole loans unnecessary at this time. (The FDIC is conducting a pilot program for the sale of the loan portfolios of failed banks.) Whether the PPIP will jump start
the market for troubled securities remains to be seen. It is also unclear whether the change in accounting rules that permit banks to carry assets at higher valuations will inhibit banks’ willingness to sell. Similarly, it is unclear whether wariness of political risks will inhibit the willingness of potential buyers to purchase these assets.

If the economy worsens, especially if unemployment remains elevated or if the commercial real estate market collapses, then defaults will rise and the troubled assets will continue to deteriorate in value. Banks will incur further losses on their troubled assets. The financial system will remain vulnerable to the crisis conditions that TARP was meant to fix.

The problem of troubled assets is especially serious for the balance sheets of small banks. Small banks’ troubled assets are generally whole loans, but Treasury’s main program for removing troubled assets from banks’ balance sheets, the PPIP will at present address only troubled mortgage securities and not whole loans. The problem is compounded by the fact that banks smaller than those subjected to stress tests also hold greater concentrations of commercial real estate loans, which pose a potential threat of high defaults. Moreover, small banks have more difficulty accessing the capital markets than larger banks. Despite these difficulties, the adequacy of small banks’ capital buffers has not been evaluated under the stress tests.

Given the ongoing uncertainty, vigilance is essential. If conditions exceed those in the worst case scenario of the recent stress tests, then stress-testing of the nation’s largest banks should be repeated to evaluate what would happen if troubled assets suffered additional losses. Supervisors should continue their increased monitoring of problem banks, and banks too weak to survive write-downs should be required to raise more capital. If PPIP participation proves insufficient, Treasury may want to consider adapting the program to make it more robust or shifting to a different strategy to remove troubled assets from the banks’ book. Treasury should also pay special attention to the risks posed by commercial real estate loans.

Part of the financial crisis was triggered by uncertainty about the value of banks’ loan and securities portfolios. Changing accounting standards helped the banks temporarily by allowing them greater leeway in describing their assets, but it did not change the underlying problem. In order to advance a full recovery in the economy, there must be greater transparency, accountability, and clarity, from both the government and banks, about the scope of the troubled asset problem. Treasury and relevant government agencies should work together to move financial institutions toward sufficient disclosure of the terms and volume of troubled assets on institutions’ books so that markets can function more effectively. Finally, as noted above, Treasury must keep in mind the particular challenges facing small banks.

This crisis was years in the making, and it won’t be resolved overnight. But we are now ten months into TARP, and troubled assets remain a substantial danger to the financial system. Treasury has taken aggressive action to stabilize the banks, and the steps it has taken to address the problem of troubled assets, including capital infusions, stress-testing, continued monitoring of financial institutions’ capital, and PPIP, have provided substantial protec-
tions against a repeat of 2008. These steps have also allowed the
banks to take significant losses while building reserves. Nonethe-
less, financial stability remains at risk if the underlying problem
of troubled assets remains unresolved.
SECTION ONE: THE CONTINUED RISK OF TROUBLED ASSETS

The precipitous decline in the value of securities backed by pools of residential mortgages and whole mortgage loans, held by banks and other financial institutions, ignited the financial crisis. The decline was compounded by the complexity of many of the securities, the lack of accurate information about the underlying mortgages, and the chain-reactions generated by interlocking liabilities among financial institutions.

The drop in real estate values that began in 2006 undermined the economic assumptions on which millions of loans had been made and revealed that many should not have been made under any circumstances. The same conditions gave a first view of the size and scope of the potential losses to which the nation’s banks and other financial institutions could become subject if the asset values did not stabilize, and the degree to which the capital foundation of even the nation’s largest financial institutions could be impaired if the trend continued.

A substantial portion of real estate-backed securities and whole loans remain on bank balance sheets. The success of the financial stabilization effort continues to depend on how the potential impact of these assets is managed by Treasury, the Federal Reserve Board and other financial supervisors, and by the institutions themselves.

In this report, the Panel examines the risks these troubled, or “toxic,” assets continue to pose for the financial system and the economy, ten months into the financial stabilization effort. Further, the report discusses the need for, and challenges associated with, accurate valuation and transparent presentation of troubled asset holdings, attempts to estimate the size and distribution of the holdings of troubled assets that remain in the U.S. financial system, discusses Treasury’s strategies, including the design and progress of the PPIP, and suggests factors that may influence the ability of the financial system to reduce or magnify the risks troubled assets continue to pose.

A. Background

1. TREASURY’S FLEXIBILITY IN DEALING WITH TROUBLED ASSETS

From the outset, the Emergency Economic Stabilization Act (EESA) has given Treasury a choice about the way to deal with troubled assets held by financial institutions. Treasury could buy real estate-based troubled assets directly from the institutions that held them, or instead put capital directly into those institu-
tions by buying their stock, to counteract the impact of the troubled assets on the institution's stability.  

Statements from Treasury before EESA's passage initially emphasized the need to give Treasury the ability to buy troubled real estate assets from banks and other financial institutions. During this time, Treasury was exploring methods, including reverse auctions, by which to value and purchase the assets.

Throughout the legislative process preceding the passage of EESA, Treasury and the financial sector appear to have resisted allowing the government to take equity positions in financial institutions.

Nevertheless, the bill was ultimately amended in the Senate, with Treasury's apparent support, to widen Treasury's authority; that expanded authority was explicitly discussed in the House:

Mr. MORAN of Virginia. I do want to clarify that the intent of this legislation is to authorize the Treasury Department to strengthen credit markets by infusing capital into weak institutions in two ways: By buying their stock, debt, or other capital instruments; and, two, by purchasing bad assets from the institutions.

Mr. FRANK of Massachusetts. I can affirm that. The Treasury Department is in agreement with this, and we should be clear, this is one of the things that this House and the Senate added to the bill, the authority to buy equity. It is not simply buying up the assets, it is to buy equity, and to buy equity in a way that the Federal Government will able to benefit if there is an appreciation.

3 Id. at 3(9), permitting Treasury to purchase:
(A) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability, and
(B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.

4 See U.S. Department of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Emergency Economic Stabilization Act (Sept. 28, 2009) (online at www.treas.gov/press/releases/hp1162.htm) ("This bill provides the necessary tools to deploy up to $700 billion to address the urgent needs in our financial system, whether that be by purchasing troubled assets broadly, insuring troubled assets, or averting the potential systemic risk from the disorderly failure of a large financial institution."). See also U.S. Department of the Treasury, Fact Sheet, Proposed Treasury Authority to Purchase Troubled Assets (Sept. 20, 2008) (online at www.treas.gov/press/releases/hp1150.htm) ("This program is intended to fundamentally and comprehensively address the root cause of our financial system's stresses by removing distressed assets from the financial system."); U.S. Department of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Comprehensive Approach to Market Developments (Sept. 19, 2008) (online at www.trea.gov/press/releases/hp1149.htm) ("[I]lliquid assets are clogging up our financial system, and undermining the strength of our otherwise sound financial institutions.").

In a reverse auction, banks would bid down from a reserve price to the lowest price at which they were each willing to sell a particular asset. Professors Peter Cramton and Lawrence Ausubel of the University of Maryland worked with Treasury to develop a reverse auction process that the professors believed would be quick to implement and would result in a market price for the troubled assets being purchased. Peter Cramton and Lawrence Ausubel, A Troubled Asset Reverse Auction (Oct. 5, 2008) (online at www.cramton.umd.edu/papers2005-2009/ausubel-cramton-troubled-asset-reverse-auction.pdf). Professors Cramton and Ausubel have informed Panel staff that Treasury considered two forms of reverse auctions: dynamic and sealed-bid. The dynamic auction takes place over a series of rounds, whereas the sealed-bid auction has only a single round of bidding. In either case, the government is buying toxic assets from the banks, which is why it is called a reverse auction.

5 See Senate Banking Committee, Testimony of Secretary of the Treasury Henry M. Paulson, Jr., Turmoil in US Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions, 110th Congress (Sept. 23, 2008) ("Putting capital into institutions is about failure. This [the Paulson Plan] is about success.").

6 Statements of Representatives Moran and Frank, Congressional Record, H10763 (Oct. 3, 2008). Representative Frank continued:
2. TREASURY'S CHOICE

Less than two weeks after EESA was signed into law, Secretary Paulson announced that Treasury would “purchase equity stakes in a wide array of banks and thrifts.”

Treasury later explained that the change in strategy was motivated both by the severity of the crisis and the need for prompt action:

Given such market conditions, Secretary Paulson and Chairman Bernanke recognized that Treasury needed to use the authority and flexibility granted under the EESA as aggressively as possible to help stabilize the financial system. They determined the fastest, most direct way was to increase capital in the system by buying equity in healthy banks of all sizes. Illiquid asset purchases, in contrast, require much longer to execute.

The problems Treasury encountered in October 2008 illustrate the difficulties that are characteristic of attempts to remove troubled assets directly from bank balance sheets. It is easy to make direct capital injections, but setting up a structure to buy particular assets or groups of assets in the absence of liquid trading markets is more difficult. There was no assurance that—in fact no basis even for guessing whether—the $250 billion immediately available under EESA would make an appreciable dent in the troubled asset problem, but that amount could stabilize the financial system to buy time for broader issues to be addressed. No one was certain that fair values, at which there would be both willing buyers and willing sellers, could be set, at least not quickly; in fact the complex structure of the assets involved has made it difficult to this day to figure out their different values. Similarly, there was no way of knowing whether an auction or reverse auction conducted on an emergency basis would produce the very instability for the selling banks that Treasury was trying to avoid.

In implementing the powers provided for in the Emergency Stabilization Act of 2008, it is the intent of Congress that Treasury should use Troubled Asset Relief Program (TARP) resources to fund capital infusion and asset purchase approaches alone or in conjunction with each other to enable financial institutions to begin providing credit again, and to do so in ways that minimize the burden on taxpayers and have maximum economic recovery impact. Where the legislation speaks of “assets”, that term is intended to include capital instruments of an institution such as common and preferred stock, subordinated and senior debt, and equity rights. Also, it is the intent of this legislation that TARP resources should be used in coordination with regulatory agencies and their responsibilities under prompt-corrective-action and least-cost resolution statutes.

Statement of Representative Barney Frank, Congressional Record, H10763 (Oct. 3, 2008).

  [In] the last few days before we got the TARP legislation which passed on October 3rd and in the week after we got the TARP legislation, the markets continued to freeze up. We had a whole series of bank failures overseas. Five or six different countries had intervened to rescue their banks. Market participants were clamoring for us to do something quickly. We needed to do something quickly. And the way we were able to do something quickly and make a difference—and make a dramatic difference and prevent something very dire from happening was to do something quickly and inject capital.

After the legislation, it was clear that the problem was continuing to get worse. The facts were changing. Banks were failing around the world. And there was quite a problem. We needed to move quickly to really put out the fire.

The final consideration may be the most significant. The distinction between buying troubled assets and making capital injections into the institutions that hold them is a matter of strategy in a time of crisis. The difficulty caused by rapidly declining asset values is the threat of insolvency; even when markets and credit are frozen, the books of the institution can be rebalanced by increasing capital through capital injections, Stabilizing the institution can also give it the time it needs to write-down its assets in an orderly way.

B. What is a Troubled Asset?

1. GENERAL DEFINITION

Troubled assets include both securities backed by pools of residential mortgage loans or other assets, and whole mortgage loans held by banks. (This report focuses on residential loans because their loss of value is at the heart of the financial crisis; as discussed below, however, there is a serious question whether commercial real estate loans may be about to experience the same drop in value. In addition, assets such as credit card receivables may be the basis for asset-backed securities.)

A loan is a transfer of money (principal) from a lender to a borrower who agrees to repay the principal, plus interest on the amount that has not been repaid, over the term of the loan.\(^{10}\)

The amount of the loan and the interest rate reflect, in addition to prevailing interest rates when the loan is made, the risk of default and related risks. If the loan is secured by a piece of property (often called collateral), as residential or commercial mortgages almost always are, one of the factors taken into account in setting the amount of the loan and the degree of risk is the value of the collateral. The value of the loan payments at any particular time during its term is called the “discounted present value” to reflect the fact that payments are to be made in the future.\(^{11}\)

A “troubled asset” is a loan or security whose original credit risk assumptions have come into serious question. Several factors can cause an asset to become “troubled,” including: (1) the fact that the “credit risk” on which the loan was based has increased, so that the loan’s value has dropped; and (2) the fact that the borrower on the underlying loan has actually failed to make a number of required payments or has stopped making payments altogether. The degree of non-performance is important because of the effect of accounting

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\(^{10}\) Usually, the time for repaying a loan, and for paying interest during the loan term, are predetermined.

\(^{11}\) “Discounted present value” refers to the value of an asset’s hold-to-maturity payoff—future payment or series of future payments, discounted to reflect the time value of money, represented by an accepted rate of interest, and other factors such as investment risk—at the time the calculation is made. Standard asset pricing models for mortgage-backed securities, for example, consider an asset’s present value to be the weighted average sum of the future payoffs of the underlying assets (e.g., residential mortgages) using an appropriate discount rate based on factors listed below. As such, fair value of these exposures is based on estimates of future cash flows from the underlying assets. To determine the performance (hence risk-adjusted discount rate) of the underlying portfolios (e.g., packaged mortgages), entities estimate the prepayments, defaults and loss severities based on a number of macroeconomic factors, including housing price changes, unemployment rates, interest rates, and borrower and loan attributes. In addition, mortgage performance data from external sources such as Treasury’s OCC and OTS Mortgage Metrics Report are incorporated into the pricing models. Default risk on the underlying asset is calculated using the ratings distributed by rating agencies such as Moody’s and Standard & Poor’s. However these agencies have come under heavy criticism as some of the assets that received a “AAA” rating from these agencies ended up with significant default risk.
rules—which may require a write-down of the value of the loan on the lender’s books—although the loan may still be performing in many cases and could be paid-in-full if held to maturity.

Reasons for these situations can include: (1) the nature of the loan itself (i.e., loan terms the borrower proves unable to meet); (2) the lender’s acceptance of greater than normal credit risk (e.g., reduced documentation or inadequate scrutiny of the borrower’s credit history); (3) a change in the economic condition of the borrower (for example, due to unemployment, disability, or a sudden costly medical emergency); (4) a decline in the value of the property below the remaining loan balance owed, that may give a borrower—especially one to whom one of the other reasons also applies—fewer options moving forward; and (5) borrower fraud.

Even under normal market conditions, a certain number of loans will be “troubled,” or, to use a more technical term, “impaired.” The masses of troubled assets that now weigh down the financial system are overwhelmingly residential real estate loans whose loss of value reflects the continued decline in real estate values and current economic conditions, especially rising unemployment (as discussed below). The volume stems from the boom in mortgage lending produced by the real estate bubble. The troubled assets at the heart of the crisis generally fall into two categories: (1) complex securities, part or all of which were sold to third parties; and (2) whole loans. Within the banking system, a relatively small number of banks (out of the more than 8,000 U.S. chartered banks) typically own pieces (or all) of the complex securities. The troubled assets held by smaller banks are likely to be whole loans. Although larger banks also hold whole loans, these smaller and community bank holdings serve

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12 In early May 2009, Moody’s Economy.com estimated that of 78.2 million owner-occupied single-family homes, 14.8 million borrowers, or 19 percent, owed more than their homes were worth at the end of the first quarter, up from 13.6 million borrowers at the end of 2008. This is an increase of 8.8 percent between the end of 2008 and the close of the first quarter of 2009. Deutsche Bank estimated that in the first quarter of 2011, overall 48 percent of U.S. homeowners will owe more than their house is worth, including 41 percent of prime conforming loans, 46 percent of prime jumbo loans, 69 percent of subprime loans and 89 percent of options adjustable rate loans. Karen Weaver and Ying Shen, Drowning in Debt—A Look at “Underwater” Homeowners, Deutsche Bank (Aug. 5, 2009).

13 Loans other than residential mortgage loans, for example, commercial mortgage loans, credit card receivables, automobile loans and student loans, can also face problems relating to performance. Many of these loans are themselves pooled and repackaged as complex securities; a deeper recession, including rising unemployment and falling real estate values, can change the repayment expectations attached to those loans as well. As the Panel noted in its May report, credit card and student loan delinquencies or defaults are increasing. Congressional Oversight Panel, May Oversight Report: Reviving Lending to Small Businesses and Families and the Impact of the TALF, at 26–30 (May 7, 2009) (online at cop.senate.gov/documents/cop-050709-report.pdf) (hereinafter “Panel May Report”). Therefore, a substantial challenge for financial institutions is to determine how much of a capital buffer they should have in place to make up for these other types of loans that enter into default.

14 After decades of relative stability, the rate of U.S. homeownership began to surge in the early part of this decade, rising from 64 percent in 1994 to a peak of 69 percent in 2004. Federal Reserve Bank of San Francisco, FRBSF Economic Letter: The Rise in Homeownership (Nov. 3, 2008) (online at www.frbsf.org/publications/economics/letter2008cl2008-30.html). As discussed below, vast quantities of these loans were combined into pools that were in turn fragmented and resold as investments in ways that make valuing either the investments or the underlying loans difficult or impossible. Moreover, the sale to third parties was in many cases not complete, as also discussed below, a fact multiplied the ultimate risk of liability involved.

as a powerful reminder that the troubled assets problem extends far beyond the 19 largest banks subject to the government stress tests.

2. COMPLEX SECURITIES

Troubled complex securities began as pools of thousands of individual loans (primarily residential) that were securitized for sale to investors.17 The pools became the basis for a bewildering array of multi-level investment arrangements that tried to divide the cash flow from the pools into various degrees of risk and return. These were based, in turn, on assumptions about the rate at which mortgages would pay off and the level of default the mortgages in the pool were likely to experience.

The simplest type of structure is illustrated by the following figure.

**Figure 1: Diagram of a Complex Security**18

The levels (or “tranches”) that characterize complex securities reflect different degrees of risk and return and have different priorities in receiving interest and principal flows from the underlying mortgages. The senior level receives its pass-through of interest and principal payments first, but it receives a relatively lower interest payment to reflect its lower risk. The mezzanine level falls in the middle—possessing a second call on payments and a higher interest rate to reflect its higher risk. The junior tranche receives its portion of the pass-through of interest and principal payments only after the first two levels receive their portions and would be the first to suffer upon non-payment or default of the underlying mortgages. Correspondingly, holders of the junior tranche would receive the highest interest rate—assuming no default—to reflect their higher risk.

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18 This diagram is based on the chart that appears in Janet M. Tavakoli, *Structured Finance and Collateralized Debt Obligations: New Developments in Cash and Synthetic Securitization* (John Wiley and Sons Ltd.), at 71 (2008).
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Super-senior tranches sit above the senior tranche and hence receive their payments before anyone else. But their value was theoretically a sliver of the total value of the pool and they were presumed—incorrectly as it turned out—to be substantially risk-free. Banks generally kept these securities (or placed them in special purpose vehicles—SPVs—that they had created); this increased the relative return on the senior securities by removing the calculation of that return the slice of the total that had the lowest return because it had the least risk.

In the years preceding the financial crisis, the securitization market experienced widespread growth and attracted substantial investor interest. Strong global growth and low interest rates encouraged investors to seek high-yield returns in a deeply liquid market (which they found in mortgage-related securities), inflating asset prices and further suppressing interest rates in the process. Some banks and other financial institutions, themselves enticed by the prospect of higher returns and the supposed low-risk of these types of mortgage-related investments, purchased complex securities for investment purposes.

In response, the securitization markets became increasingly complex. Different types of structured vehicles were created based upon underlying assets. At the more senior levels of debt, investors were able to obtain better yields than those available on more traditional securities (e.g., corporate bonds) with a similar credit rating. Investors, including banks, insurance companies, investment funds, hedge funds, and wealthy individuals, also perceived added benefits resulting from the diversification of the complex securities portfolio and the credit support built into the transactions. This increased investor interest prompted the creation of different types of securities as issuers started looking for new assets to collateralize or new ways to collateralize them. Some of these structured finance developments included:

- Mortgage pools that were combined with separate mortgage pools.
- Mortgage pools that were combined with pools of loans from entirely different types of asset pools (i.e., other types of mortgages, automobile loans, student loans, credit card receivables, small business loans and some corporate loans).
- Complex securities that were created by using existing tranches of other complex securities as collateral.
  - In these cases, the underlying pool consisted of interests in tranches of many different asset-backed securities.
  - The perception was that having multiple pools of mortgages reflected in the complex security would provide increased di-

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20 Letter from Secretary of the Treasury Timothy F. Geithner to Congressional Oversight Panel Chair Elizabeth Warren (Apr. 2, 2009).

21 Id.

22 It turned out that the credit ratings assigned to the complex securities vehicles proved inaccurate.

versification benefits along with loss mitigation if a small number of mortgages were to become nonperforming.

This list is only illustrative. There are even more complicated variations.

However, the structures unwound quickly—or at least appeared to do so—for what are, at bottom, simple reasons. Once rates of default on subprime and other mortgages began to increase and real estate prices began to drop steeply, it increasingly appeared that the rate of return, and thus the value of these structured investments, reflected faulty assumptions about risk. The complexity of the structured vehicles surrounding securitization and the lack of distribution and disclosure of information about the terms of the underlying loans, coupled with uncertainty about future performance, made the challenges associated with asset valuation and liquidity quickly apparent.

As the economic assumptions about property values and default rates reflected in these securities proved increasingly inaccurate, the securities’ values dropped precipitously, and no one could agree on what they were worth. Any price-discovery mechanism for these assets was frozen because most investors or traders would not take the risk of purchasing them under any circumstances. The more defaults increased and home prices dropped, the more the assets became—in the popular term—“toxic,” and the more difficult it was to turn the assets into cash. In other words, the more illiquid the market for them became, the more attention began to turn to the risks they posed for their holders, especially banks.

As the security structures became more removed from the original pools that ostensibly supported them, the valuation, and even the awareness of the degree of risk carried by the securities for either their originators or their investors, became more and more difficult, and ultimately almost impossible, to estimate.

Banks could have exposure in several ways to these fluctuations in value:

1. A bank could have originated the sale of the securities and retained a portion of one or more of the tranches in connection with their origination by the bank, to facilitate the sale of the securities in general, or to meet related capital requirements. This proved to be most serious in the case of the super-senior tranches banks retained. As credit rating agencies recognized that they had been “far too generous with their ratings of securities based on subprime mortgages, including their triple-A ratings of super-senior tranches of [certain asset-backed complex securities],” they issued “sudden, multi-notch downgrades in massive and historically unprecedented proportions.”24 These substantial downgrades caused “huge mark-to-market losses” on super-senior tranches held by nearly all large financial institutions,25 with resulting reductions in bank capital in at least some cases.

2. A bank could have retained a direct or indirect monetary commitment to the investors in the securities it originated. Because most securitized investments must be bankruptcy remote,
securitization transactions are routed through SPVs. The loans are sold to the SPVs and then investors purchase securities issued by the SPVs. As discussed below, new accounting rules will require the value of these assets to be restored directly to bank balance sheets beginning in 2010 under many circumstances—a change that will further increase bank exposure.26

In addition, a feature of the present troubled securities was a so-called “bank buy-back” feature that entitled holders to give the securities back to the bank upon a triggering event such as economic decline, at a premium to the current market price. This is much like a money-back guarantee to the buyer of the loan if the debtor defaults. As defaults increased, institutions with such obligations faced a double-edged sword because these assets moved back onto their balance sheets, while these institutions wound up paying a premium price for them even though they were worth significantly less due to market conditions.

3. A bank could have bought securities originated by other banks, for trading or investment. Banks that had purchased complex securities, either to trade or hold, were faced with a direct problem—how to value those securities in their various asset accounts. These issues are discussed below.

4. A bank could have issued or held a credit default swap27 relating to a particular complex security or held a share in a pool of credit default swaps based on the underlying value of other complex securities. In either case, a decline in the value of the complex securities underlying the swap, or pool of swaps, would likely flow through to the bank’s balance sheet because the bank either was called upon to make good or post additional collateral on swaps it had written, or saw the value of its own swap or interest in a swap pool decline.

3. WHOLE LOANS

A whole loan is a single loan recorded on the books of the bank that made it. A loan becomes troubled if the likelihood that it will be repaid has declined below the amount of the bank’s loan loss reserve for that loan. The reasons for the decline are no different than those that affect the worth of mortgages underlying complex securities, but the decline in the value of whole loans does not set off the sort of chain reaction created by troubled securities.

The impairment of whole loans may be structurally less complicated than the impairment of complex securities, but its potential impact is no less difficult or important. The growing number of unpaid whole loans is also worrisome. For example, recent reports and statistics published by the FDIC indicate that overall loan quality at American banks is the worst in at least a quarter

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26 Based on information submitted by the BHCs, bank supervisors predict that this change alone could result in approximately $900 billion in assets being brought back onto the balance sheets of these institutions. Board of Governors of the Federal Reserve System, The Supervisory Capital Assessment Program: Design and Implementation, at 16 (Apr. 24, 2009) (online at www.federalreserve.gov/newsevents/press/bcreg/bcreg20090424a1.pdf) (hereinafter “SCAP Design Report”).

27 Credit default swaps are a way of managing debt. The issuer of the swap agrees to pay the holder (the issuer’s counter party) the amount of a debt that the counterparty is owed by a third party, if the third party fails to do so. For example, the holder of a corporate bond may hedge its exposure by entering into a CDS contract as the buyer of protection. If the bond goes into default, the proceeds from the CDS contract will cancel out the losses on the underlying bond.
century, and the quality of loans is deteriorating at the fastest pace ever. Of the total book of loans and leases at all banks, totaling $7.7 trillion at the end of March 2009, 7.75 percent were showing signs of distress—a total of $596.75 billion.\footnote{Federal Deposit Insurance Corporation, Quarterly Banking Profile (First Quarter 2009), at 5–13 (online at www2.fdic.gov/qbp/2009mar/qbp.pdf).} The percentage of loans at least ninety days overdue, or on which the bank has ceased accruing interest or has written-off, is also at its highest level since 1984, when the FDIC first began collecting such statistics.\footnote{Id.}

The predominance of whole loans, not only in residential real estate but in areas such as commercial real estate, further underscores the importance of those loans to bank balance sheets. The consequences of defaults of course spread into the real economy, and by reducing, for example, employment in construction and related fields, have a redoubled effect on the default rate in whole loans. But the range of potential harm goes even beyond that; defaults on commercial loans that support multi-family housing can lead to deterioration in building maintenance and ultimately to displacement of tenants.

The threat of growing waves of whole loan defaults can cause more significant problems for small and midsize institutions than for large ones.\footnote{Id.} Smaller institutions are less able to tap capital markets than their larger rivals, increasing their need for government assistance to help counteract the impact of the defaulted loans on their balance sheets. As of August 7, 72 banks, most of them community institutions, had failed since the beginning of 2009.\footnote{Richard Parkus and Jing An, The Future Refinancing Crisis in Commercial Real Estate, Part II: Extensions and Refinements, at 23 (July 15, 2009) (hereinafter “Parkus July Report”) (“[E]xposure to commercial real estate loans) increases markedly for smaller banks. For the four largest banks (on the basis of total assets), this exposure is 12.3%, for the 5–30 largest banks, the exposure is 24.5%, while for the 31–100 largest banks, the exposure grows to 38.9%.”).} This is in addition to the 26 banks that failed during the course of 2008.\footnote{Id.} The recent release of quarterly results from regional banks provides a sobering portrayal of the potential pitfalls in the future.\footnote{Federal Deposit Insurance Corporation, Failed Bank List (online at www.fdic.gov/bank/individual/failed/banklist.html) (accessed Aug. 9, 2009).} These problems highlight the substantial gap between large banks, some of which have recently announced profits in investment banking and trading, and small and midsize banks that rely on more traditional transactional services such as accepting deposits and issuing loans.\footnote{Id.} Such problems are expected to worsen as commercial real estate loans continue to decline.

4. TROUBLED LOANS, BANK BALANCE SHEETS, AND BANK CAPITAL

Troubled loans have a significant negative effect on the capital of the banks that hold them; the two operate jointly. Although

\footnote{Andrew Martin, Regional Banks’ Profits Are Hurt by Loan Losses, New York Times (July 23, 2009), at 23bank.html? r=1&s cp=1&sq=regional%20banks%20profits&s t=cse) (noting how KeyCorp of Cleveland is preparing for losses on commercial real estate loans and SunTrust Banks and Wells Fargo remain very concerned about residential real estate loans).}
bank capital computations are often very technical and complicated, the core of the rules can be stated simply. A bank's capital strength is generally measured as the ratio of specified capital elements on the firm's consolidated balance sheet (for example, the amount of paid-in capital and retained earnings) to its total assets. Decreases in the value of assets on a bank's balance sheet change the ratio by requiring that amounts be withdrawn from capital to make up for the losses. Losses in asset value that are carried directly to an institution's capital accounts without being treated as items of income or loss have the same effect.

During the financial crisis, all of these steps accelerated dramatically. A plunge in the value of a bank's loan portfolio that has a significant impact on the value of the bank's assets—as it usually will—triggers a response by the bank's supervisor, one that usually requires the institution to raise additional capital or even pushes a bank into receivership. Otherwise, the bank's assets simply cannot support its liabilities and it is insolvent. The TARP attempted to restore a balance by shoring up bank capital directly—this was one of the reasons for Treasury's decision in the late fall of 2008 that only capital infusions made sense.

The problem of unresolved bank balance sheets is intertwined with the problem of lending, as the Panel has observed before. Uncertainty about risks to bank balance sheets, including the uncertainty attributable to bank holdings of the toxic assets, caused banks to protect themselves by building up their capital reserves, including devoting TARP assistance to that end. One consequence was a reduction in funds for lending and a hesitation to lend even to borrowers who were formerly regarded as credit-worthy.

5. LOAN LOSS RESERVES

The effect of the loan losses that unbalanced the relationship between bank assets and liabilities passed through banks' loan loss reserves to their income statements and on to their balance sheets. Loan loss reserves are accounts set aside by entities to cover probable loan losses. Each quarter a bank charges off losses incurred during the past quarter, thereby reducing the allowance for loan losses (i.e., the account). It also makes a provision (“provides,” adding to the allowance) for future loan losses based on the losses that
An effective loan review system and controls that identify, monitor, and manage asset quality problems in an accurate and timely manner are essential. These systems and controls must be responsive to changes in internal and external factors affecting the level of credit risk and ensure the timely charge-off of loans, or portions of loans, when a loss has been confirmed.

Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5: Accounting for Contingencies (FAS No. 5), at 3 (Mar. 1975) (hereinafter "FAS No. 5"). From an accounting perspective, loan loss reserves guidance is provided by the Financial Accounting Standards Board. See FAS No. 5, supra note 41; Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 114: Accounting by Creditors for Impairment of a Loan, an Amendment of FASB Statements No. 5 and 15 (FAS No. 114) (May 1993). Paragraph 8 of FAS No. 5 stipulates the following two conditions for a firm to record a provision for loan loss:

1. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. This condition implies that it must be probable that one or more future events will occur confirming the fact of the loss.

2. The amount of loss can be reasonably estimated.

For each period for which results of operations are presented, a creditor also shall disclose the activity in the total allowance for credit losses related to loans, including the balance in the allowance at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off.
During the same period, Bank of America incurred $16.2 and $6.9 billion of net loan losses respectively—a total of $23 billion. Increasing provisions for loan losses reduces earnings and adds significant strain to institutions during cyclical periods.

The following table summarizes the changes in the allowance for credit losses for 2008, 2007, and 2006.

**FIGURE 2: BANK OF AMERICA ALLOWANCE FOR CREDIT LOSSES, 2006–2008**

<table>
<thead>
<tr>
<th>2008</th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for loan and lease losses, January 1</td>
<td>$11,588</td>
<td>$9,016</td>
</tr>
<tr>
<td>Adjustment due to the adoption of SFAS 159</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans and leases charged off</td>
<td>(17,666)</td>
<td>(7,730)</td>
</tr>
<tr>
<td>Recoveries of loans and leases previously charged off</td>
<td>1,435</td>
<td>1,250</td>
</tr>
<tr>
<td>Net charge-offs</td>
<td>(16,231)</td>
<td>(6,480)</td>
</tr>
<tr>
<td>Provision for loan and lease losses</td>
<td>26,922</td>
<td>8,357</td>
</tr>
<tr>
<td>Other (*)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allowance for loan and lease losses, December 31</td>
<td>23,071</td>
<td>11,588</td>
</tr>
<tr>
<td>Reserve for unfunded lending commitments, Jan. 1</td>
<td>518</td>
<td>397</td>
</tr>
<tr>
<td>Adjustment due to the adoption of SFAS 159</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Provision for unfunded lending commitments</td>
<td>(97)</td>
<td>28</td>
</tr>
<tr>
<td>Other (*)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserve for unfunded lending commitments, Dec. 31</td>
<td>421</td>
<td>518</td>
</tr>
<tr>
<td>Allowance for credit losses, December 31</td>
<td>$23,492</td>
<td>$12,106</td>
</tr>
</tbody>
</table>

* The 2008 amount includes the $1.2 billion addition of the Countrywide allowance for loan losses as of July 1, 2008. The 2007 amount includes the $725 million and $25 million additions of the LaSalle and U.S. Trust Corporation allowance for loan losses as of October 1, 2007 and July 1, 2007. The 2006 amount includes the $577 million addition of the MBNA allowance for loan losses as of January 1, 2006.

**FIGURE 3: BANK OF AMERICA ALLOWANCE FOR CREDIT LOSSES, Q1 2008—Q1 2009**

<table>
<thead>
<tr>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for loan and lease losses, January 1</td>
<td>$23,071</td>
</tr>
<tr>
<td>Loans and leases charged off</td>
<td>($7,356)</td>
</tr>
<tr>
<td>Recoveries of loans and leases previously charged off</td>
<td>$414</td>
</tr>
<tr>
<td>Net charge-offs</td>
<td>($6,942)</td>
</tr>
<tr>
<td>Provision for loan and lease losses</td>
<td>$13,352</td>
</tr>
<tr>
<td>Allowance for loan and lease losses, March 31</td>
<td>($433)</td>
</tr>
<tr>
<td>Reserve for unfunded lending commitments, January 1</td>
<td>$29,048</td>
</tr>
<tr>
<td>Allowance for credit losses, March 31</td>
<td>$30,405</td>
</tr>
</tbody>
</table>

6. ACCOUNTING FOR TROUBLED ASSETS

**a. Fair Value Accounting for Debt and Equity Securities**

The method for valuation of loans is set by the Financial Accounting Standards Board (FASB) as part of its promulgation of generally accepted accounting principles (GAAP). Particular principles are embodied in particular Financial Accounting Standards (FASs).

Prior to 1993, assets such as mortgages and mortgage-backed securities were generally carried on bank books according to the original loan amount. A new value would not be implemented until after the asset was sold. Under the basic standard issued and implemented in 1993 (FAS 115), the manner in which debt and equity securities are valued depends on whether those loans are held on the books of a financial institution in its (1) trading account (an ac-
Credit impairment is assessed using a cash flow model that estimates cash flows on the underlying mortgages, using the security-specific collateral and transaction structure. The model estimates cash flows from the underlying mortgage loans and distributes those cash flows to various tranches of securities, considering the transaction structure and any subordination and credit enhancements that exist in the structure. It incorporates actual cash flows on the mortgage-backed securities through the current period and then projects the remaining cash flows using a number of assumptions, including default rates, prepayment rates, and recovery rates (on foreclosed properties). If cash flow projections indicate that the entity does not expect to recover its amortized cost basis, the entity recognizes the estimated credit loss in earnings.

Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 157: Fair Value Measurements (FAS 157) (September 2006) (hereinafter “FAS 157”). FAS 157 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the entity’s market assumptions. FAS 157 requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value of assets. These two types of inputs have created a three fair value hierarchy: Level 1 Assets (mark-to-market), Level 2 Assets (mark-to-model), and Level 3 Assets (mark-to-model).

a. Impact of New Mark-to-Market Accounting Rules

FAS 115 was implemented before financial innovation spawned complex securitization products that were more difficult to price. To deal with the complexity problem, the accounting rules were changed in 2006.44 FAS 157, implemented in 2006, was meant to

b. Impact of New Mark-to-Market Accounting Rules

FAS 115 was implemented before financial innovation spawned complex securitization products that were more difficult to price. To deal with the complexity problem, the accounting rules were changed in 2006.45 FAS 157, implemented in 2006, was meant to

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Level 1—Liquid assets with publicly traded quotes. The financial institution has no discretion in valuing these assets. An example is common stock traded on the NYSE.

Level 2—Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which
provide a clear definition of fair value based on the types of metrics utilized to measure fair value (market prices and internal valuation models based on either observable inputs from markets, such as current economic conditions, or unobservable inputs, such as internal default rate calculations). In effect, the new rules governed when a permanent impairment had to be recognized by a bank holding the asset. When mortgage defaults rose in 2007 and 2008, the value of underlying assets, such as mortgage loans, dropped significantly, causing banks to write-down both whole loans and mortgage-related securities on their balance sheets through unrealized losses on their income statements. Many banks expressed displeasure, arguing that the available market prices were misleading because they reflected the values that would have been obtained through forced sales within a distressed market when no such sales were taking place. Banks claimed that the rule distorted their financial positions because they were not in fact selling the assets in question and in fact might well recover more than the fire sale write-down price.46 The banks also claimed that the distortions had an immediate effect on available required capital and the stock prices of the institutions involved, both as a result of shareholder sales and market speculation.47

In April 2009, FASB again adjusted the accounting rules to loosen the use of immediate fair value accounting. It adjusted marking-to-market guidance in circumstances when fair value indicates a necessary adjustment to reflect a permanent impairment. One of the new rules suspends the need to apply fair value principles for securities classified under available-for-sale or held-to-maturity if market prices are either not available or are based on a distressed market.48 The rationale for this amendment is that security invest-
ments held by an entity without the intent to sell can distort earnings in an adverse market climate.

The second new rule (FAS 115–2) applies to permanently impaired assets classified as available-for-sale or held-to-maturity, that the holder does not intend to sell, or believes it will not be forced to sell, before they mature. Under the new rule, the part of the permanent impairment that is attributable to market forces does not reduce earnings and does not reduce regulatory capital; under the old rule, the part of the permanent impairment attributable to market forces does reduce earnings and regulatory capital. Banks argued that the market prices for many asset-backed debt securities had fallen sharply due to adverse market conditions despite the underlying loans backing the securities continuing to pay as expected. Hence the rule change protects bank capital from changes in the market value of impaired assets that the bank decides to hold in the hope of eventual recovery.

The changes in these accounting rules are the subject of a continuing debate on which the Panel takes no position. First, although the new interpretation was issued at the beginning of April, it was made retroactive to the beginning of 2009 for firms that elected early adoption and wished to restate their financial reports. For example, Bank of New York Mellon experienced a one-time increase in their first quarter 2009 earnings of $676 million (after-tax) on net income of $322 million as a result of retroactively implementing the new mark-to-market FASB rules.

Second, institutions moved securities from their trading account to available-for-sale and held-to-maturity accounts to take them out of an automatic mark-to-market classification and into classifications that fall under the new rule.

Third, the new rule reduces investor transparency as institutions are not required to use observable market inputs if the bank managers consider the market to be "distressed." As such, investors have difficulty valuing assets that fall under the new rule.

The details of these accounting issues are less important than their impact. As a result of the crisis, asset values are uncertain. By increasing bank managements’ use of discretion in valuing assets, the new rules reinforce the underlying uncertainty in valuation, especially because banks may not apply the rules in a uniform way. Thus, there is no way of knowing whether a bank’s assets are of a sufficient realizable value to support the bank’s liabil-

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49 Financial Accounting Standards Board, FASB Staff Position: Recognition and Presentation of Other-Than-Temporary Impairments (FSP No. FAS 115–2 and FAS 124–2) (hereinafter “FSP FAS 115–2”). This FASB Staff Position (FSP) amends the recognition guidance for the other-than-temporary impairment (OTTI) model for debt securities and expands the financial statement disclosures for OTTI on debt securities. Under the FSP, an entity must distinguish debt securities the entity intends to sell or is more likely than not required to sell the debt security before the expected recovery of its amortized cost basis. The credit loss component recognized through earnings is identified as the amount of principal cash flows not expected to be received over the remainder term of the security as projected based on the investor’s projected cash flow projections using its base assumptions. Part of the entity’s required expansion in disclosure includes detailed explanation on the methodology utilized to distinguish securities to be sold or not sold and to separate the impairment between credit and market losses. FSP FAS 115–2 does not change the recognition of other-than-temporary impairment for equity securities.

50 The Bank of New York Mellon Corporation, First Quarter 2009 Form 10-Q (Apr. 8, 2009), at 46 (online at www.sec.gov/Archives/edgar/data/1390777/000119312509105511/d10q.htm##text=8461_27).

51 FSP 157–4, supra note 48, at 16.

52 Mark-to-Market Analysis, supra note 46, at 12.
ities, let alone to preserve the capital necessary to support lending. To lower the risk of this uncertainty, banks, especially large banks, have reduced participation in the credit markets. Whatever the merits of the new accounting rules, their application adds to the sort of uncertainty on which financial crises feeds.

C. ESTIMATING THE AMOUNT OF TROUBLED ASSETS

The risks troubled assets continue to pose for the banking system depend on how many troubled assets there are. But no one appears to know for certain. To frame the discussion in the report, this section provides readers with a perspective on the size and current state of the troubled assets pool.

Some caveats are in order at the outset. It is impossible to ever arrive at an exact dollar amount of troubled assets, but even the challenges of making a reliable estimate are formidable. There are several reasons. No agreed-upon definition of “troubled asset” (or of asset subcategories) exists. It is difficult to assemble relevant (and reliable) numbers from publicly-available information. Values and asset quality fall along a constantly changing continuum. The relevant markets are huge, complex, and global. It is often difficult to distinguish troubled assets from assets that have already been written-down to reflect current conditions. Finally, the effect of future conditions on the asset pool can only be projected, and loss estimates are no better than the projections themselves, a fact reflected in the steep drop in the value of troubled complex securities once the wave of subprime loan defaults began. However, meaningful estimates can still be derived to help inform this discussion.

This section reflects several approaches. First, it assembles information from the financial statements for the 19 stress-tested bank holding companies. Second, it examines the data on loans from these same BHCs that are more than 90 days past due. Next it discusses the credit default exposure of these same BHCs. Finally it models prospective losses on whole loans for all BHCs with over $600 million in assets, thus including smaller national and regional BHCs and the largest community banks that are BHCs. (A more in-depth discussion of the techniques used can be found in the Annex to Section One of this report.)

In publicly-available data reviewed by the Panel, the 19 stress-tested BHCs have reported:

- $657.5 billion in Level 3 assets;
- $132.9 billion in annualized loan losses;
- $264.6 billion in past due loans; and
- $8.9 trillion in credit default sub-investment grade exposure.

\footnote{There are, however, accepted definitions of degrees of loan impairment.}
\footnote{As of March 31, 2009. Level 3 assets are described supra note 45.}
\footnote{As of June 30, 2009.}
\footnote{As of March 31, 2009.}
\footnote{As of March 31, 2009.}
1. INFORMATION FROM COMPANY FINANCIAL STATEMENTS AND FEDERAL RESERVE BHC REPORTS

The Panel has aggregated information from public financial records by summing the values of the appropriate line items from each bank’s financial statements as reported to the SEC and the Federal Reserve Board. The usefulness of public financial records is limited, though, by a lack of uniformity in reporting and formatting and a lack of granularity. The Panel is not trying to determine the correct valuation of any of these assets, simply to reach an estimate of their size based on the values banks assigned to them.

a. Level 3 Assets

The Panel first examined Level 3 assets which are required to be reported and disclosed by the Financial Accounting Standards Board (under FAS No. 157) and the Federal Reserve Board. Level 3 assets include assets for which it is difficult to find reliable external indicators of value. Because many toxic assets are inherently difficult or impossible to model, they are most likely to be found on a bank’s balance sheet as Level 3 assets, thus this number is instructive. Given the complexity of the packaging of certain real estate-related securities and the illiquidity in the markets, certain assets that fall under the Level 3 category are not non-performing assets, and certain assets that fall within the Level 2 assets (and occasionally even Level 1) may also ultimately prove troubled.

According to first quarter 2009 financial statements, the 19 stress-tested financial institutions held approximately $657.5 billion of Level 3 assets. This was a 14.3 percent increase in Level 3 assets compared to three months prior (December 31, 2008). In addition, certain financial institutions such as Bank of America, PNC Financial, and Bank of New York Mellon had twice as many assets (in terms of dollars) classified as Level 3 in the first quarter of 2009 compared to year-end 2008. BHCs such as Morgan Stanley had more than ten percent of their total assets categorized as Level 3.

FIGURE 4: LEVEL 3 ASSET EXPOSURES

<table>
<thead>
<tr>
<th>MBS</th>
<th>ABS</th>
<th>Loans</th>
<th>Mtg. serv.</th>
<th>Other assets</th>
<th>Deriv.</th>
<th>AFS sec.</th>
<th>Corp. debt</th>
<th>Other sec.</th>
<th>Total</th>
<th>% change</th>
<th>% of total assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of America</td>
<td>$10.4</td>
<td>$9.6</td>
<td>$14.3</td>
<td>$14.1</td>
<td>$6.1</td>
<td>$41.8</td>
<td>$11.9</td>
<td>$18.7</td>
<td>$126.9</td>
<td>127%</td>
<td>5%</td>
</tr>
<tr>
<td>Bank of New York-Mellon</td>
<td>$3.1</td>
<td>$0.2</td>
<td>$0.1</td>
<td>$0.3</td>
<td>$3.7</td>
<td>441%</td>
<td>2%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BB&amp;T</td>
<td>$0.4</td>
<td>$0.2</td>
<td>$1.0</td>
<td>$1.6</td>
<td>3%</td>
<td>1%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital One Financial</td>
<td>$0.3</td>
<td>$2.2</td>
<td>$0.7</td>
<td>$2.3</td>
<td>$5.4</td>
<td>30%</td>
<td>3%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Citigroup</td>
<td>$18.5</td>
<td>$26.1</td>
<td>$0.2</td>
<td>$5.5</td>
<td>$2.5</td>
<td>$49.9</td>
<td>$20.9</td>
<td>$123.6</td>
<td>–15%</td>
<td>7%</td>
<td></td>
</tr>
</tbody>
</table>

58 See Annex to Section One for details on sourced data.
59 See Annex to Section One for further discussion.
61 See supra note 45.
62 Does not include American Express which did not report Level 3 Asset data in its SEC filings.
The Panel conducted an analysis of loan losses and non-performing loans based on data from the financial statements from year-end 2007 through the second quarter of 2009 for the 19 stress-tested BHCs. As of the second quarter of 2009, the 19 stress-tested BHCs had $132.9 billion in annualized loan losses. With a combined loan loss cumulative annual growth rate during this period of 56.6 percent, the stress-tested BHCs continue to experience substantial whole loan write-downs on their balance sheets. Further, non-performing loans increased significantly for all the stress-tested BHCs between the second quarters of 2008 and 2009.

Exposure to past due securitization assets for the 19 largest BHCs increased from $23.2 billion year-end 2007 to $264.6 billion as of the end of the first quarter 2009. Past due securitization assets increased eleven times in 15 months. For example, Bank of America had $5.0 billion of past due securitization assets on its balance sheet at the end of 2007, but that number ballooned to $141.7 billion at the end of March 2009 (some of this resulted from its acquisitions of Countrywide and Merrill Lynch).
d. Credit Default Sub-Investment Grade Exposure

Credit derivatives on sub-investment grade assets create large amounts of unregulated exposure to potential defaults on lower quality loans, amplifying the effect of defaults. Similar to past due securitization assets, credit derivative exposure for sub-investment grade assets experienced a significant uptick in the same period. Sub-investment grade credit derivative exposure for the 19 largest BHCs grew from $1.6 trillion in year end 2007 to $8.9 trillion in the first quarter of 2009 as a result of downgrades.

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The data used in creating this chart came from the quarterly Federal Reserve Bank Holding Company Performance Reports of the following companies from the period 12/31/07 to 3/31/09: Bank of America; Bank of New York Mellon; BB&T; Capital One Financial; Citigroup; Fifth Third Bank; Goldman Sachs; J.P. Morgan Chase; KeyCorp; Morgan Stanley (online at www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx).

This graph presents two very different sets of values given the amount of Past Due 90+ Loans held by the various banks differs substantially. Presenting the data in this way reflects each bank's holdings on a percentage basis as each.

This analysis does not include American Express, GMAC, and MetLife which did not include Credit Derivative Sub-Investment Grade data per their FED Y-9Cs.
The data used in creating these graphs were derived from the quarterly Federal Reserve Bank Holding Company Performance Reports of the following companies from the period 12/31/07 to 3/31/09: Bank of America; Bank of New York Mellon; BB&T; Capital One Financial; Citigroup; Fifth Third Bank; Goldman Sachs; J.P. Morgan Chase; KeyCorp; Morgan Stanley; PNC Financial; Regions Financial; Sun Trust Banks; U.S. Bancorp; Wells Fargo (online at www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx).

These graphs present two very different sets of values given the amount of Sub-investment Grade Credit Derivative held by the various banks differs substantially. Presenting the data in this way reflects each bank's holdings on a percentage basis as each.

As the data collected for this graph is driven by filings that are required of BHCs, no data is available prior to the first quarter of 2009 for Goldman Sachs and Morgan Stanley (which only recently became BHCs).
Whole loans have been the primary source of income for traditional banks for more than 100 years, and remain such for many of the smaller banks in the United States. A loan is simply modeled by discounting its expected cash flows to the present, while along the way applying some default and recovery assumptions. Given knowledge about the individual or entity that the loan was made to, and the value of its collateral, it is fairly simple to calculate default and recovery rates. For these reasons, the Panel focused its quantitative efforts on modeling losses in whole loans, assets which represent over $5.9 trillion in the 719 banks modeled by the Panel. The Panel also chose to model only whole loans because they are the only troubled asset for which sufficient information is available to create a reasonable model with few assumptions that can be tested under a number of different scenarios. As a result, the Panel's modeling is of greatest relevance to banks that have invested a larger portion of their assets in whole loans, which tend to be smaller banks. It should be remembered that this does not portray the whole problem for larger banks because it does not include their exposure to losses on account of complex securities.

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70 See Annex to Section One for a more thorough discussion of the Panel's model.

71 Even with this information, however, default rates cannot be predicted with perfect accuracy. Importantly, such predictions are based on the assumption that the information passed on by the originator of the loan is absolutely correct, an assumption which, especially in 2006 and 2007, was not always true. Moreover, default rates are typically based on historical experience, which is an unreliable guide after the bursting of an unprecedented bubble.

72 Data was obtained from Bank Holding Company Consolidated Financial Statements, also known as Federal Reserve Form Y–9C (online at www.ffiec.gov/nicpubweb/nicweb/NicHome.aspx).
a. Modeling

The Panel used a model developed by SNL Financial to assess whole loan losses and potential capital shortfalls for all BHCs with over $600 million in assets. This group includes the stress-tested BHCs, national BHCs that were not stress tested, but more significantly includes medium to large regional BHCs.

The model tested the banks against two scenarios: it began with the “starting point” assumptions used similar to the Federal Reserve Board in its analysis, and then used assumptions that were 20 percent more negative. These assumptions were used to project loan losses and BHCs’ net revenue, before subtraction for loan loss reserves, for the next two years. Using this information and data on the BHCs’ loan loss reserves, the model was then able to calculate the amount of capital necessary for each BHC to recapitalize after the losses it sustained in the scenario.

b. Results of the Panel’s Analysis of Loan Losses

The Panel’s analysis shows that given the necessary capital additions raised since May 2009, the 18 largest BHCs would be able to deal with projected losses in their whole loan portfolios. This strength is, in large part, due to the rebound in earnings of banks in the first quarter of 2009; those earnings increased even if one excludes one-time accounting adjustments. This is very encouraging, especially considering the recent trends in the Case-Shiller index, which showed that housing prices may be rebounding. But again, this analysis deals only with whole loans; it does not include the risks these large banks face from their holdings of complex securities. The Panel has not analyzed how the interaction of whole loans and complex security holdings could affect large banks.

The Panel’s analysis of troubled whole loans suggests they pose a threat to the financial health of smaller banks (“$600 million to $100 billion group”). Using the same assumptions, it looks as if banks in the $600 million to $100 billion group will need to raise significantly more capital, as the estimated losses will outstrip the

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73 Based in Charlottesville, Virginia, SNL Financial provides news, data, and analysis on various business sectors, including banking and other financial institutions.

74 Excluding 66 banks which did not supply enough information to calculate Tier 1 common capital for the period ending March 31, 2009.


76 Loan losses are calculated as the product of the loan loss rate as dictated by the scenario, with the total loans of that type held by each bank. The Panel used two methods to calculate loan losses: a standard and a customized. The standard method used the loan loss rates stated in the stress test and uniformly applied them across all of the BHCs considered. The customized approach attempted to tailor these aggregate loan loss rates to individual banks, on the basis of their past performance. Thus for banks whose loans consistently outperformed the market, their loan loss rate was lowered, while banks that consistently held lower quality loans had their loan loss rates raised.

77 Calculated based on data from the past two years.

78 To test the accuracy of its estimates, the Panel calibrated its model to the results of the stress tests. In doing so, it simply used the results as a baseline and did not mean to accept or reject the assumptions made there. The median result reached by the Panel in calibrating its results was 2.5 percent higher than the stress tests; the difference was most likely the result of the portions of the stress tests that cannot be independently replicated.

79 Excludes GMAC due to no reported data in the FED Y9-C reports.

80 See, e.g., Standard & Poor’s, Home Price Declines Continue to Abate According to the S&P/Case-Shiller Home Price Indices (July 28, 2009) (online at www2.standardandpoors.com/spf/pdf/index/CSHomePrice_Release_072820.pdf) (“The 10-City and 20-City [Case-Shiller] Composites reported positive returns for the first time since the summer of 2006.”). This figure is not seasonally adjusted.

81 $600 million was chosen as the floor asset level because it is the lowest at which the requisite information for modeling the loan losses and revenues was present in public filings.
projected revenue and reserves. Under the “starting point” scenario, this second group of banks will need to raise $12–14 billion in capital to offset their losses, while in the “starting point + 20%” scenario, non-stress-tested banks are expected to have to raise $21 billion in capital to offset their losses. The capital shortfall for those relatively smaller banks, as shown below in Figure 8, is primarily due to the lack of reserves, which on average account for only 25 percent of the expected loan losses.

**FIGURE 7: LOAN LOSSES PROJECTED FROM Q1 2009 INFORMATION**

(Dollars in millions)

<table>
<thead>
<tr>
<th></th>
<th>Starting Point</th>
<th>Starting Point + 20%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Standard</td>
<td>Customized</td>
</tr>
<tr>
<td>Top 18 BHCs</td>
<td>486,658</td>
<td>504,083</td>
</tr>
<tr>
<td>All Banks with Assets $100B to $600M</td>
<td>152,134</td>
<td>123,069</td>
</tr>
<tr>
<td>Total (All banks $600M+)</td>
<td>638,591</td>
<td>627,152</td>
</tr>
</tbody>
</table>

82 See supra, note 74. See also Annex to Section One of this report.
83 Stress-tested BHCs excluding GMAC.
84 Excluding Keycorpor, which is one of the 18 BHCs, but whose assets have fallen below $100 billion.

**FIGURE 8: CAPITAL SHORTFALLS PROJECTED FROM Q1 2009 INFORMATION**

(Dollars in billions)

<table>
<thead>
<tr>
<th></th>
<th>Starting Point</th>
<th>Starting Point + 20%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Standard</td>
<td>Customized</td>
</tr>
<tr>
<td>Top 18 BHCs</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>All Banks with Assets $100B to $600M</td>
<td>11.70</td>
<td>13.99</td>
</tr>
<tr>
<td>Total (All banks $600M+)</td>
<td>11.70</td>
<td>13.99</td>
</tr>
</tbody>
</table>

85 Stress-tested BHCs, excluding GMAC.
86 Excluding Keycorpor, which is one of the 18 BHCs, but whose assets have fallen below $100 billion.

The calculations performed by the Panel imply that while the 18 largest BHCs are sufficiently capitalized to deal with whole loan losses, the relatively smaller BHCs, i.e., those in the $600 million to $100 billion group, are not, and are going to require additional capital given more severe economic conditions. The Panel sees the undercapitalization of the BHCs in the latter group as a serious issue; those banks may have access to a comparatively smaller pool of investors, and could face significant challenges in raising the necessary capital.

### 3. ESTIMATES FROM OTHER SOURCES

The Federal Reserve, IMF, Goldman Sachs and RGE Monitor have each performed independent analyses of expected loan losses and complex securities write-downs across U.S. banks. These analyses looked at the entirety of bank portfolios, not just whole loans. Although none of these organizations made public the models they used, it is useful to compare their results to gain a sense of the scale of the troubled asset problem. It is important to remember that while the IMF, Goldman Sachs and RGE Monitor estimates were based on neutral projections of the future, the Federal Reserve estimate was based on a downside, or stressed, projection. It should be noted that the Panel’s analysis of whole loans is a subset of the universe of assets these estimates looked at, and so the Pan-
el's estimates of troubled whole loan exposure should not be directly compared to these estimates.

Figure 9: Comparison of 2009–10 Write-Down Estimates for U.S. Banks

<table>
<thead>
<tr>
<th>Test</th>
<th>Banks Measured</th>
<th>Assumed Peak to Trough House Price Decline</th>
<th>Date</th>
<th>Total Write-downs (2007–10) ($b)</th>
<th>Remaining Write-downs (2009–10) ($b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Reserve Stress Test (Adverse Case).</td>
<td>BHGCs 88.</td>
<td>47%</td>
<td>May 2009</td>
<td>N/A</td>
<td>$599.2</td>
</tr>
<tr>
<td>IMF</td>
<td>All U.S. Banks</td>
<td>40%</td>
<td>April 2009</td>
<td>$1,060</td>
<td>$550</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>All U.S. Banks</td>
<td>40%</td>
<td>January 2009</td>
<td>$960</td>
<td>$450</td>
</tr>
<tr>
<td>RGE Monitor 89</td>
<td>All U.S. Banks</td>
<td>41%</td>
<td>January 2009</td>
<td>$1,730</td>
<td>$1,220</td>
</tr>
</tbody>
</table>

87 The Case-Shiller 20-City Composite Index shows that housing prices have declined 32 percent from peak to trough as of May 2009. Standard & Poor’s, S&P/Case-Shiller Home Price Indices, Seasonally Adjusted, Composite 20 Index (online at www.standardandpoors.com/spf/pdf/index/SA_CSHomePrice_History_072820.xls) (accessed Aug. 4, 2009). However, non-seasonally adjusted home prices increased in May 2009, the first month to see an increase since July 2006, perhaps indicating that the home price slide is beginning to bottom out.

88 These BHGCs hold two thirds of U.S. bank assets.

89 RGE Monitor’s remaining write-downs estimate for U.S. banks is significantly higher than the other estimates both because it estimates a greater amount of credit losses and because it predicts a greater percentage of those losses will be borne by U.S. banks. For example, as compared to the IMF estimate, RGE Monitor assumes 29 percent greater aggregate credit losses, and assigns 49 percent, as compared to the IMF’s 39 percent, to U.S. banks.

All of these estimates, including the Panel’s own, suggest that substantial troubled assets remain on banks’ balance sheets.

D. CURRENT STRATEGIES FOR DEALING WITH TROUBLED ASSETS

Approaches taken in two prior banking crises are useful in placing current strategies in perspective. Those approaches also suggest some possible steps to address the current situation.

1. PAST APPROACHES

a. LESS DEVELOPED COUNTRY (LDC) CRISIS

Beginning in the early 1970s, Latin American countries’ borrowing increased significantly. At the end of 1970, outstanding debt from all sources totaled $159 billion. By 1978, it had risen to $506 billion, and in 1982 it totaled $722 billion. The eight largest money-center banks held $121 billion of this debt. By the early 1980s, money-center banks carried high exposure to the risks of these loans—the average money-center bank carried an LDC loan to total capital and reserves concentration of 217 percent. In August of 1982, Mexico was the first country to announce that it could no longer make interest payments on the debt. By the end of that year, approximately 40 other countries had joined it in failure to meet debt service obligations.

From 1983 through 1989, the banks and countries negotiated to reschedule and restructure the debt. At the same time, banks increased loan loss reserves; by the end of 1989, banks’ loan loss reserves totaled nearly 50 percent of their outstanding LDC loans. In

80 All dollar values in this section are adjusted for inflation, as measured by the consumer price index (CPI), to reflect their approximate current-dollar value. See U.S. Department of Labor, Bureau of Labor Statistics, CPI Detailed Report, Data for June 2009, at 72, 74 (July 15, 2009) (online at www.bls.gov/cpi/cpidx9006.pdf).
81 Id.
82 Id. at 199.
83 Id. at 206.
1989, Treasury Secretary Nicholas Brady developed a plan to convert the non-performing LDC debt into tradable, dollar denominated bonds. Because these bonds, called Brady Bonds, were tradable, they allowed banks to get the debt off their balance sheets, thus reducing the concentration risk. It also amounted to a forgiveness of approximately one third of the $328 billion in outstanding debt.95

The success of the work-outs in this situation raises the question whether a series of work-outs shaped to the current crisis would help alleviate the situation. Indeed, Treasury, the Federal Reserve Board, and the Federal Reserve Bank of New York have taken something of this approach in dealing with AIG.96 Treasury has indicated its view that such work-outs cannot play more than a limited role now,97 but repayment of TARP assistance by many institutions and the hoped for restarting of the markets for troubled securities make supervised work-outs a matter worth exploring.

b. The Resolution Trust Corporation

A few years later, the banking industry faced a domestic asset quality crisis. In the late 1980s, over one thousand savings and loan institutions (or “thrifts”) failed.98 In 1989, Congress created the Resolution Trust Corporation (RTC) to aid the FDIC in the process of resolving failed savings and loan institutions.99 The RTC’s role was to take control of the assets, both sound and troubled, of any thrift the FDIC placed in receivership, and eventually sell them on the market. The RTC sold the assets of 747 failed institutions with total assets of approximately $400 billion.100 It disposed of 95 percent of the thrifts’ overall assets, with a recovery rate of approximately 85 percent of the value of the assets it acquired.

The RTC experience presents an example of one course the government can take to resolve failed banks and their troubled loan portfolios. In contrast to assisting banks that remain open for business, with or without some amount of government ownership, the RTC dealt with only closed institutions and their assets. In its operations, the RTC attempted to sell as many whole thrifts as pos-
sible, which had the effect of passing along both the assets and liabilities of a failed institution. Investors contemplating bidding for any particular institution would have to exercise substantial due diligence in reviewing a failed thrift's assets to estimate reasonably their salvageable value, including the ability to readily foreclose on defaulted loans and acquire the underlying collateral. In practice, this meant that the bids the RTC received, especially early on, reflected a substantial risk premium.

Not all of the failed savings and loans assigned to the RTC could be resolved using the whole thrift transaction process. The FDIC often shut the thrift down and paid off the depositors. The RTC would then sell the assets. The RTC used three methods for disposing of assets. It sold the majority of the assets through auctions, but assets were also disposed of through equity partnerships and securitization. At least $232 billion of assets were sold using these three methods.

Auctions were the most common method that the RTC used to dispose of assets. Initially it sold assets one by one, but by mid-1990 it began to use bulk sales of packaged assets. The auctions were either sealed-bid auctions or "open outcry" auctions, using an auctioneer and often held near the location of the assets.

The RTC used equity partnerships in situations where the market price for a bulk sale was significantly less than what the RTC hoped to obtain for the assets. These partnerships involved a private sector partner that would obtain a partial interest in the group of assets, while the RTC retained an equity interest. The private sector partner would manage the assets and the sale of the assets, providing the RTC with distributions from the proceeds of the sales. In addition the RTC used securitization as a method to dispose of commercial and multi-family loans. It is seen as a pioneer in this field.

The RTC is widely regarded as having been a success. But that success was in large measure a function of the nature of the institutions it resolved and the composition and relative transparency of their loan portfolios. The resolution of a failed institution is a very different task than attempting to coax a solvent firm to take significant write-downs by selling its loans at a discount. The RTC had two other important differences from the current situation. First, the RTC sold assets held by bankrupt thrifts that had been seized by regulators. Second, it was selling assets, not buying them (albeit a subsidy was provided in both cases). In contrast to certain types of troubled assets held by troubled financial institutions in the current financial crisis, the underlying properties on which thrifts had made loans were easily identifiable and were often large projects that could be appraised and for which completion costs could be readily estimated. Whether investors acquired these tangible assets directly from the RTC or as collateral for the troubled loans of the institutions on which they were successful bidders, the

101 In addition, on some occasions, the FDIC stripped out certain assets before placing the institution up for auction.
102 GAO Audit, supra note 100, at 9.
103 Section 21Ab(h)(3)(A)(ii) of the Federal Home Loan Bank Act of 1932 required the RTC to use private sector resources to the extent that it was "practicable and efficient."
ability of the market to value these assets to the satisfaction of buyers and sellers was a key factor in the RTC’s successful sales.

2. TREASURY’S PRESENT STRATEGY

Treasury’s policies to date have indicated its awareness of the problems posed by the continued presence of troubled assets in the banking system. It has recognized that valuation directly affects bank solvency and ability to lend. Treasury’s implementation of the TARP—especially its capital injection policy and the related implementation of the stress tests by the Federal Reserve Board—combines a variety of approaches toward protecting the financial system against the threat posed by troubled assets and weak balance sheets. Those approaches are promising, but they also face obstacles.

a. The Capital Purchase and Capital Assistance Programs

Treasury can inject further capital assistance into banks under the original Capital Purchase Program or the Capital Assistance Program (CAP).104 Thus, Treasury retains the option to follow the strategy it used at the beginning of the crisis: shoring up bank capital directly to offset losses derived from troubled assets. It may prove that this capacity is important, to assist smaller banks, as well as to continue to support larger institutions that prove to still be at risk. Approximately 445 banks have received capital assistance since January 1, 2009.105 However, this type of assistance has in the past raised issues as to whether the transactions maximized taxpayer value (see February report).

b. The PPIP

Treasury’s Public-Private Investment Program (PPIP) is aimed directly at troubled assets. Treasury has worked to build a structure that it believes can restart the market, and encourage price discovery, for those assets, and thus go a long way to resolving uncertainty about the way banks should value these assets.

The PPIP was originally created with two sub-programs: a legacy securities program, aimed at complex securities, and a legacy loans program, aimed at troubled whole loans. The legacy loans program was designed to create Public-Private Investment Funds (PPIFs) using a mix of private and public equity and FDIC-guaranteed debt that would be created to buy and manage pools of mortgages and similar assets. A bank, in consultation with its primary regulators, Treasury, and the FDIC, would identify assets, typically a pool of loans that the bank would like to sell. Then the FDIC would analyze the asset pool to determine the appropriate guaranteed debt-to-equity ratio that could be supported by the pool for the PPIF that would buy the loans, guided by a third party valuation firm. The highest ratio permitted would be a six-to-one debt-to-equity ratio. The debt would be guaranteed by the FDIC on a non-recourse basis, so that the borrower had no additional liability; Treasury, using TARP funds, and the private in-

105 Id.
Treasury provided the following example in its press release announcing the program:

If a bank has a pool of residential mortgages with $100 face value that it is seeking to divest, the bank would approach the FDIC. The FDIC would determine, according to the above process, that they would be willing to leverage the pool at a 6-to-1 debt-to-equity ratio. The pool would then be auctioned by the FDIC, with several private sector bidders submitting bids. The highest bid from the private sector—in this example, $84—would be the winner and would form a Public-Private Investment Fund to purchase the pool of mortgages. Of this $84 purchase price, the FDIC would provide guarantees for $72 of financing, leaving $12 of equity. The Treasury would then provide 50 percent of the equity funding required on a side-by-side basis with the investor. In this example, Treasury would invest approximately $6, with the private investor contributing $6. The private investor would then manage the servicing of the asset pool and the timing of its disposition on an ongoing basis—using asset managers approved and subject to oversight by the FDIC.

In announcing the PPIP in February, the Administration cited the need to provide greater means for financial institutions to cleanse their balance sheets of both types of what it calls “legacy assets.” In a follow-up March press release, Treasury emphasized one of the major points of this report, namely, that troubled assets “create uncertainty around the balance sheets of . . . financial institutions, compromising their ability to raise capital and their willingness to increase lending.” Treasury reaffirmed and expanded on these themes in the white paper accompanying the March 23, 2009 press release announcing the details of the program:

A variety of troubled legacy assets are currently congesting the U.S. financial system. An initial fundamental shock associated with the bursting of the housing bubble and deteriorating economic conditions generated losses for leveraged investors including banks. This shock was compounded by the fact that loan underwriting standards used by some originators had become far too lax and by the proliferation of structured credit products, some of which were ill understood by some market participants.

The resulting need to reduce risk triggered a wide-scale deleveraging in these markets and led to fire sales. As prices declined further, many traditional sources of capital exited these markets, causing declines in secondary market liquidity. As a result, we have been in a vicious cycle in which declining asset prices have triggered further...
deleveraging and reductions in market liquidity, which in turn have led to further price declines. While fundamentals have surely deteriorated over the past 18–24 months, there is evidence that current prices for some legacy assets embed substantial liquidity discounts.  

The crucial elements of the program, according to Treasury, are: (1) “maximizing the impact of each taxpayer dollar” by using private capital to leverage public financing;  

(2) shifting some of the risk onto the private sector by using private capital; and (3) using market competition to assist in setting prices.

The proper balance of risk and reward between the public and private investors is key to the PPIP’s success. Treasury has said that “[t]he approach is superior” to the alternatives because “simply hoping for banks to work legacy assets off over time risks prolonging a financial crisis,” while government action alone would require taxpayers to “take on all the risk of such purchases—along with the additional risk that taxpayers will overpay if government employees are setting the price for those assets.”

Alternative options for tackling this problem relied solely on public funds and did not sufficiently address the pricing issues plaguing these markets.

A key aspect of the PPIP is its purported ability to use the markets to provide some form of reliable valuation for these assets. Treasury believes the PPIP can create a “market pricing mechanism.” The PPIP is designed to give investors an incentive, in the form of risk sharing with and financing guaranteed by the government, to compete to buy legacy securities; the more money that flows into the markets because of this competition and the more auction results indicate asset prices, the more the markets will open and banks have objective indicators to firm up accurate val-

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110 PPIP White Paper, supra note 108.

111 As the securities portion of the PPIP is structured, the amount of risk the public sector may bear depends on how the individual fund manager chooses to provide funding to the fund. The fund manager may choose to create a $1 billion fund with $500 million of private equity and $500 million of public (Treasury) equity, in which case the private investors and the public have half the risk and half the reward. The fund manager may alternatively seek to create a fund of up to $2 billion by accepting $1 billion in public financing in the form of secured non-recourse loans from Treasury. Under this scenario, the public is at risk for 75 percent of the downside and 50 percent of the upside.

The fund managers may also use the TALF to shift even more of the downside risk to the public. Treasury has explicitly stated that it anticipates that fund managers will seek TALF financing to purchase eligible CMBS. In this case, a fund manager would request a TALF loan to pay the $500 million private equity portion of the PPIP fund (or PPIF). Assuming a haircut of 15 percent, the Fund would receive a TALF loan of $425 million and would therefore need to raise only $75 million in the capital markets. The private sector would have only 3.75 percent of the downside while still retaining the right to 50 percent of the upside.

Under the loan program, the private investor may buy at up to a six-to-one-debt-to-equity ratio. And the equity is contributed in equal parts by the private investor and Treasury. Since the financing is provided in the form of non-recourse loans, the public could be responsible for up to 50 percent of the downside risk for each investment while sharing in only 50 percent of the potential profit.

Although the current allocation places the heavier risk on the public, Treasury has noted that the risk allocation under the PPIP is more favorable to taxpayers than an alternative that would require the U.S. government to purchase assets directly and therefore bear all of the risk.

112 PPIP March Release, supra note 106.

113 PPIP March Release, supra note 106. Treasury has the right to terminate a fund in several situations to protect the taxpayers’ investments from changes in circumstance. Several rules assure that Treasury will share equally in all distributions. All of the investment funds must report to Treasury each month.

114 PPIP March Release, supra note 106.

115 PPIP White Paper, supra note 108.
ues for the assets they retain on their balance sheets. Although the current funding structure of the legacy securities program involves a degree of subsidization, Treasury has noted that the ability to share equally in asset price increases (as well as losses) is a critical program feature and is far preferable to a situation in which the government is forced to purchase all of the risk of direct asset purchases.\(^{116}\) In addition to this risk sharing, Treasury has built the legacy securities program to help create market demand—and hence liquidity—by encouraging competition among the funds created under the program. It hopes that the presence of nine (or potentially more) funds created for the sole purpose of buying legacy securities will create incentives to raise price levels as the funds compete until prices reach a level at which banks are willing to sell.\(^{117}\)

In building the PPIP, Treasury’s strategy resembles its strategy for the TARP generally. It does not seek to “clear” all troubled assets from bank balance sheets, or to have a stake in buying all troubled assets, any more than it wants to own permanent stakes in banks. Instead it hopes to reinvigorate the markets so that normal market processes can again operate; if investors become confident that troubled assets carried on bank balance sheets can be reliably priced, the system again becomes self-supporting, subject to normal supervisory oversight. Treasury remains ready to inject more money into the program if further “pump-priming” is necessary to accomplish that objective.

Assistant Secretary of the Treasury for Financial Stability Herbert Allison explained Treasury’s view of PPIP in his testimony before the Panel on June 24, 2009:

> It’s our belief that when markets are illiquid and a bank tries to sell assets, they’re selling at fire sale prices because it’s a highly-inefficient market. The idea is that if we increase liquidity, if we can act as a catalyst to get these markets going, we will see the spreads between bid and ask declining and there will be more activity, more sales by banks, more investment by individuals in a self-reinforcing process, but we have to, we think, play a role in jumpstarting sectors of the securitization market so that can happen.\(^{118}\)

The success of the PPIP as described by Treasury depends on whether the circumstances in which it operates enable it to restart the markets in a way that leads to accurate price discovery and creates an upward spiral (more accurate pricing, more investors, and so forth) to replace the downward spiral of 2008. Several obstacles lie in the way. It is not necessary that they be eliminated all

\(^{116}\) PPIP March Release, supra note 106. Obviously, such a situation would also provide the public with the opportunity to reap 100 percent of any upside as well.

\(^{117}\) Competition among applicants for selection as fund managers is also important. The application process includes a review of the applicant’s experience managing assets such as the “legacy” securities, the value of the applicant’s current assets under management, and other related qualifications. Treasury has reported receiving more than 100 applications for the limited number of positions. To the extent this process awards fund manager status to only the most highly qualified, Treasury believes it has the advantage of retaining top talent for the task of valuing and purchasing assets through a mechanism that may be more effective than hiring such qualified investors as government employees as would be necessary to enable the government to buy the assets on its own.

\(^{118}\) Allison Testimony, supra note 37.
at once; in fact it is in the nature of an effort such as this that progress will at first perhaps be incremental.

There is a question as to whether the PPIP produces true price discovery because of the degree of government subsidization involved. The value of an asset is discounted by the magnitude of the risk, but the intention of the program is to reduce the risk and therefore reduce the discount required by the buyer. The risk does not evaporate but is instead being absorbed by the government. This is likely the reason that Treasury is emphasizing the return of liquidity to the markets once initial purchases are made on a subsidized basis; market participants can determine a non-subsidized price to keep the market going—the key is to bring the first investors back into the markets so that the process can start.

The next problem is more serious. Once a bank sells a legacy security or legacy loan, it must book the sale value, but if the bank holds the asset, it may continue to mark the asset at the higher value permitted by the new rule. Thus any sale at less than amortized cost value would forgo the benefit of being able to avoid distress pricing and force perhaps substantial write-downs. In addition, the acceptance of accurate pricing in the market may require banks to write-down even the holdings they retain. At the same time, of course, banks can book a profit, especially if they have already written-down the asset in question, and then sell it for more than its carrying value.

But the central issue underlying the PPIP is the same as the question underlying virtually all discussions of troubled assets: valuation. As discussed above, the program may start an upward cycle to start the markets flowing (although that objective is in itself not without some risk to banks if it forces downward valuation of assets that remain on balance sheets). But the converse is also possible, namely that the market will not function because prospective buyers will value such assets only at prices at which institutions holding them will not sell, either because to do so will require them to record write-downs on their books—reducing operating income and ultimately capital—or because they believe that the economic value at which they are carrying the loans is accurate and reflects economic conditions they expect to improve, or both.119

As with all TARP programs, there is a risk that banks and investors may be wary of the program because of fears that participation will subject them to statutory restrictions, including those that they cannot anticipate. Government involvement has been viewed by many institutions as subject to unpredictable change.120

119 It is unlikely that the distinction between liquidity and price is absolute. Thus, the market for legacy securities may be characterized in part by an absence of liquidity (for example, because investors are unwilling to commit themselves for more than a short period given anticipated changes in interest rates, others may remain wary of pricing uncertainty). As indicated in the text, this distinction can put something of a ceiling on the degree to which the PPIP can attack the problem. Lucian Bebchuck, Buying Troubled Assets (Apr. 2009) (online at www.law.harvard.edu/programs/olin_center/papers/pdf/Bebchuck_636.pdf).

120 In a recent newsletter, banking and finance lawyer Harold Reichwald of the law firm Manatt, Phelps & Phillips noted that a provision of the newly enacted Helping Families Save Their Homes Act of 2009 would require certain participants in the PPIP loans program to provide government access to financials and other information. The newsletter notes that, without further clarity from the FDIC and Treasury on the execution of this provision, “there is a considerable risk that potential purchasers may decide it is better to simply sit on the sidelines without having an audit spotlight on them.” Harold Reichwald, PPIP and TARP Transparency (May 21, 2009) (online at www.manatt.com/news.aspx?id=9498).
public outrage that followed the disclosure of bonus plans of various firms that have previously received TARP assistance has highlighted the public’s expectations and may have exacerbated the problem.\textsuperscript{121}

Although Treasury has attempted to build into the program a number of protections for the public, including conflict of interest rules for the selection and operation of fund managers, the Special Inspector General for TARP (the SIGTARP) described continuing concerns regarding those protections in its July 21, 2009 quarterly report to Congress.\textsuperscript{122} In its April 2009 report, the SIGTARP noted a number of concerns, including concerns regarding conflicts of interest, collusion among fund managers, money laundering, and increased government exposure through the use of the Term Asset-Backed Loan Facility (TALF) and PPIP in conjunction with one another.\textsuperscript{123} These issues, the July report found, have been largely ameliorated. The SIGTARP found, however, that several concerns remain unaddressed. First, the SIGTARP is concerned that Treasury has not mandated strong “walls” between PPIFs and the other funds managed by fund managers. Treasury has resisted stronger “walls,” citing funds’ inability to use a firm’s best talent if those employees would be walled off from any other firm work, statements by various pre-qualified fund managers that they would withdraw if required to implement such walls, and lack of necessity since PPIF managers would, according to Treasury, not have material non-public information from Treasury. These and other factors are, in Treasury’s view, sufficient to mitigate the potential harm.\textsuperscript{124} The SIGTARP believes such walls are nonetheless necessary to protect against improper transfer of information within firms.

Other issues that still concern the SIGTARP include the SIGTARP’s requests that Treasury: (1) provide regular disclosures to the SIGTARP (which may be then disclosed to the public) of

\textsuperscript{121} As the American Bankers Association explained in a letter sent to the House of Representatives opposing additional restrictions on executive compensation for CPP recipients because of the impact of uncertainty on business operations, “the risk of unilateral changing of the rules at any time . . . is extremely disruptive to sound business planning.” Memorandum from Floyd Stoner, American Bankers Association to Members of the House of Representatives (March 30, 2009) (online at www.aba.com/NR/rdonlyres/76DCD307-2D7E-48A6-A10F-623175F0AED/59034/ExecComp_ABAHouseLetter_033009.pdf).


\textsuperscript{123} Id.

\textsuperscript{124} Id. at 175–179.
PPIF trading activity;\textsuperscript{125} (2) implement a system of metrics by which to measure PPIF performance and that would provide a benchmark for determining whether the manager of an under-performing PPIF may be removed for cause;\textsuperscript{126} (3) require fund managers to disclose to Treasury information about holdings in eligible assets and in related assets or exposures to related liabilities;\textsuperscript{127} and (4) require the disclosure by the fund managers of beneficial ownership of the PPIFs.\textsuperscript{128}

Although on its way to becoming operational, the current PPIP represents a significantly scaled-down version of the $75–100 billion program originally outlined for the securities and loan programs combined. Instead, Treasury has announced that it will commit $30 billion to this program. Treasury has stated that the larger program is no longer needed because of improvements in the financial sector and in banks’ ability to raise capital, but that the program could be expanded later if necessary.\textsuperscript{129}

At present, only one of the two sub-programs—the legacy securities program—is on the path to becoming fully operational. On July 8, 2009, Treasury announced that it had pre-qualified nine fund managers.\textsuperscript{130} When the Program was announced in late March, Treasury stated that it expected to pre-qualify at least five fund managers, but that it would select more if the pool of applicants proved to be sufficiently strong.\textsuperscript{131} The fact that almost twice the planned number of fund managers was selected is encouraging as it reflects both the level of interest among serious contenders and the quality of the applicants. Furthermore, a larger number of fund managers means a larger number of buyers competing in the marketplace for the same legacy assets, which, as discussed above, should have a positive impact on the market’s ability to assign value to the assets. As of the date of this report, the selected firms have until early October to raise $500 million in capital. Treasury expects that some of the firms will have done so, and that the first legacy securities transactions will close in August.

The legacy loan program, however, has been postponed. On June 3, 2009, the FDIC announced that it would postpone the loan program until further notice. A press release from the FDIC stated that “development of the Legacy Loans Program (LLP) will continue, but that a previously planned pilot sale of assets by open banks will be postponed.”\textsuperscript{132} The press release continued, quoting FDIC chairman Sheila Bair as saying that “[b]anks have been able to raise capital without having to sell bad assets through the LLP, which reflects renewed investor confidence in our banking sys-

\textsuperscript{125} Id. at 179.
\textsuperscript{126} Id. at 182.
\textsuperscript{127} Id. at 182–183.
\textsuperscript{128} Id. at 183.
\textsuperscript{130} The nine firms selected are: BlackRock Inc., Invesco Ltd., Alliance Bernstein LP, Marathon Asset Management, Oaktree Capital Management, RLJ Western Asset Management, the TCW Group Inc., Wellington Management Co., and a partnership between Angelo, Gordon & Co. LP, and GE Capital Real Estate. Id.
\textsuperscript{131} PPIP March Release, supra note 106.
Instead, the FDIC plans to “test the funding mechanism contemplated by the LLP in a sale of receivership assets this summer.” On July 31, the FDIC indicated that it “would continue to develop this program by testing the LLP’s funding mechanism through the sale of receivership assets,” and that this step will allow the FDIC to be ready to offer the LLP to open banks “as needed.”

While the current strategy for the legacy securities program may be appropriate, the delay in the legacy loan program may be problematic. As indicated above, many smaller and community banks continue to hold whole loans. As the effects of the economic downturn have rippled through every layer of the nation’s financial system, unemployment continues to climb and smaller businesses to falter, these local banks have faced ever increasing default levels. Unlike large banks that can sustain a certain number of defaults, even of large commercial loans, smaller banks may have far more difficulty in absorbing more than a few large loan losses. The FDIC’s statement that “[b]anks have been able to raise capital without having to sell bad assets through the LLP” may not reflect the reality for these banks.

Moreover, the FDIC pilot program may not provide a complete picture of the issues that will be encountered in extending the legacy loan program to solvent banks. Under that program, as indicated above, a bank may not want to sell. But the FDIC does have an incentive to sell because it wishes to dispose of assets obtained in its receivership capacity. It may be willing to sell assets at a lower price than an operating bank, for the reasons discussed above. And an auction that sets a low price under these circumstances may trigger the sort of downward cycle that is the opposite of the PPIP’s objective.

In the end, it may be best to evaluate the PPIP not in terms of the number of assets its partnerships purchase, but in terms of whether the program actually creates price discovery for assets where currently no transactions are occurring and that transactions then occur without federal support. Treasury believes that the programs can push the markets in that direction and that this push would make the PPIP a success. At the end of the day, banks may or may not be pleased by a return to market pricing for assets for which there were previously no transactions, but the problem of troubled assets cannot be resolved until such pricing returns. A key question is whether the PPIP is properly designed and/or robust enough to produce that result.

Either way, one barrier to the success of the PPIP is a simple lack of information. There remains only fragmentary knowledge about the size of the supply pool for legacy securities because there is little or no transparency in the troubled asset markets. The published stress test results gave no information about the total holdings of potentially troubled assets on the books of the banks tested. But markets need information to retain liquidity and function efficiently.

133 Id.
134 Legacy Asset Program Statement, supra note 129.
136 Why Toxic Assets Are So Hard to Clean Up, supra note 23.
The question is whether steps could be taken to increase the level of information about troubled assets on bank balance sheets, to facilitate the success of the legacy loan and securities programs, without creating a risk of market instability. Treasury and relevant government agencies should work together to move financial institutions toward sufficient disclosure of the terms and volume of troubled assets on banks’ books so that markets can function more effectively. For example, the agencies could explore a uniform definition of troubled securities and uniform rules for balance sheet presentation, as a means to creating a database of the available information.\textsuperscript{137} This approach would not encompass the universe of legacy securities, many of which are held by non-banks, but it could assist the legacy loans program more successfully because that program only applies to the purchase of loans from banks.

\begin{itemize}
\item[b. The Stress Tests] One of Treasury’s strategies for addressing the impact of troubled assets on BHCs’ balance sheet was stress tests.\textsuperscript{138} The stress tests estimated the losses that the 19 largest BHCs would suffer through the end of 2010, based on specified economic assumptions, resulting from debtors defaulting on the loans made by those BHCs, decreases in value of the securities the BHCs held as investments (for the BHCs with the largest trading portfolios), and losses on the trading of securities.
\end{itemize}

The loss totals for the relevant classes of assets were:
\begin{itemize}
\item Mortgages (first & second lien, junior)—$185.5 billion;
\item Commercial & Industrial Loans (including real estate)—$113.1 billion;
\item Securities (AFS and HTM), Trading & Counterparty—$134.5 billion; and
\item Credit Card Loans & Other—$166.1 billion.
\end{itemize}

The tests then projected how much capital the BHCs would need in order to absorb those losses.

The stress tests were designed to extend the stabilization of the banking system through 2010 based on certain assumptions about the current value and likely losses of troubled assets.\textsuperscript{139} In their conception and execution, they indicate an evolution of Treasury’s original capital infusion strategy. Once again, Treasury and the supervisors stated that their purpose was to ensure that the tested banks have enough capital to balance the potential impact of any losses,\textsuperscript{140} including those derived from existing troubled assets and attempts to work out the problem by the banks involved; for that reason 10 of the tested banks had to increase their capital base to have enough capital on hand. The process required that banks attempt to increase their capital with privately-raised equity or debt, rather than with additional funds supplied by the taxpayers. Taxpayer funds could only be obtained if private funding was unavail-
able, at the cost of issuance of additional stock (potentially common stock) to Treasury.

It is also significant that the stress tests are “forward-looking,” as the banking supervisors have emphasized. Rather than waiting to respond to events, the supervisors have used the tests to require capital buffers to be built in advance of any problem, based on projections about the economy and its impact on bank operating results. Finally, the forward-looking nature of the stress tests can have a corollary impact on the troubled assets problem. It may provide a breathing period that allows the tested banks to dispose of their troubled assets in an orderly way, without imposing extreme effects on their operating results in any one period.141

At the same time, the protection the stress tests provide for banks may not extend past 2010; the Federal Reserve Board has said that reduction of capital to normal levels after 2010 is permitted. “[i]f the economy recovers more quickly than specified in the more adverse scenario, firms could find their capital buffers at the end of 2010 more than sufficient to support their critical intermediation role and could take actions to reverse their capital build-up.”142 The supervisors should be careful to assure that the timing of any such reduction does not leave bank balance sheets exposed to a sudden economic turnout.

An additional caution is that the stress tests only apply to the nation’s 19 largest institutions. Smaller banks are not subject to the same degree of protection. Attempting to ameliorate that difference is discussed below.

Finally, it should be noted that the stress test process was built on existing regulatory and accounting requirements and did not introduce new measures of risk or change the way banks’ risk was measured. The tests were affected only to a limited extent by new accounting rules. Recent accounting guidance that allows more flexibility in calculating the value of securities portfolios was not taken into account in estimating losses. On the other hand, accounting rules not yet in effect that will require off-balance sheet assets (such as special-purpose vehicles formed to securitize banks’ assets) to be brought onto banks’ balance sheets were treated as already in effect, resulting in a more conservative calculation.

c. Conditions for Exit from the TARP

When Treasury and the bank regulators allow an institution to repay its TARP assistance, they have made a judgment that it no longer requires the boost to its balance sheet that the initial assistance provided at the deepest part of the financial crisis. An implicit conclusion is that the risk of troubled assets on a particular institu-

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141 At the same time, the stress tests applied only to the nation’s 19 largest BHCs.
142 SCAP Design Report, supra note 26, at 5. In its paper discussing the results of the stress tests, the Board stated that: “Specifically, the stress test capital buffer for each BHC is sized to achieve a Tier 1 risk based ratio of at least 6 percent and a Tier 1 Common capital ratio of at least 4 percent at the end of 2010 under the more adverse macroeconomic scenario. By focusing on Tier 1 Common capital as well as Tier 1 capital, the stress tests emphasized both the amount of a BHC’s capital and the composition of its capital structure. Once the stress test upfront buffer is established, the normal supervisory process will continue to be used to determine whether a bank’s current capital ratios are consistent with regulatory guidance.” Board of Governors of the Federal Reserve System, The Supervisory Capital Assessment Program: Overview of Results, at 14 (May 7, 2009) (online at www.federalreserve.gov/newsevents/press/bcreg/bcreg20090507a1.pdf) (hereinafter “SCAP Results”).
tion’s balance sheet is not more than its own capital base can support.

The terms for approval of repayment require this conclusion:

[Bank] supervisors will weigh an institution’s desire to repay its TARP assistance against the contribution of that assistance to the institution’s overall soundness, capital adequacy and ability to lend.\textsuperscript{143} BHCs must also have a comprehensive internal capital assessment process.\textsuperscript{144} In addition, prior to repayment, the eighteen stress-tested BHCs that received TARP funds must have a post-repayment capital base consistent with the stress test capital buffer, and must demonstrate their financial strength by issuing senior unsecured debt for terms greater than five years, not backed by FDIC guarantees, and in amounts sufficient to demonstrate a capacity to meet funding needs independently.\textsuperscript{145}

This statement indicates that the supervisors see the stress tests and the repayment of assistance as working together to protect bank balance sheets. But supervisory flexibility underlies the stress test’s assumptions. The supervisors’ administration of these conditions should take account of the possibility of greater losses on those assets than are anticipated by the stress tests and the current value at which those assets are carried on the balance sheets of the banks they supervise.

d. Economic Improvement

In the end, as Treasury has recognized, nothing will help control the risks of troubled assets as much as economic improvement, and nothing will increase those risks as much as deterioration in economic conditions. A consequence of a more robust economy should be an increase in property values, stabilization and then steady decrease in unemployment, and a slowing of mortgage defaults. But whether deteriorating conditions will worsen the problem of troubled assets depends on the extent to which those assets have been already written-down on balance sheets. As the report indicates, it is likely that some write-downs in the value of complex securities have occurred, although the write-down rate for whole loans may be less. Thus management of the economy goes hand-in-hand with specific supervisory measures to limit the damage troubled assets can cause.

e. Treasury Strategy: A Summary

Treasury has built a set of interlocking measures to deal with troubled assets. It hopes to build capital protections going out 18 months through the stress tests, require supervisory approval before banks can pay back their TARP assistance, and use the PPIP to get the market for troubled assets going again.


\textsuperscript{144}Id.

\textsuperscript{145}Id.
All of these steps reflect a desire to resolve the troubled assets problem and return to a strengthened financial sector, subject to careful supervision and retention of the capacity to intervene again if conditions worsen. The steps indicate that Treasury, the supervisors, and, hopefully, the banks themselves, have learned from the crisis, but the success of those steps also depends on the degree to which that education has taken place. The question remains whether Treasury’s assumptions are correct, and whether the protections they have built into the system are sufficient.

E. Commercial Real Estate

The future of commercial real estate values may prove to be an important factor for the maintenance of stability in the banking sector. Like residential property, commercial property is held both in the form of complex securities and whole loans, and a similar crisis in that sector could trigger losses of its own. Before turning to a discussion of the future of the toxic assets problem, the report briefly reviews the state of the market for commercial real estate.

1. COMMERCIAL MORTGAGE-BACKED SECURITIES

Bank troubles with CMBS are two-pronged: defaults are rising, suggesting eventual write-downs of ownership stakes, and the new issuance market remains nearly completely silent. By one estimate, CMBS trusts hold 45 percent of outstanding U.S. commercial mortgages. The CMBS market has been virtually frozen since the spring of 2008. (No CMBS were issued from January 2009 through May 2009.) During its last active period, the spring of 2008, banks were estimated to hold an estimated 23 percent portion of total CMBS investments. These CMBS investors are now holding asset pools with a delinquent unpaid balance of $28.85 billion, an alarming 585 percent increase over the June 2008 delinquent unpaid balance of $4.18 billion. In line with this sharp jump, CMBS pools held as collateral 54 percent of all commercial loans that moved from delinquency to outright default. The number of CMBS pool loans either 90 days delinquent or already foreclosed (thus in default or on the cusp of default) rose 32 percent from May to June and is up 411 percent versus June 2008.

Bank CMBS holdings represent nearly a quarter of an increasingly troubled overall CMBS market whose now diminished value

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146 The stress tests indicate potential losses for commercial real estate loans for the 19 stress-tested institutions of $53.0 billion through 2010. SCAP Results, supra note 142.


148 Id. at Exhibit 1, CMBS Issuance by Month: 2006–2009.


152 Realpoint Report, supra note 150, at 1.
is still nevertheless a substantial $750 billion. Banks do generally report their CMBS holdings on quarterly filings. But, as with other possibly troubled assets, it is an open question as to when or if a bank chooses to write off a troubled asset, whether commercial or otherwise. Regardless of whether this write-off occurs, though, testimony at the Panel's hearing in New York on commercial real estate suggests continued losses in commercial real estate (CRE) asset value over the next several years as the pools containing the most troubled loan vintages face high rates of term default.

2. WHOLE LOANS

While CMBS problems are undoubtedly a concern, the Panel finds even more noteworthy the rising problems with whole commercial real estate loans held on bank balance sheets. These bank loans tend to offer a riskier profile as compared to CMBS, suggesting high term default rates while the economy remains weak. Another worrying and salient feature of these loans is that they are held in a higher proportion by super-regional, regional and smaller banks as opposed to larger money center banks. In a recent speech, Janet L. Yellen, the President of the San Francisco Federal Reserve Bank stated that “[t]o date, the community banks under greatest financial stress are those with high real estate concentrations in construction and land development lending.” Under its worst case scenario, the Panel's model of whole loan losses estimates potential core CRE and construction loan losses through 2010 of $81.1 billion at 701 banks with assets between $600 million and $80 billion.

Term defaults of these bank loans present a near term problem. But another obstacle looms if a loan is able to escape term default and reach maturity. The Panel, informed by the testimony of a prominent CRE market analyst, took note of this issue in its June Report:

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153 CMSA Statistics Compendium, supra note 147, at 14, Exhibit 11: CMBS Breakdowns by Deal and Property Type.


155 A recent report notes that “[l]enders have been slow to foreclose on assets and the phrase “pretend & extend” has recently entered the vernacular.” Real Capital Report, supra note 151, at 15. The Panel heard testimony in May indicating that not all future CRE losses of this sort were taken into account by the bank supervisors’ stress tests, to the extent such losses might occur in 2011 or later. See Congressional Oversight Panel, Transcript of COP Field Hearing in New York City on Corporate and Commercial Real Estate Lending, at 57–58 (May 28, 2009).

156 See Part B(3) of Section One of this report for a discussion of whole loans as they relate to troubled assets generally.

157 Bank loans, especially those originated during the period from 2004–2007 when underwriting standards were most lacking, tended to be more heavily tilted toward much riskier construction and development loans as opposed to core commercial real estate loans. Parkus July Report, supra note 30.

158 Parkus July Report, supra note 30.


160 When potential multifamily residence loan losses are added to core CRE and construction loan losses, the estimate rises to $87.7 billion through 2010. See supra, section C(2) for a complete discussion of the Panel’s model methodology and results. See also Maurice Tamman and David Enrich, Local Banks Face Big Losses, Wall Street Journal (May 19, 2009) (online at online.wsj.com/article/SB124209114847632587.html) (presenting an analysis suggesting the possibility of $99.7 billion in CRE loan losses through 2010 at 900 small and midsize banks).
Poorly underwritten CRE loans made in the easy credit years (e.g., 2005–2007) will reach maturity and will in many instances fail to qualify for refinancing. As the [Deutsche Bank] report explains, the high percentage of loans not qualifying for refinancing, and hence in danger of default without significant injections of new equity, is attributable to the combined effects of stricter underwriting standards, steep declines in property values, and reduced income streams to finance the loans because of lower rents and increased vacancies. The findings are based on quantitative data for commercial mortgage-backed securities (CMBS), which constitute 25 percent of the core CRE market. While the authors of the report state that there was insufficient data to perform a detailed study in the larger non-CMBS sector, the authors say they expect a similar if not higher level of maturity defaults on non-securitized CRE bank portfolio loans because portfolio loans typically have shorter maturities (which would not allow sufficient time for property values to recover from their present depressed levels) and higher risk profiles than CMBS.161

If the heaviest losses were still solely on the horizon, it is possible that intervening actions might function to prevent the worst loss predictions. Banks might be able to restructure problem CRE loans with more success than they have found in the residential mortgage sector. Property values could stabilize, moderating the issue of negative equity. But what seems to have occurred between May and July 2009 is a growing recognition that loan losses are both occurring now in greater numbers even while maturity losses still loom in the future. Second quarter 2009 earnings releases already reflect mounting commercial property write-downs.162 This reflects the significant rise in term defaults occurring now; maturity defaults will enter the picture beginning in 2010 when the first wave of troubled bank loan vintages mature. Because the CMBS market remains substantially impaired,163 banks are also generally unable to distribute the risk of their current portfolios through packaged securities.164

The data above raise several concerns as to how the commercial property market will affect the larger issue of troubled assets. Troubled commercial real estate loans can themselves be considered a type of troubled asset. Significant write-downs of these loans may make it more difficult for banks to remain healthy without removing other troubled assets from their balance sheets. Most concerning is the speed with which the commercial market has dete-

161 Panel June Report, supra note 38; Parkus July Report, supra note 30.
163 Wharton School of the University of Pennsylvania, On Shaky Ground: Commercial Real Estate Faces Financial Tremors (July 22, 2009) (online at knowledge.wharton.upenn.edu/arti-
cle.cfm?articleid=2296).
164 The Federal Reserve’s Term Asset Lending Facility (TALF) is meant to address this issue and was recently opened up to both new CRE loans as well as existing CMBS. It is unclear as to whether TALF will be successful at unfreezing the CMBS market.
riorated in 2009. If consumer lending and residential mortgages also remain weak, banks may face additional losses in asset value. Both banks and regulators will be forced to face this issue in the larger context of addressing a solution for bank troubled assets.

F. The Future

The nation’s banks continue to hold on their books billions of dollars in assets about whose proper valuation there is a dispute and that are very difficult to sell without banks experiencing substantial write-downs that can trigger a return to financial instability. Whatever values are assigned to these troubled assets for accounting purposes, their actual value and their potential impact on the solvency of the banks that hold them are uncertain and will likely remain so for some time; the degree of uncertainty is difficult for anyone to estimate confidently. Treasury’s strategy works to control the impact of the uncertainty, and it has stabilized the financial situation effectively, but the impact of the strategy may be less strong if present conditions change.

There are a number of reasons that present conditions may worsen:

1. Unemployment continues to rise, and both government and private economists have noted that an improvement in employment may lag several years behind the return of economic growth generally, as is true in most recoveries and has been noted as a potential problem for this recovery.

2. Bank lending has not recovered.

3. Both large BHCs, somewhat smaller regional BHCs, and small banks are increasingly at risk from troubled whole loans, as discussed above.

4. The plunge in values that affected the residential real estate market may be moving to the commercial real estate market as properties come up for refinancing and that financing is unavaiable because of the drop in commercial and retail activity arising

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165 See, e.g., House Committee on Financial Services, Testimony of Chairman of the Board of Governors of the Federal Reserve System Ben Bernanke, Hearing on the Semi-Annual Report of the Federal Reserve on Monetary Policy, 111th Cong. (July 21, 2009) (“Even though—if the economy begins to turn up in terms of production, unemployment is going to stay high for quite a while. And so, it’s not going to feel like a really strong economy.”); Phil Izzo, Few Economists Favor More Stimulus (July 10, 2009) (online at online.wsj.com/article/SB124708099206913393.html) (“‘The mother of all jobless recoveries is coming down the pike,’ said Allen Sinai of Decision Economics.”). See Allison Testimony, supra note 37, at 15:20–23 (“Our financial system and our economy remain vulnerable, with unemployment still rising, house prices falling, and pressure on commercial real estate continuing to build.”).

from the economic downturn. Like residential property, commercial property is held both in the form of complex securities and whole loans, and a similar sell-off in that sector could trigger losses of its own and a more general renewed pressure on bank balance sheets that would again call into question the true value of residential mortgage loans.

5. To the extent banks have not written-down troubled assets, they are in effect continuing to invest in those assets by holding them for a future return. That is not an unreasonable strategy in itself. But it only postpones the day of reckoning if it turns out that, rather than appreciating, the assets depreciate.

As the report has discussed, Treasury’s strategy has stabilized the system. There are several additional measures that Treasury should consider to supplement that strategy in certain circumstances.

Continued Stress-Testing. First, as the Panel recommended in June and Assistant Treasury Secretary Allison agreed, the Federal Reserve Board should repeat the stress tests, looking forward two years, if economic conditions worsen to the point that they exceed the adverse economic scenario used in the tests. In addition, stress-testing should be a regular feature of the 19 BHCs’ examination cycles so long as an appreciable amount of troubled assets remain on their books, economic conditions do not substantially improve, or both.

It is important to recognize that only the nation’s 19 largest institutions have been stress-tested. There are approximately 7,900 other banks, some large national institutions, some smaller regional institutions, and many small and community banks, and more than 350 of those banks also received capital infusions under the TARP. More important, many of the smaller institutions may be especially at risk if the economy does not improve.

Resource considerations would likely bar stress-testing for these institutions in the same manner as the prior tests. But it may be that sample testing, rules for self-testing, or general templates could provide a reasonable approximation of the direction given to the large banks by the stress tests, and perhaps lead to a general formula for determining whether additional capital buffers were required.

Continued Monitoring. Supervisors are already monitoring potential problem banks at an increasing rate. For example, the Federal Reserve Board, Office of the Comptroller of the Currency, and FDIC are issuing supervisory memoranda (requiring capital or similar actions by particular banks), at a rate that would exceed...
the rate for 2008 by about 50 percent. The review of conditions for repayment of TARP assistance also represent a careful type of monitoring, in line with the objectives of the stress tests.

An important part of the necessary monitoring, as the supervisors have recognized, will involve a review of the way banks themselves model the risk from the assets they hold, as part of their balance sheet and reporting determinations. Especially after hundreds of billions of dollars of TARP assistance, the banks themselves must assume a heavy responsibility for better risk management and capital protection.

**A Balance Between Credit and Protection.** One of the most serious consequences of the crisis was the bank pull-back from lending as capital was devoted to strengthening balance sheets. It is important that capital is raised to levels at which the two objectives do not compete; otherwise, the economic recovery—and with it the slow resolution of the problem of troubled assets will be stopped, if not reversed.

**Careful Calibration of the Legacy Loans and Legacy Securities Programs.** PPIP should be monitored closely to determine whether it is fulfilling its purpose. Even given its use to restart the markets rather than to take large numbers of troubled assets off bank balance sheets, Treasury should consider whether the PPIP legacy securities program should be expanded if the markets would appear to benefit from additional “pump-priming.” If the program is not working, Treasury should consider adopting a different strategy to remove the troubled assets from banks’ books.

The future of the legacy loans program is more important. Given the growing problem of whole loan defaults and the way in which those defaults affect smaller banks that were not stress tested, it is difficult to understand why the same approach should not be applied to whole loans as is to be applied to legacy securities. As the only initiative designed specifically to reopen the market for troubled whole loans, failure to start the legacy loan program raises concerns about whether Treasury has a workable strategy to deal with banks’ troubled loans.

**Increased Disclosure.** In order to advance a full recovery in the economy, there must be greater transparency, accountability, and clarity, from both the government and banks, about the scope of the troubled asset problem. Treasury and relevant government agencies should work together to move financial institutions toward sufficient disclosure of the terms and volume of troubled assets on banks’ books so that markets can function more effectively.

The events of September 2008 and the course of previous financial crises are a reminder that, despite all of these steps, the risks exist that current strategies will not suffice. If that were so, re-
course to additional capital infusions could again arguably be the best way to stabilize the system (assuming of course that any infusions were backed by adequate protections for the taxpayers). But unless Congress extends the authority of Treasury to enter into new TARP commitments, more capital infusions may not be possible because Treasury’s ability to make such commitments expires no later than October 2010.173

In that circumstance, a great share of the burden may fall on the FDIC. During the early days of the crisis, the FDIC sold either the assets it assumed in resolving a bank failure or the failed institution itself in transactions that cost the insurance fund billions of dollars. The FDIC lost $10.7 billion in resolving the failure of IndyMac174 and $4.9 billion in resolving the failure of Bank United.175 It could do so again, but such losses could be on an even greater scale, and they would mean that the FDIC and ultimately the taxpayer absorb the asset pricing uncertainties that have infected the system all along.

If no additional TARP funding were available, the government might consider the costs and benefits of using an RTC-like strategy to purchase for eventual resale potentially troubled assets from open banks meeting certain capital standards, in order to maintain the health of those banks. Such an approach would require careful structuring, and it would, again, shift, but not eliminate the problems of value and pricing of the purchased assets. It would also entail substantial funding both to purchase the assets and to pay for operating costs, including the hiring of experienced personnel to manage the loan purchase and resale program. The funding might be provided by the issuance of bonds by the entity (as was the case with the RTC). The Panel is not recommending this alternative, merely suggesting its consideration by policy-makers.

G. CONCLUSION

Troubled assets were at the heart of the crisis that gathered steam during the last several years and erupted in 2008. The stabilization of the financial system is a significant achievement, but it does not mark an end to the crisis. One continuing uncertainty is whether the troubled assets that remain on bank balance sheets can again become the trigger for instability.

It is impossible to resolve the argument about whether banks are or are not solvent because of the uncertain value of their loans. The importance of that question will be reduced substantially if the economy improves and unemployment drops. However, the acid test will come if unemployment remains high and residential and commercial mortgage defaults increase. Moreover, such instability may not emerge until the full extent of any coming crisis in commercial mortgages is fully felt or banks can evaluate the experience of loans that come due after the 2009–10 stress test period.

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173 EESA 120(b).
Treasury has adopted a strategy that it hopes will strengthen at least the nation’s largest banks to withstand a return instability. Several supplemental steps may help reduce the risks that this could occur:

1. As recommended by the Panel in June, supervisors should repeat the stress tests if economic conditions worsen beyond the adverse economic scenario originally used.

2. Treasury must assure robust legacy securities and legacy loan programs or consider a different strategy to do whatever can be done to restart the market for those assets.

3. Treasury and relevant government agencies should work together to move financial institutions toward sufficient disclosure of the terms and volume of troubled assets on banks’ books so that markets can function more effectively.

4. Treasury must be prepared to turn its attention to small banks in crafting solutions to the growing problem of troubled whole loans. Those banks face special risks with respect to problems in the commercial real estate loan sector. As one example, the methodology and capital buffering involved in the stress tests could be extended to the nation’s smaller banks on a forward-looking basis.

Ultimately, everything depends on the care and responsibility exercised by both banks and supervisors in carefully controlling risk and watching for signs of trouble. There is no substitute for acting in advance of a crisis, especially now that some of the signals of potential concern should be clear.

The problem of troubled assets was long in the making, and it would be foolish to think that it could be resolved overnight, or that doing so would not involve balancing equally legitimate considerations affecting the banking industry and the public interest. But it would be equally foolish to think that the risk of troubled assets has been mitigated or that it does not remain the most serious risk to the American financial system.
ANNEX TO SECTION ONE: ESTIMATING THE AMOUNT OF TROUBLED ASSETS—ADDITIONAL INFORMATION AND METHODOLOGY

A. Caveats in Assessing the Amount of Troubled Assets

1. FINDING TROUBLED SECURITIES IN FINANCIAL STATEMENTS

In its search for the value of U.S. bank held troubled assets, the Panel found that the information required in regulatory filings is insufficient for fully assessing the value of troubled assets. The two main issues the Panel had to navigate were the lack of uniformity and the lack of granularity in the public statements of these institutions.

The lack of uniformity in financial reporting precludes almost any attempt to aggregate data across institutions. While some institutions provide very detailed statements, which break down asset items to reasonable levels of classification, other institutions provide almost no detailed data at all, leaving the reader to guess at line items that incorporate a number of sometimes very dissimilar items. As a result of these classification differences, when aggregating, the Panel was forced to use only the least detailed company's categories, thus rendering an enormous amount of information unusable.

Even the formatting of the financial statements is entirely different across banks. As a result of these classification differences, even finding the line item in each statement is a difficult task, requiring a long search through reports which can be over 300 pages.

Because of the change in accounting rules brought about by FAS 157–4, assets which were formerly held in the trading account, and thus marked-to-market, can be transferred out, labeled as held-to-maturity, and marked-to-model.176 As a result of differing policies regarding early adoption of FAS 157–4, the statements for individual companies use a different methodology from the fourth quarter of 2008 to the first quarter of 2009, making comparisons problematic from one quarter to the next.

The lack of granularity means that even at the most detailed level presented, the information provided is not rich enough to determine the amount of troubled assets. For example, Citigroup, in which the government has a very large equity stake (34 percent), prepares extraordinarily comprehensive financial statements, showing a great deal of information at very detailed levels.177 However, even Citigroup, in the 10–Q from the first quarter of 2009, presents only a blanket number of $49.9 billion in Level 3 derivatives.178 Obviously derivatives come in many shapes and sizes, but Citigroup provides no information on the nature of this nearly $50

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176 Financial Accounting Standards Board, Determining Fair Value When the Volume and Level of Activity for the Assets or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (Apr. 9, 2009) (FSP FAS 157–4).
billion line item.\textsuperscript{179} Furthermore, it is unclear how much of this Level 3 exposure is netted out.\textsuperscript{180} As Citigroup aggregates amounts, almost $1 trillion was netted out of derivatives Levels 1 through 3.\textsuperscript{181} This means that Citigroup could have anywhere from $0 to $50 billion dollars in Level 3 derivatives exposure.\textsuperscript{182}

In addition, it is common knowledge among market participants that loans that originated in 2006 and 2007 were created under relatively lenient lending practices, meaning that many of the loans from this period, and the securities based on them, are more likely to default.\textsuperscript{183} It would therefore be useful for the BHCs to break out their loan and MBS numbers by vintage, allowing investors to judge for themselves how much they trust the securities’ ratings.

In the search for troubled assets, failure to identify these items causes troubled and non-troubled assets to be placed on the same line, making it impossible to differentiate the two types of assets.

Finally, and most importantly, each bank uses a different, undisclosed method to calculate the value of the items in their financial statements; all of these models however must conform to GAAP and their results must be reviewed by the banks independent public accounting firm. Still, because troubled assets are, by their nature, Level 3, and therefore marked-to-model, it is impossible with reasonable confidence to compare the values of troubled assets across banks. For example, Bank of America might hold a set of derivatives that it values at $100 billion under its valuation model, but that Citigroup, if it held those same derivatives, may value them at $50 billion under its valuation model. The differences in modeling techniques of different banks, combined with the fundamentally difficult issues in modeling these securities, even assuming access to the relevant data, makes it impossible to fully assess the value of troubled assets based on the public disclosures of the banks.

2. DIFFICULTIES IN MODELING TROUBLED SECURITIES AND CREDIT DEFAULT SWAPS\textsuperscript{184}

There are a number of different types of troubled assets, each with its own degree of modeling difficulty. The simplest is a loan. The relative ease in modeling whole loans reflects the fact that their payouts, and hence their value, are only based on one security, the loan itself. Mortgage backed securities (MBS), on the other hand, group together larger numbers of loans whose future values were deemed to depend on one another only to a small degree.
Banks pooled many whole loans into an SPV, and then defined a set of rules governing tranches which they issued. The set of rules was structured so that the vast majority of the purchased tranches would be investment grade, and all of the risk would be associated with the subordinate tranches. Thus, for a large group of randomly collected loans, it seemed exceedingly unlikely that a large percentage of them would default. The pricing, and rating, of these securities required assumptions about the default correlations between each of the mortgages in the pool. With pools containing thousands of whole loans, such an assessment is nearly impossible.

Estimates of correlation have an enormous effect on the rating, and thus the estimated likelihood of default of a complex security. A correlation of 1.0 would imply that all of the securities would fail at once, meaning that the entire pool retained the default probabilities of the loans of which it was composed. If, on the other hand, the correlation was 0, then the failure of one loan would be independent of the failure of another loan, making the probability that the entire pool would default the product of the default probabilities from each individual loan. These two results are clearly divergent, and a slight variation in the estimated correlation can have a large effect on the credit rating, and therefore the value of a loan. One of the main reasons that these securities are now troubled is that the banks and rating agencies under-estimated the relative effect of a systemic shock. In other words, in a recession, mortgage default rates rise, causing many loans to default at the same time that would otherwise not do so. As a result, the diversification which the banks had relied on to strengthen the credit of their MBSs disappeared, vastly lowering the credit rating, and thus the value of these securities.

The issue of measuring correlations within a mortgage pool grows more complicated when we consider CDOs, which packed many MBS together from different mortgage pools. In this case, the payouts can be tied to so many whole loans at their base that it is impossible to model the correlations between all of these loans, or even to figure out which loans are backing the payments. The more complicated the structures became the more difficult it became to model the correlations. At this point it becomes nearly impossible to sort through all of the securities that a tranche is dependent upon, or the correlation between all of the securities.

Credit Default Swaps (CDS) can be purchased on many different debt securities, from residential real estate loans to bonds. Essentially, the value of a credit default swap is based on two main features of a debt product, its default and recovery rates. Thus, the value of a credit default swap is the difference between the payments made by the buyer and the expected payout of the seller. The default rate determines how likely it is that the seller will be forced to pay, and the recovery rate determines how much. CDSs are more difficult to value than loans, because inherently their values are based off the prediction of low-probability large payouts, much like other forms of insurance. This is further complicated by

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185 CDS can be sold on any debt based product, such as CDOs or CLOs. Whereas the inherent structure of the CDO or CLO complicates the modeling of these instruments, it is the inherent properties of the underlying that present issues when valuing CDS securities. The structure of the CDS is in most cases very simple.
the fact that a CDS is based solely on the two most difficult pieces of a debt product to predict, its default and recovery rates.

To summarize, modeling the performance of complex securities, based on the performance of thousands of loans, is like trying to model large chunks of the mortgage market, and then trace all of the payments from individual loans through layers of rules governing payouts, until you reach the top. Further, this task is made less possible by the amplification of the issues with modeling the securities at the lower levels. For example, the difficulties in modeling the default rate for a loan are multiplied over the enormous number of loans that feed into the more complex securities. Thus it seems that the only products on which an outside observer can attempt to make a good faith valuation are whole loans, a fact confirmed to the Panel by more than a dozen academics.

**B. Troubled Assets from Financial Statements**

Although somewhat limited, meaningful estimates can still be derived from public documents to help inform the scope of troubled assets. Figure 10 below highlights Level 3 assets for the stress-tested BHCs as of December 31, 2009 which includes assets that are difficult to find reliable external indicators of value. This illustrates the dollar amount of Level 3 assets as a percentage of total assets.

![Figure 10: Level 3 Asset Exposures](chart.png)

<table>
<thead>
<tr>
<th>Institution</th>
<th>MBS</th>
<th>ABS</th>
<th>Loans</th>
<th>Mortg. Serv.</th>
<th>Other Assets</th>
<th>Deriv.</th>
<th>AFS Sec.</th>
<th>Corp. Debt</th>
<th>Other Sec.</th>
<th>Total</th>
<th>% of Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of America</td>
<td>$7.3</td>
<td></td>
<td>$5.4</td>
<td>$12.7</td>
<td>$3.6</td>
<td>$8.3</td>
<td>$18.7</td>
<td></td>
<td></td>
<td>$56.0</td>
<td>3%</td>
</tr>
<tr>
<td>Bank of New York-Mellon</td>
<td>$0.004</td>
<td></td>
<td>$0.0</td>
<td>$0.4</td>
<td></td>
<td>$0.2</td>
<td>$0.08</td>
<td>$0.4</td>
<td></td>
<td>$0.7</td>
<td>0%</td>
</tr>
<tr>
<td>Capital One Financial</td>
<td></td>
<td>$0.2</td>
<td>$1.5</td>
<td>$0.06</td>
<td>$2.4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$4.2</td>
<td>3%</td>
</tr>
<tr>
<td>Citigroup</td>
<td>$50.8</td>
<td></td>
<td>$0.2</td>
<td>$5.7</td>
<td>$0.4</td>
<td>$60.7</td>
<td>$283.3</td>
<td></td>
<td></td>
<td>$146.0</td>
<td>8%</td>
</tr>
<tr>
<td>Fifth Third Bank</td>
<td></td>
<td>$0.007</td>
<td></td>
<td>$0.03</td>
<td></td>
<td>$0.1</td>
<td>$0.0</td>
<td>$0.2</td>
<td></td>
<td>$0.2</td>
<td>0%</td>
</tr>
<tr>
<td>GMAC</td>
<td>$1.5</td>
<td></td>
<td>$1.9</td>
<td>$2.8</td>
<td>$0.04</td>
<td>$0.1</td>
<td></td>
<td>$7.2</td>
<td></td>
<td>$7.2</td>
<td>4%</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>$15.5</td>
<td></td>
<td>$12.0</td>
<td>$8.5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$59.6</td>
<td>7%</td>
</tr>
<tr>
<td>JPMorgan Chase</td>
<td>$12.9</td>
<td></td>
<td>$19.8</td>
<td>$9.4</td>
<td>$11.4</td>
<td>$31.8</td>
<td>$12.4</td>
<td>$6.5</td>
<td>$4.9</td>
<td>$109.0</td>
<td>5%</td>
</tr>
<tr>
<td>KeyCorp</td>
<td></td>
<td>$1.1</td>
<td></td>
<td>$0.0</td>
<td></td>
<td></td>
<td></td>
<td>$0.9</td>
<td>$2.0</td>
<td>$2.9</td>
<td>2%</td>
</tr>
<tr>
<td>MetLife</td>
<td>$0.9</td>
<td>$2.5</td>
<td>$0.2</td>
<td>$3.0</td>
<td></td>
<td></td>
<td></td>
<td>$13.4</td>
<td>$2.0</td>
<td>$15.4</td>
<td>4%</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td></td>
<td></td>
<td></td>
<td>$40.9</td>
<td>$34.5</td>
<td>$1.1</td>
<td></td>
<td>$85.9</td>
<td></td>
<td>$85.9</td>
<td>13%</td>
</tr>
<tr>
<td>PNC Financial</td>
<td>$1.4</td>
<td></td>
<td>$0.7</td>
<td>$0.1</td>
<td>$4.8</td>
<td></td>
<td></td>
<td>$7.0</td>
<td></td>
<td>$7.0</td>
<td>2%</td>
</tr>
<tr>
<td>Regions Financial</td>
<td></td>
<td>$0.1</td>
<td></td>
<td>$0.1</td>
<td></td>
<td></td>
<td></td>
<td>$0.4</td>
<td>$0.5</td>
<td>$0.9</td>
<td>0%</td>
</tr>
<tr>
<td>State Street</td>
<td></td>
<td>$0.8</td>
<td></td>
<td>$0.8</td>
<td></td>
<td></td>
<td></td>
<td>$2.0</td>
<td>$9.2</td>
<td>$11.2</td>
<td>5%</td>
</tr>
<tr>
<td>SunTrust Banks</td>
<td>$1.4</td>
<td>$0.8</td>
<td>$1.2</td>
<td>$1.7</td>
<td></td>
<td></td>
<td></td>
<td>$3.6</td>
<td></td>
<td>$3.6</td>
<td>2%</td>
</tr>
<tr>
<td>U.S. Bancorp</td>
<td>$1.8</td>
<td></td>
<td>$1.2</td>
<td>$1.7</td>
<td></td>
<td></td>
<td></td>
<td>$4.8</td>
<td></td>
<td>$4.8</td>
<td>2%</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td></td>
<td>$4.7</td>
<td>$14.7</td>
<td>$2.0</td>
<td>$7.9</td>
<td>$22.7</td>
<td></td>
<td>$3.5</td>
<td>$55.5</td>
<td>$59.0</td>
<td>5%</td>
</tr>
</tbody>
</table>

Total                      |     |     |       |             |              |        |          |            |            | $575.1|                 |

The data used in creating this chart is derived from the quarterly and yearly SEC filings of the following companies from the period 12/31/08 to 3/31/09: Bank of America; Bank of New York Mellon; BB&T; Capital One Financial; Citigroup; Fifth Third Bank; GMAC; Goldman Sachs; J.P. Morgan Chase; KeyCorp; MetLife; Morgan Stanley; PNC Financial; Regions Financial; State Street; SunTrust Bank; U.S. Bancorp. Analysis does not include American Express (AXP) which did not include Level 3 Asset data in its SEC filings.

Figure 11 below illustrates the change in dollar amount of the loan losses (net charge-offs) and loan loss reserves for the stress-tested BHCs over an eighteen month period (January 1 2007—June 30 2009). This highlights the significant increase in loan losses recognized over this period for all the stress-tested banks.
The data used in creating this chart were derived from models prepared by the Panel staff in conjunction with information from the quarterly and yearly SEC filings, and company earnings reports of the following companies from the period 12/31/07 to 6/30/09: American Express, Bank of America, Bank of New York Mellon, BB&T, Capital One Financial, Citigroup, Fifth Third Bank, GMAC, Goldman Sachs, J.P. Morgan Chase, KeyCorp, MetLife Inc., Morgan Stanley, MUFG, PNC Financial Services, Regions, SunTrust Banks, U.S. Bancorp, and Wells Fargo. Analysis does not include GMAC which did not include loan losses and non-performing loans data in its SEC filings.

Figure 12 below illustrates the significant increase in non-performing loans as a percentage of total loans for the stress-tested BHCs over a one year period (June 30 2008—June 30 2009). This highlights the significant increase in non-performing loans on the banks' balance sheets over this period.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Q2 2009</th>
<th>Q2 2008</th>
<th>% of Total Loans Q2 2009</th>
<th>% of Total Loans Q2 2008</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of America</td>
<td>$29,181</td>
<td>$9,156</td>
<td>$942,248</td>
<td>$870,464</td>
<td>3.10</td>
</tr>
<tr>
<td>BB&amp;T</td>
<td>$2,091</td>
<td>$1,016</td>
<td>$100,334</td>
<td>$95,715</td>
<td>2.08</td>
</tr>
<tr>
<td>Capital One</td>
<td>$28,246</td>
<td>$11,626</td>
<td>$641,700</td>
<td>$746,800</td>
<td>4.40</td>
</tr>
<tr>
<td>Fifth Third</td>
<td>$2,587</td>
<td>$1,726</td>
<td>$83,537</td>
<td>$81,573</td>
<td>2.05</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>$14,785</td>
<td>$5,273</td>
<td>$680,601</td>
<td>$538,029</td>
<td>2.17</td>
</tr>
<tr>
<td>JPMorgan Chase</td>
<td>$2,587</td>
<td>$1,016</td>
<td>$100,334</td>
<td>$95,715</td>
<td>2.08</td>
</tr>
<tr>
<td>KeyCorp</td>
<td>$2,587</td>
<td>$1,016</td>
<td>$100,334</td>
<td>$95,715</td>
<td>2.08</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>$14,785</td>
<td>$5,273</td>
<td>$680,601</td>
<td>$538,029</td>
<td>2.17</td>
</tr>
<tr>
<td>PNC Financial Services</td>
<td>$4,032</td>
<td>$695</td>
<td>$168,888</td>
<td>$72,828</td>
<td>2.39</td>
</tr>
<tr>
<td>Regions</td>
<td>$2,618</td>
<td>$1,410</td>
<td>$96,149</td>
<td>$98,267</td>
<td>2.72</td>
</tr>
<tr>
<td>SunTrust Banks</td>
<td>$3,200</td>
<td>$2,091</td>
<td>$100,334</td>
<td>$95,715</td>
<td>2.08</td>
</tr>
<tr>
<td>U.S. Bancorp</td>
<td>$3,200</td>
<td>$2,091</td>
<td>$100,334</td>
<td>$95,715</td>
<td>2.08</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>$15,798</td>
<td>$4,073</td>
<td>$821,014</td>
<td>$599,237</td>
<td>1.92</td>
</tr>
</tbody>
</table>

* Data not available

* Data not available

The data used in creating this chart were derived from models prepared by the Panel staff in conjunction with information from the quarterly and yearly SEC filings, and company earnings reports of the following companies from the period 12/31/07 to 6/30/09: American Express, Bank of America, Bank of New York Mellon, BB&T, Capital One Financial, Citigroup, Fifth Third Bank, GMAC, Goldman Sachs, J.P. Morgan Chase, KeyCorp, Morgan Stanley, PNC Financial, Regions Financial, State Street, SunTrust Bank, U.S. Bancorp, and Wells Fargo.
Thus, by several different estimates from publicly available information, significant amounts of troubled assets appear to remain on banks’ balance sheets.

C. The Panel’s Model of Loan Losses and Capital Shortfalls

1. INTRODUCTION

The Panel’s quantitative efforts focused on modeling losses in whole loans, assets which represent over $5.9 trillion in the 719 banks modeled by the Panel. Such loans are the only troubled asset for which sufficient information is available to create a reasonable model with few assumptions that can be tested under a number of different scenarios.

2. METHODS

SNL Financial developed a model for assessing loan losses and capital requirements for banks that was modified by the Panel for scenario testing. The model tests all BHCs which have assets greater than $600 million, a group that includes the stress-tested and other large BHCs and medium to large regional BHCs, against more severe economic scenarios, similar to the Federal Reserve Board in its analysis. Loan losses are calculated as the product of the loan loss rate as dictated by the scenario, with the total loans of that type held by each BHC. This number is combined with an estimate of the company’s Pre-Provision Net Revenue (PPNR) for the next two years, a number which is calculated from the past two years, and the company’s loan loss reserves to yield the amount of capital necessary for the bank to be recapitalized after the losses sustained in the scenario.

The Panel used two methods to calculate loan losses: a standard and a customized. The standard method used the loan loss rates similar to the Federal Reserve Board in its analysis and uniformly applied them across all of the BHCs considered. The customized approach attempted to tailor these aggregate loan loss rates to individual banks, on the basis of their past performance. Thus for banks whose loans consistently outperformed the market, their loan loss rate was lowered, while BHCs that consistently held lower quality loans had their loan loss rates raised.

Two scenarios were analyzed by the Panel. In each scenario, the only modifications were in the loan loss expectations. The loan loss assumptions in the two scenarios were:

<table>
<thead>
<tr>
<th>FIGURE 13: ASSUMED LOAN LOSS RATES</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>First lien mortgages</td>
</tr>
<tr>
<td>Closed-end junior lien mortgages</td>
</tr>
</tbody>
</table>

---

189 Data from BHC Y–9Cs.
190 See Part E of this Annex to Section One for a detailed discussion of SNL’s methods.
191 Excluding 66 banks which did not supply enough information to calculate Tier 1 common capital for the period ending March 31, 2009.
192 This calculation would not have resulted in any net change in the aggregate loan loss numbers; however, the panel imposed a floor of 25% and a cap of 200% on these modifications.
To test the accuracy of its estimates, the Panel calibrated its model to the results of the stress tests. In doing so, it simply used the results as a base line and did not mean to accept or reject the assumptions made there. The median result reached by the Panel in calibrating its results was 2.5% higher than the stress tests, and was most likely the result of the portions of the stress tests that cannot be independently replicated.

### D. Results

The Panel’s analysis shows that although the stress-tested BHCs may be sufficiently capitalized to deal with losses in their whole loan portfolios, BHCs in the $600 million to $100 billion range will likely need to raise significantly more capital if they experience increased loan losses due to an economic downturn. As shown by the following graph, smaller banks have fewer reserves to absorb losses.

#### FIGURE 13: ASSUMED LOAN LOSS RATES—Continued

<table>
<thead>
<tr>
<th></th>
<th>Starting Point</th>
<th>Starting Point + 20%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(Percent)</td>
<td></td>
</tr>
<tr>
<td>Home equity lines of credit (HELOC)</td>
<td>11.0</td>
<td>13.2</td>
</tr>
<tr>
<td>Commercial &amp; industrial loans</td>
<td>8.0</td>
<td>9.6</td>
</tr>
<tr>
<td>Construction &amp; land development loans</td>
<td>18.0</td>
<td>21.6</td>
</tr>
<tr>
<td>Multifamily loans</td>
<td>11.0</td>
<td>13.2</td>
</tr>
<tr>
<td>Commercial real estate loans (nonfarm, nonresidential)</td>
<td>9.0</td>
<td>10.8</td>
</tr>
<tr>
<td>Credit card loans</td>
<td>20.0</td>
<td>24.0</td>
</tr>
<tr>
<td>Other consumer loans</td>
<td>12.0</td>
<td>14.4</td>
</tr>
<tr>
<td>Other loans</td>
<td>10.0</td>
<td>12.0</td>
</tr>
</tbody>
</table>

193 Loan loss rates were taken from the stress test’s “more adverse” scenario. Federal Reserve Board, The Supervisory Capital Assessment Program Overview of Result, at 5 (May 7, 2007) (online at www.federalreserve.gov/newsevents/press/bcreg/bcreg20090507a1.pdf).

194 Loan loss rates were calculated as 1.2 times the rates from the “starting point” scenario.

#### FIGURE 14: LOAN LOSSES PROJECTED FROM Q1 2009 INFORMATION

[Dollars in millions]

<table>
<thead>
<tr>
<th></th>
<th>Starting Point</th>
<th>Starting Point + 20%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Standard</td>
<td>Customized</td>
</tr>
<tr>
<td>Top 18 BHCs 196</td>
<td>486,458</td>
<td>504,083</td>
</tr>
<tr>
<td>All Banks with Assets $600M to $100B to</td>
<td>152,134</td>
<td>123,069</td>
</tr>
<tr>
<td>Total (All banks $600M+)</td>
<td>638,591</td>
<td>627,152</td>
</tr>
</tbody>
</table>

196 Stress tested BHCs excluding GMAC.

197 Excluding Keycorp, which is one of the 18 BHCs, but whose assets have fallen below $100B.

#### FIGURE 15: CAPITAL SHORTFALLS PROJECTED FROM Q1 2009 INFORMATION

[Dollars in billions]

<table>
<thead>
<tr>
<th></th>
<th>Starting Point</th>
<th>Starting Point + 20%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Standard</td>
<td>Customized</td>
</tr>
<tr>
<td>Top 18 BHC 198</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>All Banks with Assets $600M to $100B to</td>
<td>11.70</td>
<td>13.99</td>
</tr>
<tr>
<td>Total (All banks $600M+)</td>
<td>11.70</td>
<td>13.99</td>
</tr>
</tbody>
</table>

198 Stress tested BHCs excluding GMAC.

199 Excluding Keycorp, which is one of the 18 BHCs, but whose assets have fallen below $100B.

To test the accuracy of its estimates, the Panel calibrated its model to the results of the stress tests. In doing so, it simply used the results as a base line and did not mean to accept or reject the assumptions made there. The median result reached by the Panel in calibrating its results was 2.5% higher than the stress tests, and was most likely the result of the portions of the stress tests that cannot be independently replicated.
As evidenced by the graph below, the projected capital shortfall is concentrated in banks with total assets ranging from $1 billion to $100 billion. Under both scenarios, the capital shortfall for banks with less than $100 billion in assets is an order of magnitude greater than the shortfalls for the 18 stress-tested BHCs. The Panel sees this as a serious issue; smaller banks may have access to a comparatively smaller pool of investors, and could face significant challenges in raising the necessary capital.
E. SNL Financial Model Methodology

1. OVERVIEW

SNL conducted two stress tests on the Tier 1 common capital of bank holding companies with assets greater than $600 million, using two different hypothetical loan loss rate methodologies. One methodology assumed loan losses over the next two years for each bank by evaluating their current delinquency rates for each loan type, while the other uniformly applied the more adverse loan loss rates that were specified in the Supervisory Capital Assessment Program (SCAP) report, regardless of individual bank delinquency rates. SNL used regulatory financials as of March 31, 2009, but Tier 1 common capital was adjusted for common capital offerings completed between April 1st and July 24th, following the methodology of the SCAP report. All data used in the model is from the March 31, 2009 bank holding company Y9–C filings with the Federal Reserve.

2. LOAN LOSSES—CUSTOMIZED SCENARIO

SNL determined hypothetical loan loss rates by adjusting the SCAP’s adverse loan loss rates for each bank. SNL compared each bank’s delinquent loans by loan type—defined as loans 30 to 89 days past due and 90–plus days past due, and loans in nonaccrual status, excluding any government-guaranteed loans—to the aggregate delinquency rate, by loan type, for all of the banks in the anal-

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200 The starting point + 20% portion of the column represents the marginal increase from the capital required under the starting point scenario.
ysis and calculated a ratio for each bank (the bank’s individual delinquencies divided by the industry delinquency rate for each loan type). SNL then applied this ratio to the SCAP’s adverse loan loss rates to create individualized loss rates for each bank. For instance, if a company had a delinquency rate lower than the industry average, SNL lowered the hypothetical loan loss rate by the same proportion.

SNL limited the maximum loss rates to the greater of the bank’s delinquency rates or 4× the SCAP’s more adverse rate (the pro-rated loss rates were also capped at 100 percent). It also set a minimum loss rate of 25 percent of the SCAP’s more adverse rate. As such, the aggregate loan loss rates for the banks in this analysis will not equal the most adverse loan loss rates specified in the SCAP report due to the caps and floors imposed on the customized loss rates for each loan type.

3. LOAN LOSSES—STANDARDIZED SCENARIO

Using the “more adverse” loan loss rates from the SCAP report, SNL uniformly applied these rates to each loan type for each bank holding company to determine the total losses for each loan portfolio. For example, the SCAP report specified that First Lien Mortgages were stressed under the most adverse scenario at an 8.5 percent loss rate. This rate was then applied to each bank within the analysis.

Under each scenario, consolidated loans in both foreign and domestic offices for each loan type are used where possible. However, real estate loan types in the model, such as first lien and closed-end junior lien mortgages, home equity lines, multifamily loans, construction and land development, and commercial real estate loans, represent the bank’s domestic loans in each category due to lack of disclosure of consolidated loans. Therefore, the total loans stress-tested may not equal the total amount of consolidated loans at each bank holding company.

For both loan loss scenarios, a 35 percent tax rate was applied to the loss for each bank. The calculated loan losses for each bank were then applied against the bank’s excess loan loss reserve. SNL assumed that each bank would have to maintain a one percent loan loss reserve to total loans ratio. SNL then decreased Tier 1 common capital for the losses not absorbed by the excess reserves.

The loan portfolio detail for each bank holding company used to calculate loan losses is located in the HC-C schedule (Loans & Leases) within the bank’s Y–9C filing with the Federal Reserve.

4. FUTURE EARNINGS

Like the Federal Reserve in its stress test, SNL used pre-provision net revenue to predict 2009 and 2010 earnings for the banks. SNL predicted pre-provision net revenue for each bank by taking the average pre-provision net revenue, from each bank’s Y–9C filing, as a percent of average assets for the last twelve months ending March 31, 2009, and the prior twelve months ending March 31, 2008, and projecting that rate forward over two years, based on the company’s most recent asset size. Pre-provision net revenue was defined by the Federal Reserve as net interest income plus non-interest income minus non-interest expense, but SNL “normalized”
its predictions by excluding gains on sale of securities (losses were included), goodwill impairment and amortization of intangibles from 2007 and 2008 data. For banks that did not have any data available for the last two years or for any bank with pre-provision net revenue less than 0.75 percent of assets over the period, SNL assumed a pre-provision net revenue rate of 0.75 percent of most recent assets. SNL found that some banks had large losses related to sale of securities that occurred primarily due to write-downs associated with Fannie Mae’s collapse in 2008. Since these losses were one-time and were not recurring, SNL assumed a 0.75 percent rate as a minimum for pre-provision net revenue as that represented roughly half the mean rate for the banks stress-tested. A 35 percent tax rate was then applied to each bank’s pre-provision net revenue.

The income statement detail for each bank holding company used to calculate pre-provision net revenue is located in the HI schedule (Income Statement) within the bank’s Y–9C filing with the Federal Reserve.

5. NET CAPITAL REQUIREMENTS

SNL calculated Tier 1 common capital for each bank holding company from their HC-R schedule (Regulatory Capital) of the Y–9C filing with the Federal Reserve. A total of 66 banks were excluded from the analysis since they did not supply enough information to calculate Tier 1 common capital for the period ending March 31, 2009.

SNL calculated the hypothetical decrease in Tier 1 common capital by netting out the amount of loan losses under each scenario, assuming that loan loss reserves could be depleted to just one percent of loans, and adding in the expected two-year PPNR, all after taxes. SNL then added any common capital raised between March 31, 2009, and July 24, 2009.

Those bank holding companies with a pro forma Tier 1 common capital to risk-adjusted assets ratio less than four percent, the SCAP capital requirement, were designated as needing additional capital under an adverse economic environment; the additional capital needed was specified as the amount needed to increase their Tier 1 common capital levels to equal four percent of their risk-adjusted assets.
SECTION TWO: ADDITIONAL VIEWS

A. Senator John E. Sununu

I believe that the purchase of troubled assets as proposed under the PPIP is an important area of oversight for the Panel. The August Report, however, was affected by many of the same challenges that have prevented the Panel from achieving a greater level of consensus in its work to date. These include an approach in early drafts that is often too broad in its treatment of institutions and regulators, delays in preparing drafts driven by the significant changes that must be made, and the inclusion of policy recommendations that are controversial and/or fall outside the Panel’s statutory mission.

Through extended and extraordinary work, the Panel staff has been able to incorporate a very large number of requests for changes to the Report. While the improvements made to the text of the August Report have been sufficient to allow me to support its passage, I feel that it is important to highlight and clarify the areas where problems remain, where consensus has not been reached, and where the Panel should refocus its oversight efforts.

First, the August Report discusses and pursues specific changes in or alternatives to existing federal policy. Some proposals are framed as “alternatives,” others as “conclusions.” These include alternative Strategies for Dealing with Troubled Assets (pp. 36–39), a discussion of proposals for The Future (pp. 58–60), and a series of Conclusions (pp. 60–61). Engaging in an extended presentation of policy alternatives and recommendations is inappropriate for several reasons:

• Scope. Policy-making falls well outside the primary statutory mission of the Congressional Oversight Panel. This is the job of Congress, Treasury, and the responsible regulatory agencies. The Panel should work to inform policy makers by collecting and presenting information, and providing sound analysis of existing TARP programs. Good oversight may not always attract the same headlines as controversial policy proposals, but it is valuable; more important, this is the task assigned to the Panel.

• Expertise. Several of the assessments and conclusions within the August Report are based upon the Panel staff performing loan loss modeling and stress tests on financial institutions (see pp. 33–35). The economic environment chosen—“20 percent more negative”—appears to be quite arbitrary, and a broad conclusion is drawn that “… while the largest BHCs are sufficiently capitalized to deal with whole loan losses, the smaller BHC’s are not (p. 35).” These results are then used to suggest a modification or re-evaluation of the capital ratios for financial institutions (p. 61, item 4). Conducting stress tests, making conclusions about regulatory capital, and recommending changes to the capital requirements of financial institutions are well outside the Panel’s area of responsibility and expertise.

• Timing. Even in a situation where some Panel members feel that alternatives to existing programs should be discussed, we should at least provide the opportunity for programs to be established before offering criticism. It is quite premature to consider...
modifications to PPIP, a program that has yet to be fully implemented.

- Costs to Taxpayers. At no point in the presentation of alternatives or conclusions are the potential costs to taxpayers discussed in detail. This includes, for example, a suggestion that “Treasury must...do whatever can be done to restart the market for those securities” (p. 61, item 2) as well as recommendations for conducting stress tests on smaller banks (p. 61, item 4). It is unwise to include sweeping, and potentially costly, suggestions in a report that should be focused on basic oversight and program operations.

A second broad concern is that the time and effort devoted to extended discussion of policy alternatives in the August Report (as well as previous Reports) has limited or even prevented the Panel’s assessment of several key programs established under the TARP. Congressman Jeb Hensarling provides a thorough summary of the need for more oversight in these areas within his own Alternative Views. Most notably, however, the Panel has yet to formally evaluate the following programs:

- Funding for Systemically Significant Failing Institutions (AIG)
- Funding and Programs affecting Fannie Mae and Freddie Mac
- Funding Provided to Auto Manufacturers, Automotive Parts Manufacturers, and Automotive Finance Firms
- Portfolio Guarantees provided to Citigroup and Bank of America

These are large programs that consume over twenty percent of the total funds Congress has authorized under TARP. Congress and the public would benefit from the Panel’s assessment of their structure, cost, and implementation to date. Nine months after establishing the Congressional Oversight Panel, this has yet to be done.

The work of the Congressional Oversight Panel is important to Congress, the Treasury, and to taxpayers. Our statutory mission and primary focus should be to provide an independent assessment of the operation and performance of programs created under the Troubled Asset Relief Program. Where material weaknesses in programs exist, the Panel should be clear about the need for improvements. The Panel is not, however, a policy-making body. By re-focusing effort on the essential oversight of TARP programs, the Panel can better meet congressional intent and serve the public interest as well.

B. Rep. Jeb Hensarling

Although I commend the Panel and its staff for their efforts in producing the August Report, I do not concur with all of the analysis and conclusions presented in the report and cannot support its approval.

The Panel proposes a number of approaches regarding the problems presented by toxic assets. Although there is no assurance that any of these alternatives will offer definitive solutions, it is clear that most of the proposals will require taxpayers to fund significant amounts either to purchase distressed loans and securities or prop-up problematic financial institutions. It is possible that the toxic asset market is already beginning to heal itself and that the inter-
vention proposed by the Panel could be inappropriate—if not counterproductive. For this reason, I think it premature to endorse one or more of the approaches proposed by the Panel, but, instead, suggest that Treasury and the Fed continue to monitor the toxic asset market. If the “green shoots” of economic recovery continue to develop it’s likely that the bid-asked spreads for toxic assets will narrow as the sellers and buyers of those assets regain confidence and as the inventory of houses and commercial property is absorbed into the broader economy. The process will not proceed as quickly as we would like. In my view, a less than optimal pace of recovery should not be used by the Obama Administration or Congress to justify additional governmental investment of involuntary taxpayer capital.

As the report alludes, there is no doubt a need for an “accurate valuation” of the projected losses and capital shortfalls arising from the troubled assets that continue to plague the balance sheets and income statements of both large and small financial institutions. Were such a valuation accomplished, it would be helpful in assessing systemic financial contagion and establishing a path to economic recovery. Although an interesting and insightful project, this is a task that I view as almost impossible and one not nearly as important as providing taxpayers with insight into whether TARP is actually working and what financial institutions (and even automakers) have done with TARP investments.

The Panel originally undertook to model whole loans and securitized loans, but finally chose to model only projected losses and capital shortfalls arising from whole loans held by certain “banks.” The Panel started with the “more adverse” assumptions used by the Federal Reserve Board in conducting the recently completed stress-test analysis and then ran the numbers again based upon assumptions that were 20 percent more negative. The Panel concluded that “while the 18 largest BHCs are sufficiently capitalized to deal with whole loan losses, the . . . smaller BHCs . . . are not, and are going to require additional capital given more adverse economic conditions.” While I am encouraged by the Panel’s conclusion regarding the 18 largest BHCs, I am not necessarily discouraged by the results for the smaller banks since it is entirely possible that the input assumptions used by the Panel were excessively pessimistic. As with any econometric model, input assumptions drive the output results and it is far from clear that future economic conditions will be 20 percent more negative than the “more adverse” standard adopted by the Fed for the stress-tests. Observers should resist the temptation to report the Panel’s finding in this regard in a simplistic and alarmist manner.

VerDate Nov 24 2008 02:35 Aug 20, 2009 Jkt 051601 PO 00000 Frm 00070 Fmt 6602 Sfmt 6602 E:\HR\OC\B601A.XXX B601Atjames on DSKG8SOYB1PROD with REPORTS
When an oversight body attempts to place a price tag on any group of toxic assets, the implication is that the government must intervene to either purchase or arrange a purchase of such assets, which would likely require a generous taxpayer subsidy as an incentive to remove them from the holders’ balance sheets. If assets like mortgage-backed securities are thinly-traded because spreads are too wide for a legitimate price discovery process, then a valuation below the reservation price of the financial institutions holding the assets could infer that the government should inject even more capital into the institutions. A valuation equal to or above the reservation price of the financial institutions could infer that the government should subsidize private investors. As I discussed in an addendum to the Panel’s July Report on TARP warrant repurchases, I am worried that the current report may again attempt to jumpstart the price discovery process using mechanisms the Panel or outside experts have developed without understanding the costly consequences.

In the section of the report dedicated to “The Future” of the Continued Risk of Toxic Assets, the Panel concludes: “Even given its use to restart the markets rather than to take large numbers of troubled assets off bank balance sheets, Treasury should consider whether the PPIP legacy securities program should be expanded if the markets would appear to benefit from additional ‘pump-priming.’ If the program is not working, Treasury should consider adopting a different strategy to remove the troubled assets from banks’ books.” Additionally, in the “Conclusion” section of the current report the Panel states: “Treasury must assure robust legacy securities and legacy loan programs or consider a different strategy to do whatever can be done to restart the market for those assets.”

Although limited governmental intervention may be merited under certain circumstances, both of these recommendations seem to me as advocacy for yet another bailout of failed federal program with involuntary taxpayer capital while voluntary investor capital remains on the sidelines—largely due to the uncertainty injected into the program by the Administration and by Congress. It is worthwhile to note that private capital has given a lackluster reception to Treasury’s Public-Private Investment Program (PPIP), citing concerns about “doing business with the government.” Many investors factor “Country Risk” into investment decisions when dealing in economies affected by unstable governments. My fear is now they must now do so when investing in the United States economy.

If PPIP’s investment vehicles experience high returns, and participants are paid contractually-agreed upon returns, will they be subject to confiscatory measures if the amounts are considered in retrospect “excessive”? What sort of corporate governance measures will be required? Could statutory provisions governing TARP be enacted that would apply additional restrictions? The Panel’s report does not adequately address these issues. With such questions lingering, firms will calculate the risks associated with a program like PPIP and quite possibly view alternative investments as more favorable undertakings. As I discussed in an addendum to the Farm
Credit Report, it is critical that the Obama Administration and Congress properly vet all issues of "political risk" that may arise with respect to any retroactive mandates that are incorporated into the PPIP program after its launch.

I am also troubled by the nature of the Panel's oversight as presented in this report. Once again, the policy recommendations presented in the report is outside the scope of the Panel's authority and could diminish the Panel's ability to discharge its statutory responsibility of investigating current programs in dire need of oversight. TARP has morphed into a complex web of eight official programs, and the Panel should continue to press Treasury for a legal justification for its authority to recycle TARP funds for other uses and new programs. In my view, proper oversight should include (1) analyzing programs proposed by Treasury to determine if they are reasonable, transparent, accountable and properly designed for their intended purpose, (2) determining if the programs are being properly implemented in a reasonable, transparent and accountable manner, (3) determining if taxpayers are being protected, (4) determining the success or failure of the programs based upon reasonable, transparent, accountable and objective metrics, (5) analyzing Treasury's exit strategy with respect to each investment of TARP funds, (6) analyzing the corporate governance policies and procedures implemented by Treasury with respect to each

203 My comments on political risk are noted on pages 99–100 of the Farm Credit Report at cop.senate.gov/documents/cop-072109-views.pdf.

In addition, many recipients have been stigmatized by their association with TARP and wish to leave the program as soon as their regulators permit. Some of the adverse consequences that have arisen for TARP recipients include, without limitation, executive compensation restrictions, corporate governance and conflict of interest issues, employee retention difficulties and the distinct possibility that TARP recipients (including those who have repaid all Capital Purchase Program advances but have warrants outstanding to Treasury) may be subjected to future adverse rules and regulations. In my opinion the TARP program should be terminated due to, among other reasons, (1) the clear desire of the American taxpayers for the TARP recipients to repay all TARP related investments sooner rather than later; (2) the troublesome corporate governance and regulatory conflict of interest issues raised by Treasury's ownership of equity interests in the TARP recipients, (3) the stigma associated with continued participation in the TARP program by the recipients, and (4) the demonstrated ability of the current Administration to use the program to promote its economic, social and political agenda. I introduced legislation (H.R. 2745) to end the TARP program on December 31, 2009. In addition, the legislation (1) requires Treasury to accept TARP repayment requests from well capitalized banks, (2) requires Treasury to divest its warrants in each TARP recipient following the redemption of all outstanding TARP-related preferred shares issued by such recipient and the payment of all accrued dividends on such preferred shares, (3) provides incentives for private banks to repurchase their warrant preferred shares from Treasury, and (4) reduces spending authority under the TARP program for each dollar repaid.

204 The report includes the following single reference to "political risk": "Similarly, it is unclear whether wariness of political risks will inhibit the willingness of potential buyers to purchase these assets." This is far too significant of an issue to be brushed aside with such a muted acknowledgement.

205 In addition, I have other concerns with the PPIP program. Will the newly revised mark-to-market rules discourage holders of distressed securities from selling those securities to a PPIP partnership or another purchaser? Holders may understandably elect not to dispose of their distressed securities if the sales would generate accounting losses and increase the holders' capital requirements. Will the PPIP program create a sufficient market for distressed securities so as to require holders of such securities to apply mark-to-market accounting even though they may have no present intent to sell the securities? If so, many financial institutions may have to book additional losses and raise new capital. Is the PPIP program simply a subsidy by the government that finances the purchase of distressed securities at inflated prices? If so, the program may do more harm than good when non-subsidized purchasers refuse to purchase distressed securities at the subsidized prices.

206 The eight official programs are as follows: (1) Capital Purchase Program (initial equity injections to institutions), (2) Automotive Industry Financing Program, (3) Automotive Supplier Support Program, (4) Targeted Investment Program (Citigroup, Bank of America), (5) Asset Guarantee Program, (6) Consumer and Business Lending Initiative Investment Program (TALF cushion), (7) Systemically Significant Failing Institutions (ARF) and (8) Home Affordable Modification Program.
investment of TARP funds, (7) holding regular public hearings with the Secretary and other senior Treasury officials as well as with the senior management of the institutions that received TARP funds, (8) determining how TARP recipients invested and deployed their TARP funds, and, most importantly, (9) reporting the results to the taxpayers in a clear and concise manner. The Panel should conduct its oversight activity in the most reasonable, transparent, accountable and objective manner possible with measurable standards that hold Treasury accountable for the statutory mandate of EESA that taxpayer protection is made an upmost priority.\textsuperscript{207}

In addition to providing ongoing oversight across TARP programs, it troubles me that the Panel does not investigate and report upon the following uses of taxpayer funds, which carry significant exposure to risk, on a more regular basis. The Panel should rigorously apply the above strategy to ensure complete transparency for the taxpayers.

\textbf{Systemically Significant Failing Institutions Program:} This is the formal name given to the rescue of AIG using $69.84 billion\textsuperscript{208} in TARP funds.

In April of 2009, Treasury made the decision to add almost $30 billion to the existing $40 billion already provided to AIG in exchange for preferred stock with warrants. The government has a 77.9 percent stake in the insurer. Were it to convert preferred shares into common equity, as occurred for Citigroup, the nature of ownership would change and taxpayer risk would be enhanced. (On top of this, the Federal Reserve has created a $60 billion revolving loan facility for AIG, of which $25 billion will be forgiven in exchange for preferred interest in two of its life insurance subsidiaries.\textsuperscript{209} It also holds $36 billion in AIG mortgage-backed securities through “Maiden Lane II LLC” and “Maiden Lane III LLC.”)\textsuperscript{210} Even though AIG just announced that it turned a quarterly profit for the first time in two years, it is still a struggling company that continues to draw on government loans.\textsuperscript{211} CEO Edward Liddy has stated that he expects to repay the government in three to five years,\textsuperscript{212} although he has provided no detailed plan on how this will be accomplished.

While it has conducted some meaningful oversight since November, the Panel has provided limited oversight of TARP funds invested in AIG and its affiliates.

\textsuperscript{207} EESA § 113, “Minimization of Long-Term Costs and Maximization of Benefits for Taxpayers.”
\textsuperscript{208} U.S. Department of the Treasury, Section 105(a) Troubled Assets Relief Program Report to Congress for the Period June 1, 2009 to June 30, 2009 (July 10, 2009) (online at www.financialstability.gov/docs/105CongressionalReports/105aReport_07102009.pdf) (hereinafter July 10 TARP Congressional Report’’).
\textsuperscript{212} Id.
Citigroup and Bank of America: Citigroup has received $45 billion\textsuperscript{213} in committed aid through TARP’s Capital Purchase Program and Targeted Investment Program. On top of that, Treasury and the FDIC have agreed to guarantee about $306 billion\textsuperscript{214} in assets of Citigroup.

Bank of America has received $45 billion\textsuperscript{215} in committed aid through TARP’s Capital Purchase Program and Targeted Investment Program. On top of that, Treasury and the FDIC have agreed to guarantee about $118 billion\textsuperscript{216} in assets, the majority of which Bank of America acquired through Merrill Lynch.

It is the Panel’s responsibility to shed light into TARP, including the Citigroup and Bank of America investments. The stress tests performed by the Federal Reserve assessed the capital needed for both institutions to survive an additional round of losses or further deterioration of earnings. It did not, however, fully gauge the banks’ ability to repay TARP funds or track the ways they channeled the money. The Panel should be conducting ongoing interviews with these and other major recipients of TARP funds to probe for such information, as well as to hold Treasury accountable for articulating its exit strategy with respect to each investment.

In addition, I repeat my concerns that no major traditional financial institution has testified before the Panel. In fact, only three TARP recipients have appeared as hearing witnesses; the largest was M&T Bank Corporation, which received $600 million in aid.

While it has conducted some meaningful oversight since November, the Panel has provided limited oversight of how taxpayer funds were spent by financial institutions.

Chrysler and GM: The panel held a field hearing on July 27, 2009 featuring Ron Bloom from the President’s Auto Task Force, Chrysler and GM officials, bankruptcy experts and a representative from the Indiana State pension funds, a creditor of Chrysler. No witness from the UAW, which currently holds a 67.7 percent stake in Chrysler and a 17.5 percent stake in GM through its retiree benefits trust, was available to testify, despite the Panel’s selection of a hearing location that was about a 15-minute drive from UAW headquarters.

Because this is a significant and ongoing issue involving over $80 billion\textsuperscript{217} in TARP funds and government ownership—and several questions remain unanswered about Treasury’s involvement in the bankruptcy negotiations—it is incumbent upon the Panel to make oversight of the two automakers a key area of continuing focus beyond the Panel’s report that is scheduled for release in early September.

Here is an overview of the post-bankruptcy allocations of Chrysler and GM.

Chrysler. Pursuant to the Chrysler bankruptcy, the equity of New Chrysler was allocated as follows:

\textsuperscript{213}July 10 TARP Congressional Report, supra note 208.
\textsuperscript{215}July 10 TARP Congressional Report, supra note 208.
\textsuperscript{217}July 10 TARP Congressional Report, supra note 208 $80 billion includes TARP investments in Chrysler Financial Services Americas LLC and GMAC LLC.
1. United States government (9.846 percent initially, but may decrease to 8 percent),
2. Canadian government (2.462 percent initially, but may decrease to 2 percent),
3. Fiat (20 percent initially, but may increase to 35 percent), and
4. UAW (comprising current employee contracts and a VEBA for retired employees) (67.692 percent, but may decrease to 55 percent).

The adjustments noted above permit Fiat to increase its ownership interest from 20 percent to 35 percent by achieving specific performance goals relating to technology, ecology and distribution designed to promote improved fuel efficiency, revenue growth from foreign sales and U.S. based production.

Some, but not all, of the claims of the senior secured creditors were of a higher bankruptcy priority than the claims of the UAW/VEBA. The Chrysler senior secured creditors received 29 cents on the dollar ($2 billion cash for $6.9 billion of indebtedness).

The UAW/VEBA, an unsecured creditor, received (1) 43 cents on the dollar ($4.5 billion note from New Chrysler for $10.5 billion of claims) and (2) a 67.692 percent (which may decrease to 55 percent) equity ownership interest in New Chrysler.

GM. Pursuant to the GM bankruptcy, the equity of New GM was allocated as follows:
1. United States government (60.8 percent),
2. Canadian government (11.7 percent),
3. UAW (comprising current employee contracts and a VEBA for retired employees) (17.5 percent), and
4. GM bondholders (ten percent).

The bankruptcy claims of the UAW/VEBA and the GM bondholders were of the same bankruptcy priority.

The equity interest of the UAW/VEBA and the GM bondholders in New GM may increase (with an offsetting reduction in each government’s equity share) to up to 20 percent and 25 percent, respectively, upon the satisfaction of specific conditions. It is important to note, however, the warrants received by the UAW/VEBA and the GM bondholders are substantially out of the money and it’s unlikely they will be exercised. As such, it seems most likely that the UAW/VEBA and the GM bondholders will hold 17.5 percent and ten percent, respectively, of the equity of New GM.

The GM bondholders exchanged $27 billion in unsecured indebtedness for a ten percent (which may increase to 25 percent) common equity interest in New GM, while the UAW/VEBA exchanged $20 billion in claims for a 17.5 percent (which may increase to 20 percent) common equity interest in New GM and $9 billion in preferred stock and notes in New GM.

Among others, I have asked that the Administration answer the following questions for the record:
• Will the Administration provide the Panel with the written criteria the Administration uses to determine which entities or types of entities are allowed to receive assistance through TARP?
• How much additional funding and credit support does the Administration expect to ask the American taxpayers to provide each of Chrysler and GM (1) by the end of this year and (2) during each

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following year until all investments have been repaid in full in cash and all credit support has been terminated? What will be the source of these funds?

• Will the Administration provide the Panel with a formal written legal opinion justifying (1) the use of TARP funds to support Chrysler and GM prior to their bankruptcies, (2) the use of TARP funds in the Chrysler and GM bankruptcies, (3) the transfer of equity interests in New Chrysler and New GM to the UAW/VEBAs, and (4) the delivery of notes and other credit support by New Chrysler and New GM for the benefit of the UAW/VEBAs?

• Will the Administration agree to provide the American taxpayers with timely reports describing in sufficient detail the full extent of their investments in Chrysler and GM?

• What is the Administration’s exit strategy regarding Chrysler and GM?

• When does the Administration anticipate that Chrysler and GM will repay in full in cash all TARP funds advanced by the American taxpayers?

• By making such an unprecedented investment in Chrysler and GM the United States government by definition chose not to assist other Americans that are in need. Given the economic suffering that the American taxpayers have endured during the last several months please tell us why Chrysler and GM merited such generosity to the exclusion of other American taxpayers? In other words, why would the United States government choose to reward two companies that have been mismanaged for many years, as evidenced by a protracted deterioration in the financials of both companies, at the expense of hard working American taxpayers? What information does the Administration possess that proves Chrysler and GM are both sound investments for the taxpayer?

• TARP funds were used by New Chrysler and New GM to purchase assets of the old auto makers, yet a substantial portion of the equity in the new entities was transferred to the UAW/VEBAs. As such, TARP funds were transferred to the UAW/VEBAs. In addition, New Chrysler and New GM entered into promissory notes and other contractual arrangements for the benefit of the UAW/VEBAs. Why did the United States government spend billions of dollars of taxpayer money to give preference to employees and retirees of the UAW to the detriment of other non-UAW employees and retirees whose pension funds invested in Chrysler and GM indebtedness? Why didn’t New Chrysler and New GM transfer some of their equity interests to, or enter into promissory notes and other contractual arrangements for the benefit of the non-UAW/VEBA creditors of Old Chrysler and Old GM?

• Given the judicial holdings in the Chrysler and GM bankruptcies, one might expect future firms to face a higher cost of capital, thus impeding economic development at a time when the country can least afford impediments to growth. Did the Administration consider these consequences when it orchestrated a plan that deprived certain creditors of the benefit of their bargains? How does the Administration defend the concern that, based on the Chrysler and GM precedents, the contractual rights of investors may be ignored when dealing with the United States government?
• Will Chrysler and GM promptly disclose all contractual arrangements with (1) the United States government and (2) recipients of TARP funds, together with a detailed description of the contract, its purpose, the transparent and open competitive bidding process undertaken and the arm’s length and market directed nature of the contract?
• Will Chrysler or GM be able to obtain private or public credit or enter into other contractual arrangements at favorable rates because of the implicit governmental guarantee of such indebtedness and contracts?
• How will the United States government resolve any conflict of interest issues arising from its role as a creditor or equity holder in Chrysler and GM and as a supervising governmental authority for Chrysler and GM?
• Did the Administration in any manner pressure or encourage Chrysler to accept a deal with Fiat?
• Did the Administration in any manner thwart or discourage any merger or business combination or arrangement between Chrysler and GM?
• Regarding the reorganization of the auto parts manufacturer, Delphi, on July 17 The New York Times reported:

Delphi’s new proposal [reached with its lender group] is similar to its agreement with Platinum [Equity, a private equity firm], which was announced June 1, the day GM filed for bankruptcy. But hundreds of objectors, including the company’s debtor-in-possession lenders, derided that proposal as a “sweetheart deal” that gave the private equity firm control of Delphi for $250 million and a $250 million credit line.

On June 24 The New York Times reported that “Delphi worked with G.M. and the Obama administration to negotiate with Platinum...”

Why would the Administration participate in the negotiation of a “sweetheart deal” for the benefit of Platinum Equity?
• Thomas E. Lauria, the Global Practice Head of the Financial Restructuring and Insolvency Group at White & Case LLP, represented a group of senior secured creditors, including the Perella Weinberg Xerion Fund (“Perella Weinberg”), during the Chrysler bankruptcy proceedings.

On May 3, The New York Times reported:

In an interview with a Detroit radio host, Frank Beckmann, Mr. Lauria said that Perella Weinberg “was directly threatened by the White House and in essence compelled to withdraw its opposition to the deal under threat that the full force of the White House press corps would destroy its reputation if it continued to fight.”

In a follow-up interview with ABC News’s Jake Tapper, he identified Mr. [Steven] Rattner, the head of the auto task force, as having told a Perella Weinberg official that the White House “would embarrass the firm.”

At the hearing Mr. Bloom stated that Mr. Rattner denied Mr. Lauria’s allegations.
Has any member of the Administration spoken with Mr. Lauria or representatives of Perella Weinberg regarding this matter? If so, what did they say? If not, why not?

Does the Administration plan to ask SIGTARP to subpoena Mr. Rattner, Mr. Lauria and representatives of Perella Weinberg and ask them to respond under oath? If not, why not?

Expansion of Fannie Mae and Freddie Mac through TARP: Housing government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, which currently have books of business totaling $5.27 trillion, or 72 percent of the housing market, are a centerpiece of Treasury’s “Making Home Affordable” plan. Fifty billion dollars from TARP has been committed to this loan modification effort, which is being run by the two GSEs. This TARP money will not be recouped, according to the Congressional Budget Office, which has assigned a 100 percent subsidy rate to the program. The largest segment of the plan, the Home Affordable Modification Plan (HAMP) has so far failed to produce the results the Administration initially advertised. When it was launched, Treasury said HAMP would serve three to four million homeowners, but a recent GAO report indicated it has only helped 180,000 borrowers as of July 20, 2009.

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SECTION THREE: CORRESPONDENCE WITH TREASURY UPDATE

On behalf of the Panel, Chair Elizabeth Warren sent a letter on July 20, 2009, 220 to Secretary of the Treasury Timothy Geithner and Chairman Bernanke requesting copies of confidential memoranda of understanding involving informal supervisory actions entered into by the Federal Reserve Board and the Office of the Comptroller of the Currency with Bank of America and Citigroup. The letter further requests copies of any similar future memoranda of understanding executed with Bank of America, Citigroup, or any of the other bank holding companies that were subject to the Supervisory Capital Assessment Program (SCAP). Finally, the letter asks that the Panel be apprised of any other confidential agreements relating to risk and liquidity management that Treasury, or any of the bank supervisors, has or will enter into with any of the SCAP bank holding companies. The Panel is waiting for Secretary Geithner’s and Chairman Bernanke’s responses.

On behalf of the Panel, Chair Elizabeth Warren sent a letter on May 26, 2009, 221 to Secretary Geithner requesting information about Treasury’s Temporary Guarantee Program for Money Market Funds, which is funded by TARP. The Temporary Guarantee Program uses assets of the Exchange Stabilization Fund to guarantee the net asset value of shares of participating money market mutual funds. The letter requests a description of the program mechanics and an accounting of its obligations and funding mechanisms. On July 21, 2009, Secretary Geithner responded by letter to this request.222

On behalf of the Panel, Chair Elizabeth Warren sent a letter on May 19, 2009, 223 to Secretary Geithner and Chairman Bernanke referencing public concern that Treasury and the Board had applied strong pressure on Bank of America to complete its acquisition of Merrill Lynch, despite Bank of America’s concerns about Merrill Lynch’s deteriorating financial state. The letter cites this episode as an example of the conflicts of interest that can arise when the government acts simultaneously as regulator, lender of last resort, and shareholder. The letter concludes by soliciting Secretary Geithner’s and Chairman Bernanke’s thoughts on how to manage these inherent conflicts to ensure that similar episodes do not undermine government efforts to stabilize the financial system in the future. On July 21, 2009, Secretary Geithner responded by letter.224 The Panel has not yet received a response from Chairman Bernanke.

Chair Elizabeth Warren and Panel member Richard H. Neiman sent a letter to Secretary Geithner on June 29, 2009, 225 requesting assistance with the Panel’s oversight of federal foreclosure mitigation efforts. In order to evaluate the effectiveness of foreclosure mitigation efforts, the letter requests copies of the data collected under the Making Home Affordable program, as well as relevant

220 See Appendix I of this report, infra.
221 See Appendix II of this report, infra.
222 See Appendix III of this report, infra.
223 See Appendix IV of this report, infra.
224 See Appendix V of this report, infra.
225 See Appendix VI of this report, infra.
See Appendix VII of this report, infra. The Panel continues to work with Treasury to obtain the necessary data and reports.
SECTION FOUR: TARP UPDATES SINCE LAST REPORT

A. General Motors Emerges From Bankruptcy

General Motors emerged from bankruptcy on July 10, 2009, as a new, smaller company with a pared down product line and plans to cut up to 35 percent of its management-level positions. The bankruptcy proceedings were completed in less than six weeks. The federal government holds approximately 60 percent of the outstanding shares of the new GM.

B. TARP Repayment

Financial institutions Goldman Sachs, State Street, BB&T, US Bancorp, American Express, Bank of New York Mellon and Morgan Stanley have repurchased all of the outstanding warrants that were issued by each firm to the U.S. Treasury under the Capital Purchase Program (CPP) in late 2008. Goldman Sachs paid back $10 billion in TARP funds, and paid $1.1 billion to repurchase its outstanding warrants. State Street paid back $2 billion in TARP funds, and paid $60 million to repurchase its outstanding warrants. BB&T paid back $3.13 billion in TARP funds, and paid $67 million to repurchase its outstanding warrants. US Bancorp paid back $6.599 billion in TARP funds, and paid $139 million to repurchase its outstanding warrants. American Express paid back $3.389 billion in TARP funds, and paid $340 million to repurchase its outstanding warrants. Bank of New York Mellon repaid $3 billion in TARP funds, and repurchased its outstanding warrants for $163 million. Morgan Stanley paid back $10 billion in TARP funds, and paid $950 million to repurchase its outstanding warrants. JPMorgan has repaid $25 billion but has declined to repurchase its warrants, instead asking Treasury to sell them at auction. A total of 33 banks have fully repaid their TARP investment provided under the CPP to date.

C. CPP Monthly Lending Report

Treasury releases a monthly lending report showing loans outstanding for CPP recipients. The most recent report includes data up through the end of May 2009 and shows that CPP recipients had $5.13 billion in loans outstanding as of May 31, 2009. This represents a 0.39 percent decline in loans between the end of April and the end of May.

D. Regulatory Reform Proposals

The Obama Administration has sent a series of legislative proposals to Congress over the past several weeks. Among the proposals are legislation to increase the SEC’s authority to regulate investment advisers and broker-dealers, require hedge funds to register with the SEC, provide shareholders with a non-binding “say on pay” or vote on executive compensation, increase compensation committee independence, increase the SEC’s authority over rating agencies, consolidate the Office of Thrift Supervision and the Office of the Comptroller of the Currency into a new National Bank Supervisor, provide the federal government with emergency authority
to resolve any large, interconnected financial firm in an orderly manner, and provide Treasury the authority to appoint the FDIC or the SEC as conservator or receiver for a failing financial firm that poses a threat to financial stability.

E. Legacy Loan Program (Public Private Investment Program)

The Legacy Loan Program, which is part of the Public-Private Investment Program, was designed to remove troubled loans from the balance sheets of banks. In June, the Federal Deposit Insurance Corporation announced that it would conduct a test pilot of the program with the sale of bank assets in receivership. On July 31, 2009, the FDIC announced that it will conduct its first testing of the Legacy Loan Program funding mechanism.

Under the pilot program, the receivership will transfer a portfolio of residential mortgage loans to a limited liability company (LLC) on a servicing basis in exchange for an ownership interest in the LLC. The LLC will also sell an equity share to investors, who will be responsible for managing the portfolio. Investors will be offered two different options. The first option is on an all cash basis with the FDIC owning an equity share of 80 percent and the investor owning 20 percent. The second option is a sale with leverage based on a 50–50 equity split between the FDIC and the investor.

According to the FDIC, the funding mechanism is financing offered by the receivership to the LLC using an amortizing note that is guaranteed by the FDIC. Financing will be offered with leverage of either 4–to–1 or 6–to–1, depending upon certain elections made in the bid submitted by the private investor.”

F. Term Asset-Backed Securities Loan Facility (TALF)

The Federal Reserve Bank of New York held its second special subscription on July 16, 2009, for TALF loans secured by commercial mortgage-backed securities (CMBS). The second subscription made loans available for both newly issued (issued on or after January 1, 2009) and legacy CMBS (issued before January 1, 2009). The first subscription had made loans available only for newly issued CMBS. During the July 16th subscription, $669 million in TALF loans were requested. All of the loans were requested for legacy CMBS; no loans were requested for newly issued CMBS. The next subscription for CMBS will occur August 20, 2009.

During the regular TALF subscription on August 6, 2009, $6.9 billion in loans was requested. As a point of comparison, there were $5.4 billion in loans requested at the July facility, $11.5 billion requested at the June facility, $10.6 billion requested at the May facility, $1.7 billion at the April facility, and $4.7 billion at the March facility. The August 6th subscription included requests for loans secured by asset-backed securities in the auto, credit card, floor plan, servicing advances, small business, and student loan sectors. There were no requests for loans in the equipment, or premium finance sectors.
G. Home Price Decline Protection Incentives

On July 31, 2009, Treasury announced the Home Price Decline Protection (HPDP) Program. HPDP is an expansion to the Home Affordable Modification Program (HAMP). Under the HPDP, Treasury will provide investors additional incentives for loan modifications made under HAMP on homes located in areas where home prices housing declined. According to Treasury, “incentive payments will be linked to the rate of recent home price decline in a local housing market, as well as the unpaid principal balance and mark-to-market loan-to-value ratio of the mortgage loan.” Only HAMP loan modifications begun after September 1, 2009 are eligible for HPDP payments. Mortgage loans that are owned or guaranteed by Fannie Mae or Freddie Mac are not eligible. Treasury has allocated up to $10 billion for the new program.

H. Metrics

The Panel continues to monitor a number of financial market indicators that the Panel and others, including Treasury, the Government Accountability Office (GAO), Special Inspector General for the Troubled Asset Relief Program (SIGTARP), and the Financial Stability Oversight Board, consider useful in assessing the effectiveness of the Administration’s efforts to restore financial stability and accomplish the goals of the EESA. This section discusses changes that have occurred since the release of the Panel’s July report.

• Interest Rate Spreads. Key interest rate spreads have leveled off following precipitous drops between the Panel's May and June oversight reports. Spreads remain well below the crisis levels seen late last year, and Treasury and Federal Reserve officials continue to cite the moderation of these spreads as a key indicator of a stabilizing economy.227

227 See Allison Testimony, supra note 37 (“There are tentative signs that the financial system is beginning to stabilize and that our efforts have made an important contribution. Key indicators of credit market risk, while still elevated, have dropped substantially.”)
funds across a variety of categories, ranging from mortgage loans and average loan balances for the 21 largest recipients of CPP Monthly Lending and Intermediation Snapshot tracks loan origination, a rough measure of short-term business debt, is an indicator of the availability of credit for enterprises. All three measured commercial paper values decreased since the Panel’s July report. Asset-backed, financial and nonfinancial commercial paper have all decreased since October 2008 with nonfinancial commercial paper outstanding declining by over 44 percent.

**FIGURE 19: COMMERCIAL PAPER OUTSTANDING**

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Current Level</th>
<th>Percent Change Since Last Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset-Backed Commercial Paper Outstanding (seasonally adjusted)</td>
<td>$437.8</td>
<td>-4.15%</td>
</tr>
<tr>
<td>Nonfinancial Commercial Paper Outstanding (seasonally adjusted)</td>
<td>$110.4</td>
<td>-11.99%</td>
</tr>
</tbody>
</table>

- **Commercial Paper Outstanding**. Commercial paper outstanding, a rough measure of short-term business debt, is an indicator of the availability of credit for enterprises. All three measured commercial paper values decreased since the Panel’s July report. Asset-backed, financial and nonfinancial commercial paper have all decreased since October 2008 with nonfinancial commercial paper outstanding declining by over 44 percent.

- **Lending by the Largest TARP-recipient Banks**. Treasury’s Monthly Lending and Intermediation Snapshot tracks loan originations and average loan balances for the 21 largest recipients of CPP funds across a variety of categories, ranging from mortgage loans...
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to commercial and industrial loans to credit card lines. Mortgage originations—excluding refinancing—increased by over 8 percent from April to May; further, mortgage originations have increased by more than 75 percent since October of 2008. The dramatic drop in commercial real estate has continued from the previously reported period. The data below exclude lending by two large CPP-recipient banks, PNC Bank and Wells Fargo, because significant acquisitions by those banks since last October make comparisons misleading.

FIGURE 20: LENDING BY THE LARGEST TARP-RECIPIENT BANKS

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Most Recent Data (May 2009) (dollars in millions)</th>
<th>Percent Change Since April 2009</th>
<th>Percent Change Since October 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Loan Originations</td>
<td>$200,298</td>
<td>51%</td>
<td>-8.19%</td>
</tr>
<tr>
<td>Total Mortgage Origination</td>
<td>$77,792</td>
<td>8.06%</td>
<td>75.64%</td>
</tr>
<tr>
<td>C&amp;I New Commitments</td>
<td>$33,482</td>
<td>3.06%</td>
<td>-45.20%</td>
</tr>
<tr>
<td>CRE New Commitments</td>
<td>$2,971</td>
<td>-14.38%</td>
<td>-71.77%</td>
</tr>
<tr>
<td>Mortgage Refinancing</td>
<td>$52,682</td>
<td>-7.50%</td>
<td>180.71%</td>
</tr>
<tr>
<td>Total Average Loan Balances</td>
<td>$3,337,318</td>
<td>-0.62%</td>
<td>-2.50%</td>
</tr>
</tbody>
</table>

240 On July 10, 2009 the Federal Reserve announced that it had made changes to the data in its H.8 release, which has changed previously reported figures. In order to represent measured trends accurately, the Panel has updated its figures to reflect the latest reported Federal Reserve data. See Board of Governors of the Federal Reserve System, H.8: Changes to Data and Items Reported on the Release for July 1, 2009 (July 10, 2009) (online at www.tradingurus.com/index2.php?option=com_content&task=pdf&id=17314).

241 These figures differ from the amount of total loans and leases in bank credit cited in section B of this report because FDIC data include all FDIC-insured institutions whereas the data above measure only the loans and leases in bank credit for domestically chartered commercial institutions.

• Loans and Leases Outstanding of Domestically-Chartered Banks. Weekly data from the Federal Reserve Board track fluctuations among different categories of bank assets and liabilities. Loans and leases outstanding for large and small domestic banks both fell last month.241 Total loans and leases outstanding at large banks have dropped by over 5.8 percent since last October.242

FIGURE 21: LOANS AND LEASES OUTSTANDING

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Current Level (as of 8/05/09) (dollars in billions)</th>
<th>Percent Change Since Last Report (7/31/09)</th>
<th>Percent Change Since EESA Signed into Law (10/03/08)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Domestic Banks—Total Loans and Leases</td>
<td>$3,817.8</td>
<td>-1.41%</td>
<td>-5.81%</td>
</tr>
<tr>
<td>Small Domestic Banks—Total Loans and Leases</td>
<td>$2,517.4</td>
<td>-0.63%</td>
<td>-0.01%</td>
</tr>
</tbody>
</table>

243 These figures differ from the amount of total loans and leases in bank credit cited in section B of this report because FDIC data include all FDIC-insured institutions whereas the data above measure only the loans and leases in bank credit for domestically chartered commercial institutions.

• Housing Indicators. Foreclosure filings increased by over four percent from May to June, in turn raising the rate to twenty percent above the level of last October. Housing prices, as illustrated by the S&P/Case-Shiller Composite 20 Index, continued to decline in April. The index remains down over ten percent since October 2008.


FIGURE 22: HOUSING INDICATORS

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Most Recent Monthly Data</th>
<th>Percent Change From Data Available at Time of Last Report (8/05/09)</th>
<th>Percent Change Since October 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly Foreclosure Filings</td>
<td>336,173</td>
<td>4.57%</td>
<td>20.25%</td>
</tr>
<tr>
<td>Housing Prices—S&amp;P/Case-Shiller Composite Index</td>
<td>140.1</td>
<td>-0.16%</td>
<td>-10.82%</td>
</tr>
</tbody>
</table>


FIGURE 23: ASSET-BACKED SECURITY ISSUANCE

(Dollars in millions)

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Most Recent Quarterly Data (Q2 2009)</th>
<th>Data Available at Time of Last Report (Q1 2009)</th>
<th>Percent Change From Data Available at Time of Last Report (7/9/09)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto ABS Issuance</td>
<td>$12,036.8</td>
<td>$7,574.4</td>
<td>58.8%</td>
</tr>
<tr>
<td>Credit Cards ABS Issuance</td>
<td>$19,158.5</td>
<td>$3,000</td>
<td>538.6%</td>
</tr>
<tr>
<td>Equipment ABS Issuance</td>
<td>$2,629.1</td>
<td>$514.7</td>
<td>410.8%</td>
</tr>
<tr>
<td>Home Equity ABS Issuance</td>
<td>$707.4</td>
<td>$782.1</td>
<td>9.55%</td>
</tr>
<tr>
<td>Other ABS Issuance</td>
<td>$5,444</td>
<td>$2,386.5</td>
<td>170%</td>
</tr>
<tr>
<td>Student Loans ABS Issuance</td>
<td>$7,643.8</td>
<td>$1,955.8</td>
<td>290.8%</td>
</tr>
<tr>
<td>Total ABS Issuance</td>
<td>$48,609.6</td>
<td>$16,213.5</td>
<td>199.8%</td>
</tr>
</tbody>
</table>

247 Of this amount, $23 billion was supported under the TALF. See Federal Reserve Bank of New York, Term Asset-Backed Securities Loan Facility: Announcements (accessed Aug. 5, 2009) (online at www.newyorkfed.org/markets/talf_announcements.html).

I. Financial Update

Each month since its April oversight report, the Panel has summarized the resources that the federal government has committed to economic stabilization. The following financial update provides: (1) an updated accounting of the TARP, including a tally of dividend income and repayments the program has received as of July 31, 2009; and (2) an update of the full federal resource commitment as of July 30, 2009.

1. TARP

a. Costs: Expenditures and Commitments

Treasury is currently committed to spend $532.8 billion of TARP funds through an array of programs used to purchase preferred shares in financial institutions, offer loans to small businesses and auto companies, and leverage Federal Reserve loans for facilities designed to restart secondary securitization markets. Of this total, $370.2 billion is currently outstanding under the $698.7 billion limit for TARP expenditures set by EESA, leaving $328.5 billion available for fulfillment of anticipated funding levels of existing programs and for funding new programs and initiatives. The $370.2 billion includes purchases of preferred shares, warrants...
and/or debt obligations under the CPP, TIP, SSFI Program, and AIFP; a $20 billion loan to TALF LLC, the special purpose vehicle (SPV) used to guarantee Federal Reserve TALF loans; and the $5 billion Citigroup asset guarantee, which has subsequently been exchanged for a guarantee fee composed of additional preferred shares and warrants. Additionally, Treasury has allocated $20 billion to the Home Affordable Modification Program, out of a projected total program level of $50 billion, but has not yet distributed any of these funds.

b. Income: Dividends and Repayments

The repayments of CPP preferred shares by nine of the large, stress-tested BHCs has led to a surge this month in amount of total TARP repayments—from the just under $2 billion reported in our July report to over $70 billion largely as a result of repayments. Several of those BHCs have also repurchased the warrants Treasury received in conjunction with its preferred stock investments. In addition, Treasury is entitled to dividend payments on preferred shares it has purchased, usually five percent per annum for the first five years and nine percent per annum thereafter. Treasury has begun to report dividend payments made by CPP participant banks pursuant to a recommendation in GAO's March TARP oversight report.

c. TARP Accounting as of July 31, 2009

<table>
<thead>
<tr>
<th>TARP Initiative</th>
<th>Anticipated Funding</th>
<th>Purchase Price</th>
<th>Repayments</th>
<th>Net Current Investments</th>
<th>Net Available</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>532.8</td>
<td>442.5</td>
<td>72.3</td>
<td>370.2</td>
<td>328.5</td>
</tr>
<tr>
<td>CPP</td>
<td>218</td>
<td>204.3</td>
<td>70.2</td>
<td>134.2</td>
<td>13.6</td>
</tr>
<tr>
<td>TIP</td>
<td>40</td>
<td>40</td>
<td>0</td>
<td>40</td>
<td>0</td>
</tr>
<tr>
<td>SSFI Program</td>
<td>69.8</td>
<td>69.8</td>
<td>2.1</td>
<td>67.8</td>
<td>0</td>
</tr>
<tr>
<td>AIFP</td>
<td>80</td>
<td>80</td>
<td>0</td>
<td>80</td>
<td>0</td>
</tr>
<tr>
<td>AIGP</td>
<td>5</td>
<td>5</td>
<td>0</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>CAP</td>
<td>TBD</td>
<td>0</td>
<td>N/A</td>
<td>0</td>
<td>N/A</td>
</tr>
<tr>
<td>TALF</td>
<td>20</td>
<td>20</td>
<td>0</td>
<td>20</td>
<td>0</td>
</tr>
<tr>
<td>PPIP</td>
<td>30</td>
<td>0</td>
<td>N/A</td>
<td>30</td>
<td>0</td>
</tr>
<tr>
<td>Supplier Support Program</td>
<td>256</td>
<td>3.5</td>
<td>0</td>
<td>3.5</td>
<td>0</td>
</tr>
<tr>
<td>Unlocking SBA Lending</td>
<td>15</td>
<td>0</td>
<td>N/A</td>
<td>15</td>
<td>0</td>
</tr>
<tr>
<td>HAMP</td>
<td>50</td>
<td>254</td>
<td>19.9</td>
<td>0</td>
<td>19.9</td>
</tr>
<tr>
<td>(Uncommitted)</td>
<td>167.4</td>
<td>N/A</td>
<td>N/A</td>
<td>239.8</td>
<td></td>
</tr>
</tbody>
</table>

This figure reflects the repayment of $70.173 billion in CPP funds. Secretary Geithner has suggested that funds from CPP repurchases will be treated as uncommitted funds upon return to the Treasury. See This Week with George Stephanopoulos, Interview with Secretary Geithner (Aug. 2, 2009) (online at www.abcnews.go.com/print?id=8233298) ("[W]hen I was here four months ago, we had roughly $40 billion of authority left in the TARP. Today we have roughly $130 billion, partly because we have been very successful in having private capital come back into this financial system. And we've had more than $70 billion . . . come back into the government"). The Panel has therefore presented the repaid CPP funds as uncommitted (i.e., generally available for the entire spectrum of TARP initiatives). The difference between the $130 billion of funds available for future TARP initiatives cited by Secretary Geithner and the $239.8 billion calculated as available here is the Panel's decision to classify certain funds originally provisionally allocated to TALF and PPIP as uncommitted and available for TARP generally. See infra notes xiv and xvi.

252. See, e.g., U.S. Department of the Treasury, Securities Purchase Agreement: Standard Terms (online at www.financialstability.gov/docs/CPP/Spa.pdf) (hereinafter "Securities Purchase Agreement").
255 Treasury has indicated that it will not provide additional assistance to GM and Chrysler through the AIFP. See Nick Bunkley, U.S. Likely to Sell G.M. and Chrysler, New York Times (Aug. 5, 2009) (online at www.nytimes.com/2009/08/06/business/06auto.html?scp=1&sq=ron%20bloom&st=cse) (hereinafter “U.S. Likely to Sell”). The Panel therefore considers the repaid AIFP funds to be uncommitted.

256 On July 8, 2009, Treasury lowered the total commitment amount for the program from $5 billion to $3.5 billion, this reduced GM’s portion from $3.5 billion to $2.5 billion and Chrysler’s portion from $1.5 billion to $1 billion. July 31 TARP Transactions Report, supra note 104.

257 Treasury has indicated that it will not provide additional funding to auto parts suppliers through the Supplier Support Program. See U.S. Likely to Sell, supra note 255.

258 This figure reflects the cap set on payments to each mortgage servicer. See July 31 TARP Transactions Report, supra note 104.

259 This table only reflects programs that have provided Treasury with reimbursements in the form of investment repayments, warrant repurchases or dividend payments. The table does not include interest payments made by participants in the programs.

260 As of July 31, 2009. This information was provided to the Panel by Treasury staff.

261 This number includes $1.6 million in proceeds from the repurchase of preferred shares by privately-held financial institutions. For privately-held financial institutions that elect to participate in the CPP, Treasury receives and immediately exercises warrants to purchase additional shares of preferred stock.


2. OTHER FINANCIAL STABILITY EFFORTS

Federal Reserve, FDIC, and Other Programs

In addition to the direct expenditures Treasury has undertaken through TARP, the federal government has engaged in a much broader program directed at stabilizing the U.S. financial system. Many of these initiatives explicitly augment funds allocated by Treasury under specific TARP initiatives, such as FDIC and Federal Reserve asset guarantees for Citigroup, or operate in tandem with Treasury programs, such as the interaction between PPIP and TALF. Other programs, like the Federal Reserve’s extension of credit through its section 13(3) facilities and SPVs or the FDIC’s Temporary Liquidity Guarantee Program, operate independent of TARP.

3. TOTAL FINANCIAL STABILITY RESOURCES (AS OF JULY 31, 2009)

Beginning in its April report, the Panel broadly classified the resources that the federal government has devoted to stabilizing the economy through a myriad of new programs and initiatives as outlays, loans, or guarantees. Although the Panel calculates the total value of these resources at over $3.1 trillion, this would translate into the ultimate “cost” of the stabilization effort only if: (1) assets do not appreciate; (2) no dividends are received, no warrants are exercised, and no TARP funds are repaid; (3) all loans default and are written off; and (4) all guarantees are exercised and subsequently written off.

With respect to the FDIC and Federal Reserve programs, the risk of loss varies significantly across the programs considered here, as do the mechanisms providing protection for the taxpayer against such risk. The FDIC, for example, assesses a premium of
up to 100 basis points on Temporary Liquidity Guarantee Program (TLGP) debt guarantees. The premiums are pooled and reserved to offset losses incurred by the exercise of the guarantees, and are calibrated to be sufficient to cover anticipated losses and thus remove any downside risk to the taxpayer. In contrast, the Federal Reserve’s liquidity programs are generally available only to borrowers with good credit, and the loans are over-collateralized and with recourse to other assets of the borrower. If the assets securing a Federal Reserve loan realize a decline in value greater than the “haircut,” the Federal Reserve is able to demand more collateral from the borrower. Similarly, should a borrower default on a recourse loan, the Federal Reserve can turn to the borrower’s other assets to make the Federal Reserve whole. In this way, the risk to the taxpayer on recourse loans only materializes if the borrower enters bankruptcy. The only loans currently “underwater”—where the outstanding principal amount exceeds the current market value of the collateral—are the non-recourse loans to the Maiden Lane SPVs (used to purchase Bear Stearns and AIG assets).

FIGURE 26: FEDERAL GOVERNMENT FINANCIAL STABILITY EFFORT (AS OF JULY 30, 2009)

<table>
<thead>
<tr>
<th>Program</th>
<th>Treasury (TARP)</th>
<th>Federal Reserve</th>
<th>FDIC</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>838.7</td>
<td>1,608.2</td>
<td>838.7</td>
<td>3,143.6</td>
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<tr>
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<td>390.3</td>
<td>0</td>
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<td>Loans</td>
<td>43.6</td>
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<td>0</td>
<td>1422</td>
</tr>
<tr>
<td>Guarantees</td>
<td>25</td>
<td>229.8</td>
<td>799</td>
<td>1053.8</td>
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<tr>
<td>Uncommitted TARP Funds</td>
<td>239.8</td>
<td>0</td>
<td>0</td>
<td>239.8</td>
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<tr>
<td>AIG</td>
<td>69.8</td>
<td>98</td>
<td>0</td>
<td>167.8</td>
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<td>Outlays</td>
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<td>0</td>
<td>69.8</td>
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<tr>
<td>Loans</td>
<td>0</td>
<td>98</td>
<td>0</td>
<td>98</td>
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<tr>
<td>Guarantees</td>
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<td>0</td>
</tr>
<tr>
<td>Bank of America</td>
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<td>0</td>
<td>45</td>
</tr>
<tr>
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<td>45</td>
<td>0</td>
<td>0</td>
<td>45</td>
</tr>
<tr>
<td>Loans</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Guarantees</td>
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<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Citigroup</td>
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<td>289.8</td>
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<td>45</td>
</tr>
<tr>
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<td>0</td>
<td>0</td>
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<td>10</td>
<td>244.8</td>
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<tr>
<td>Capital Purchase Program (Other)</td>
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<td>0</td>
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<tr>
<td>Guarantees</td>
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<td>0</td>
<td>0</td>
<td>0</td>
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<td>Capital Assistance Program</td>
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<td>TBD</td>
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<td>TALF</td>
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<td>180</td>
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<td>200</td>
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<td>0</td>
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<tr>
<td>Loans</td>
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<td>180</td>
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<td>Guarantees</td>
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<td>0</td>
<td>20</td>
</tr>
<tr>
<td>PPiP (Loans)</td>
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<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Outlays</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Loans</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Guarantees</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>PPiP (Securities)</td>
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<td>0</td>
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<td>30</td>
</tr>
<tr>
<td>Outlays</td>
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<tr>
<td>Loans</td>
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<td>17.5</td>
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<td>Guarantees</td>
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<td>0</td>
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<td>Home Affordable Modification Program</td>
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<td>50</td>
</tr>
<tr>
<td>Outlays</td>
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<td>0</td>
<td>50</td>
</tr>
<tr>
<td>Loans</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Guarantees</td>
<td>0</td>
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</table>
FIGURE 26: FEDERAL GOVERNMENT FINANCIAL STABILITY EFFORT (AS OF JULY 30, 2009)—Continued

[Dollars in billions]

<table>
<thead>
<tr>
<th>Program</th>
<th>Treasury (TARP)</th>
<th>Federal Reserve</th>
<th>FDIC</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automotive Industry Financing Program</td>
<td>77.8</td>
<td>0</td>
<td>0</td>
<td>77.8</td>
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<tr>
<td>Outlays</td>
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<tr>
<td>Loans</td>
<td>22.6</td>
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<td>0</td>
<td>22.6</td>
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<tr>
<td>Guarantees</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Auto Supplier Support Program</td>
<td>3.5</td>
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<td>3.5</td>
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<td>Outlays</td>
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<td>0</td>
<td>0</td>
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<tr>
<td>Loans</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Guarantees</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Unlocking SBA Lending</td>
<td>15</td>
<td>0</td>
<td>0</td>
<td>15</td>
</tr>
<tr>
<td>Outlays</td>
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<td>0</td>
<td>0</td>
<td>15</td>
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<tr>
<td>Loans</td>
<td>0</td>
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<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Guarantees</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Temporary Liquidity Guarantee Program</td>
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<td>789</td>
<td>0</td>
<td>789</td>
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<tr>
<td>Outlays</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Loans</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Guarantees</td>
<td>0</td>
<td>789</td>
<td>0</td>
<td>789</td>
</tr>
<tr>
<td>Deposit Insurance Fund</td>
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<td>37.7</td>
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<td>37.7</td>
</tr>
<tr>
<td>Outlays</td>
<td>0</td>
<td>37.7</td>
<td>0</td>
<td>37.7</td>
</tr>
<tr>
<td>Loans</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Guarantees</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Other Federal Reserve Credit Expansion</td>
<td>0</td>
<td>1,100.4</td>
<td>0</td>
<td>1,100.4</td>
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<td>Outlays</td>
<td>0</td>
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<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Loans</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Guarantees</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Uncommitted TARP Funds</td>
<td>xx</td>
<td>239.8</td>
<td>0</td>
<td>239.8</td>
</tr>
</tbody>
</table>

1. The term "outlays" is used here to describe the use of Treasury funds under the TARP, which are broadly classifiable as purchases of debt or equity securities (e.g., debentures, preferred stock, exercised warrants, etc.). The outlays figures are based on: (1) Treasury’s actual reported expenditures; and (2) Treasury's anticipated funding levels as estimated by a variety of sources, including Treasury pronouncements and GAO estimates. Anticipated funding levels are set at Treasury's discretion, have changed from initial announcements, and are subject to further change. Outlays as used here represent investments and assets purchases and commitments to make investments and asset purchases and are not the same as budget outlays, which under section 103 of ESA are recorded on a "credit reform" basis.

2. While many of the guarantees may never be exercised or exercised only partially, the guarantee figures included here represent the federal government's greatest possible financial exposure.

This figure is roughly comparable to the $13.0 billion current balance of financial system support reported by SIGTARP in its July report. See Office of the Special Inspector General for the Troubled Asset Relief Program, Quarterly Report to Congress, at 138 (July 21, 2009) (online at www.sigtarp.gov/reports/congress/2009/July2009QuarterlyReport.pdf). However, the Panel has sought to capture anticipated exposure beyond the current balance, and thus employs a different methodology than SIGTARP.

This figure includes investments under the SIFI Program: a $40 billion investment made on November 25, 2008; and a $30 billion investment committed on April 17, 2009 (less a reduction of $165 million representing bonuses paid to AIG Financial Products employees).

This figure represents the $118 billion Bank of America asset guarantee which, despite preliminary agreement, was never signed. See Congressional Oversight Panel, Quarterly Report to Congress, at 85 (July 7, 2009) (online at cap.senate.gov/documents/cop-070909-report.pdf) (hereinafter "Panel July Report").

This figure represents the $25 billion Treasury has anticipated spending under the CPP, minus the $50 billion investment in Citigroup ($25 billion) and Bank of America ($25 billion) identified above, and the $70.2 billion in repayments that will be reflected as uncommitted TARP funds.

This figure represents the $218 billion Treasury has anticipated spending under the CPP, minus the $50 billion investment in Citigroup ($25 billion) and Bank of America ($25 billion) identified above, and the $70.2 billion in repayments that will be reflected as uncommitted TARP funds.
This figure represents a $20 billion allocation to the TALF SPV on March 3, 2009. July 31 TARP Transactions Report, supra note 104. In previous reports, the Panel had projected TALF funding at a total level of $60 billion, comprising $20 billion in Treasury (TARP) guarantees and $70 billion in Federal Reserve loans. See, e.g., Panel July Report, supra note 104. However, it now appears unlikely that the program will exceed the initial $20 billion funding level. As of August 7, 2009, $41.4 billion had been lent out through the TALF to finance the purchase of ABS. Federal Reserve Bank of New York, Term Asset-Backed Securities Loan Facility—CMBS (accessed August 7, 2009) (online at http://www.newyorkfed.org/markets/TALF recent_operations.html). Federal Reserve Bank of New York, Term Asset-Backed Securities Loan Facility—CMBS (accessed August 7, 2009) (online at http://www.newyorkfed.org/markets/TALF recent_operations.html). While TALF subscriptions are expected to increase due to various factors, including the seasonal nature of student loans, the time required to structure deals related to CMBS (recently made eligible as collateral) under the program, and the financing of PPP legacy securities purchases, it would require an extremely large increase in the rate of TALF subscriptions to surpass the $20 billion currently available by year’s end.

This number derives from the unfunded $11.5 billion ratio of the value of Treasury loan guarantees to the value of Federal Reserve loans under the TALF. See U.S. Department of the Treasury, Fact Sheet: Financial Stability Plan (Feb. 10, 2009) (online at www.financialstability.gov/factsheet.pdf) (describing the initial $75 billion Treasury contribution tied to $75 billion in Federal Reserve loans and announcing potential expansion to a $100 billion Treasury contribution tied to $1 trillion in Federal Reserve loans). Because Treasury is responsible for reimbursing the Federal Reserve Board for $30 billion of losses on its $70 billion in loans, the Federal Reserve Board’s maximum potential exposure under the TALF is $38 billion.

If it now appears unlikely that resources will be expended under the PPP Legacy Loans Program in its original design as a joint Treasury-FDIC program to purchase troubled assets from solvent banks. In June, the FDIC cancelled a pilot scale test of TALF to determine if the program could be conducted under the program’s original design. See Federal Deposit Insurance Corporation, FDIC Statement on the Status of the Legacy Loans Programs (July 22, 2009) (online at www.fdic.gov/news/news/press/2009/pdf/pr20090804.pdf). In July, the FDIC released a report, supra note 2, which outlined its established procedure for selling the assets of failed banks as the Legacy Loans Programs. Federal Deposit Insurance Corporation, Legacy Loans Programs: First Loan Closing (July 30, 2009) (online at www.fdic.gov/news/news/press/2009/pdf/pr20090730.pdf). In recent testimony before the House Committee on Financial Services, FDIC Acting Chairman Daniel J. Tarullo indicated that the TALF does not involve any Treasury participation, and FDIC activity is accounted for here as a component of the FDIC's Deposit Insurance Fund surplus.

U.S. Department of the Treasury, Joint Statement by Secretary Of The Treasury Timothy F. Geithner, Chairman Of The Board Of Governors Of The Federal Reserve System Ben S. Bernanke, And Chairman Of The Federal Deposit Insurance Corporation Sheila Bair (Federal Deposit Insurance Corporation, Fact Sheet: Public-Private Investment Funds, April 7–5 (Mar. 23, 2009) (online at www.federalreserve.gov/newsevents/transcripts/20090323a.htm) "[T]he Treasury will invest up to $30 billion of equity and debt in PPIFs established with private sector fund managers and private investors for the purpose of purchasing legacy securities’’; U.S. Department of the Treasury, Joint Statement by Secretary Of The Treasury Timothy F. Geithner, Chairman Of The Board Of Governors Of The Federal Reserve System Ben S. Bernanke, And Chairman Of The Federal Deposit Insurance Corporation Sheila Bair (July 8, 2009) (online at www.financialstability.gov/latesttg_07082009.htm) ‘‘[T]he Treasury invests up to $30 billion of equity and debt in Troubled Asset Relief Program (TARP) programs invested in public-private investment funds established by Treasury.''

In previous reports, we have noted the operation of the program but have not included it in our accounting, in part because of the uncertainty of the extent of Treasury's exposure. While we now know that Treasury's exposure is $38 billion (versus $720 billion in Federal Reserve loans under the program), the financing of PPP legacy securities purchases, it would require an extremely large increase in the rate of TALF subscriptions to surpass the $20 billion currently available by year’s end.

In response to an inquiry from the Panel, see Letter from Congressional Oversight Panel Chair Elizabeth Warren to Treasury Secretary Timothy F. Geithner (May 26, 2009) (attached as Appendix II, hereinafter ‘‘Treasury MMMF Letter’’). In previous reports, the Panel has suggested that Treasury may fund any losses suffered by the ESF under the program—incurred if payouts on the program guarantees exceed income earned through premiums paid by participants—through the use of the ESF ‘‘from funds under this Act’’ does not permit Treasury to use TARP funds, which are reserved for the purchase or insurance of troubled assets, but instead, by default, directs Treasury to use non-TARP funds made available pursuant to section 118 of EESA, which provides for the ‘‘General Special Revenue Fund’’ to be used for bank recapitalization. Treasury fact sheet, supra note 104. The Treasury has indicated that it believes that it lacks authority to extend the program beyond September 18, 2009, the expiration date of the program under the guarantee agreements.

In general, the TALF in response to market conditions. In September 2008, Treasury opened its Temporary Guarantee Program for Money Mutual Funds, U.S. Department of Treasury, Temporary Guarantee Program for Money Market Mutual Funds, Fact Sheet (Sep. 18, 2008) (online at www.treasury.gov/releases/press/19816.pdf). This program uses assets of the Emergency Stabilization Fund (ESF) to guarantee the net asset value of participating money market mutual funds. Treasury PPIP Fact Sheet, supra note 104.

This figure represents the current maximum aggregate debt guarantees that could be made under the program, which, in turn, is a function of the number and size of individual financial institutions participating. As of September 19, 2008, $339 billion of debt subject to the guarantee has been announced. This figure is based on nearly $2.5 trillion calculated as of September 19, 2008' were participating in the Program as of May 1, 2009. In response to an inquiry from the Panel, see Letter from Congressional Oversight Panel Chair Elizabeth Warren to Treasury Secretary Timothy F. Geithner (May 26, 2009) (attached as Appendix II, hereinafter ‘‘Treasury MMMF Letter’’). In previous reports, the Panel has suggested that Treasury may fund any losses suffered by the ESF under the program—incurred if payouts on the program guarantees exceed income earned through premiums paid by participants—through the use of the ESF ‘‘from funds under this Act’’ does not permit Treasury to use TARP funds, which are reserved for the purchase or insurance of troubled assets, but instead, by default, directs Treasury to use non-TARP funds made available pursuant to section 118 of EESA, which provides for the ‘‘General Special Revenue Fund’’ to be used for bank recapitalization. Treasury fact sheet, supra note 104.

This figure is derived from adding the total credit the Federal Reserve Board has extended as of July 30, 2009 through the Term Auction Facility (Term Auction Credit). Discount Window (Primary Credit), Primary Dealer Credit Facility (Primary Dealer and Other Broker-Dealer Credit), Central Bank Liquidity Swaps, loans outstanding to Bear Stearns (Maiden Lane I LLC), GSE Debt (Federal Agency Debt Securities), Mortgage Backed Securities Issued by GSEs, Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, and Commercial Paper Funding Facility LLC. See Fed Balance Sheet July 30, supra note 104. The level of Federal Reserve lending under these facilities will fluctuate in response to market conditions.

In September 2009, Treasury opened its Temporary Guarantee Program for Money Mutual Funds, U.S. Department of Treasury, Temporary Guaranty Program for Money Market Mutual Funds (Sep. 29, 2009) (online at www.treasury.gov/releases/press/19816.pdf). This program uses assets of the Emergency Stabilization Fund (ESF) to guarantee the net asset value of participating money market mutual funds. At its response to an inquiry from the Panel, see Letter from Congressional Oversight Panel Chair Elizabeth Warren to Treasury Secretary Timothy F. Geithner (May 26, 2009) (attached as Appendix II, hereinafter ‘‘Treasury MMMF Letter’’). In previous reports, the Panel has suggested that Treasury may fund any losses suffered by the ESF under the program—incurred if payouts on the program guarantees exceed income earned through premiums paid by participants—through the use of the ESF ‘‘from funds under this Act’’ does not permit Treasury to use TARP funds, which are reserved for the purchase or insurance of troubled assets, but instead, by default, directs Treasury to use non-TARP funds made available pursuant to section 118 of EESA, which provides for the ‘‘General Special Revenue Fund’’ to be used for bank recapitalization. Treasury fact sheet, supra note 104. The level of Federal Reserve lending under these facilities will fluctuate in response to market conditions.

In previous reports, we have noted the operation of the program but have not included it in our accounting, in part because of the uncertainty of the extent of Treasury's exposure. While we now know that Treasury's exposure is $38 billion (versus $720 billion in Federal Reserve loans under the program), the financing of PPP legacy securities purchases, it would require an extremely large increase in the rate of TALF subscriptions to surpass the $20 billion currently available by year’s end.
SECTION FIVE: OVERSIGHT ACTIVITIES

The Congressional Oversight Panel was established as part of Emergency Economic Stabilization Act (EESA) and formed on November 26, 2008. Since then, the Panel has produced eight oversight reports, as well as a special report on regulatory reform, issued on January 29, 2009, and a special report on farm credit, issued on July 21, 2009. Since the release of the Panel’s July oversight report on warrant valuation, the following developments pertaining to the Panel’s oversight of the Troubled Asset Relief Program (TARP) took place:

• The Panel held a field hearing on July 27, 2009 in Detroit to hear testimony on Treasury’s administration of the Automotive Industry Financing Program. The Panel heard testimony from Ron Bloom, Senior Advisor at the Department of Treasury, Jan Bertsch, Senior Vice President, Treasurer, and Chief Information Officer at Chrysler, Walter Brock, Treasurer at General Motors, Sean McAlinden, Executive Vice President and Chief Economist at the Center for Automotive Research, and Barry Adler, Charles Seligson Professor of Law at the New York University School of Law. Written testimony and audio from the hearing can be found on the Panel’s website at http://cop.senate.gov/hearings/library/hearing–072709–detroithearing.cfm.

• The Helping Families Save Their Homes Act of 2009 (P.L. 111–22), signed into law on May 20, 2009, required the Panel to produce a special report on farm loan restructuring. Specifically, the Panel was asked to analyze the state of the commercial farm credit markets and the use of loan restructuring as an alternative to foreclosure by financial institutions receiving government assistance through TARP. Pursuant to the statute, the Panel released the report on July 21, 2009. A copy of the report can be found on the Panel’s website at http://cop.senate.gov/documents/cop–072109–report.pdf.

• In June, the Panel sent a letters to each of the largest mortgage servicing companies that had not signed a contract to formally participate in the Making Home Affordable foreclosure mitigation program. The letter inquired, among other things, if the servicer intends to participate, how it is handling loan modifications, and what barriers and obstacles might limit participation in the program. The Panel has received a number of responses and is currently reviewing them. This is part of the Panel's continuing oversight of foreclosure mitigation efforts.

Upcoming Reports and Hearings

The Panel will release its next oversight report in September. The report will provide an updated review of TARP activities and continue to assess the program’s overall effectiveness. The report will also examine Treasury’s administration of its Automobile Industry Financing Program, which is funded under TARP.
SECTION SIX: ABOUT THE CONGRESSIONAL OVERSIGHT PANEL

In response to the escalating crisis, on October 3, 2008, Congress provided 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 instructed the Panel to produce a special report on regulatory reform that analyzes “the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers.” The Panel issued this report in January 2009. Congress subsequently expanded the Panel’s mandate by directing it to produce a special report on the availability of credit in the agricultural sector. The report was issued on July 21, 2009.

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.

ACKNOWLEDGEMENTS

The Panel would like to acknowledge SNL Financial for their contribution to the modeling section of this report. The Panel would specially like to acknowledge John-Patrick O’Sullivan, Senior Product Manager, for his time and effort in formulating SNL’s model. Special thanks also to Professor Clayton Rose (Harvard University), Professor Ken Scott (Stanford University), Professor Simon Johnson (Massachusetts Institute of Technology), Professor Tyler Cowen (George Mason University), William M. Issac, Professor Mark Thoma (University of Oregon), Professor John Geanakoplos (Yale University), Professor Luigi Zingales (University of Chicago), Professor Joshua Coval (Harvard University), Nicolas Véron, Professor Peter Cramton (University of Maryland), Professor Lawrence Ausubel (University of Maryland), and Professor Deborah Lucas (Northwestern University) for their thoughts and suggestions.
APPENDIX I: LETTER FROM CHAIR ELIZABETH WARREN TO SECRETARY TIMOTHY GEITHNER AND CHAIRMAN BEN BERNANKE, RE: CONFIDENTIAL MEMORANDA, DATED JULY 20, 2009
July 20, 2009

The Honorable Timothy F. Geithner
Secretary of the Treasury
United States Department of the Treasury
Room 3330
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Messrs. Secretary and Chairman:

The Congressional Oversight Panel has learned that the Federal Reserve Board and the Office of the Comptroller of the Currency have entered into confidential memoranda of understanding involving informal supervisory actions affecting Bank of America and Citigroup.

I am writing to request that you furnish to the Panel copies of any such existing memoranda, as well as copies of any similar future memoranda of understanding executed with Bank of America, Citigroup, or any of the other bank holding companies that were subject to the Supervisory Capital Assessment Program. In addition, I ask you to apprise the Panel of any other confidential agreements relating to risk and liquidity management that Treasury or any of the bank supervisors has or will enter into with any of those bank holding companies.

If necessary, this information will be considered Protected Information, subject to the Panel’s Protocols for the Protection of Potentially Protected Documents Produced, or Whose Contents are Disclosed, to the Congressional Oversight Panel.

The information sought by this letter is necessary for the Congressional Oversight Panel to carry out section 125 of EESA. This information request is made pursuant to section 125(c)(3) of that Act.
I would be happy to answer any questions about this letter that you may have. If you would prefer, a member of your staff can contact the Panel’s Executive Director, Naomi Baum, to discuss any such questions. Ms. Baum’s telephone number is blank.

Sincerely,

[Signature]

Elizabeth Warren
Chair
Congressional Oversight Panel
APPENDIX II: LETTER FROM CHAIR ELIZABETH WARREN TO SECRETARY TIMOTHY GEITHNER, RE: TEMPORARY GUARANTEE PROGRAM FOR MONEY MARKET FUNDS, DATED MAY 26, 2009
May 26, 2009

The Honorable Timothy F. Geithner
Secretary of the Treasury
U.S. Department of the Treasury
Room 3330
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Mr. Secretary:

I am writing to request information about the U.S. Department of the Treasury’s Temporary Guarantee Program for Money Market Funds (Treasury Guarantee Program or the Program), which is funded by the Troubled Asset Relief Program (TARP).

In September 2008, Treasury created the Treasury Guarantee Program in the wake of the Reserve Primary Fund “breaking the buck.”1 The Treasury Guarantee Program uses assets of the Exchange Stabilization Fund (ESF) to guarantee the net asset value of shares of participating money market mutual funds. Participation is restricted to publicly offered money market mutual funds regulated under Rule 2a-7 of the Investment Company Act of 1940 and registered with the Securities and Exchange Commission and is contingent on the payment of a participation fee. While Treasury has publicly released accounting of the amount of fees collected under the Program, it does not appear to have released a detailed accounting of the total value of funds guaranteed under the Program.2

Treasury has stated that “[t]he amount of the Guarantee Payment is dependent on the availability of funds in the Exchange Stabilization Fund,”3 and there is a provision in the standard contract between the Treasury Department and Program participants stipulating that “[t]he Guarantee Payment shall in no event exceed the amount available for payment within the ESF on the Payment Date, as determined by the Treasury in its sole and absolute discretion.”4

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The ESF currently has approximately $50 billion of capital of various liquidities. The Section 131 of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343 (EESA), which was passed after the Program began, protects the ESF from incurring any losses from the Treasury Guarantee Program by requiring that Treasury reimburse the ESF for any funds used in the exercise of the guarantees under the Program. While the Program had an initial term of three months, it has been extended numerous times, most recently through September 18, 2009.

As part of its oversight responsibilities, the Congressional Oversight Panel is monitoring all TARP funding commitments and cash flows. In support of this effort, and in light of the complicated financing arrangements utilized in this particular instance, the Panel requests the following information:

1. The total current and historical value of money market mutual funds participating in the Treasury Guarantee Program;
2. The extent to which the investments in the money market funds that are guaranteed under the Treasury Guarantee Program are also insured or supported by programs initiated by the Federal Reserve in response to the financial crisis and the interplay between these liquidity support and guarantee programs;
3. The extent to which the Treasury Department’s obligations to exercise the guarantees under the Program are mitigated by its discretion to withhold payment when there are inadequate funds in the ESF given its requirement under EESA to refund the ESF when it is depleted;
4. The amount of TARP funds, if any, the Treasury Department has reserved for the possibility of its obligation to pay the guarantees under the Treasury Guarantee Program;
5. The Treasury Department’s position on its legal responsibility to reimburse Program participants in the event that TARP money has been totally expended;
6. Whether the Treasury Department has any plans to extend the program beyond September 18, 2009.

The Panel requests that you provide this information as soon as possible, but not later than Wednesday, June 3, 2009.

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7 See Treasury Program Extension Announcement, supra note 2.
Mr. Timothy F. Geithner  
May 26, 2009  

Page 3

If you have any questions or would like additional information, please contact me or have a member of your staff contact Charlie Honig at [redacted] or [redacted].

Thank you for your attention to this request.

Sincerely,

[Signature]

Elizabeth Warren  
Chair  
Congressional Oversight Panel

Mr. Richard H. Neiman  
Mr. Darnon A. Silvers  
Sen. John E. Sununu
APPENDIX III: 2009 LETTER FROM SECRETARY TIMOTHY GEITHNER IN RESPONSE TO CHAIR ELIZABETH WARREN’S LETTER, RE: TEMPORARY GUARANTEE PROGRAM FOR MONEY MARKET FUNDS, DATED JULY 21, 2009
July 21, 2009

Elizabeth Warren
Chair
Congressional Oversight Panel
732 North Capitol Street, NW
Rooms C-320 and C-617
Mailstop: COP
Washington, DC 20401

Dear Chair Warren:

Thank you for your May 26 letter concerning the funding commitment authorized under the Emergency Economic Stabilization Act (EESA), which authorizes the reimbursement of the Exchange Stabilization Fund (ESF) for any funds used for the Department of the Treasury’s Temporary Guarantee Program for Money Market Funds (“Program”).

As you know, on September 19, 2008, Treasury announced the establishment of a temporary guarantee program for the U.S. money market mutual fund industry. The Program was in response to disruptions experienced following a large money market fund’s announcement that its net asset value had fallen below $1 per share (“broke the buck”) and a run by some investors on other money market funds’ assets.

Detailed answers to each of the specific questions raised in your letter are enclosed. Please let me know if you have any additional questions on this matter.

Sincerely,

Timothy F. Geithner

cc:
Senator John E. Sununu
Representative Jeb Hensarling
Mr. Richard H. Neiman
Mr. Daron A. Silvers
Written Response to Letter from Chair Warren Dated May 26, 2009

(1) The total current and historical value of money market mutual funds participating in the Treasury Guarantee Program.

Answer: Money market funds that applied for participation in the Money Market Program represented over $3.2 trillion of money market assets as of September 19, 2008. Those funds continuing to participate as of May 1, 2009, through the Program's extension period, had an aggregate designated asset base of nearly $2.5 trillion calculated as of September 19, 2008.

(2) The extent to which the investments in the money market funds that are guaranteed under the Treasury Guarantee Program are also insured or supported by programs initiated by the Federal Reserve in response to the financial crisis and the interplay between these liquidity and guarantee programs.

Answer: The Federal Reserve has facilitated temporary support for the money market mutual fund industry and the commercial paper market primarily through its Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF); Commercial Paper Funding Facility (CPFF); and Money Market Investor Funding Facility (MMIFF). The AMLF provides loans to U.S. depository institutions and bank holding companies to finance purchases of asset-backed commercial paper from money market funds. The CPFF provides a special purpose vehicle which purchases three-month unsecured commercial paper and asset backed commercial paper directly from issuers who can then repay commercial paper investors, such as money market funds. Through the MMIFF, the Federal Reserve Bank of New York provides funding to a series of private sector special purpose vehicles to finance the purchase of certain money market instruments from money market funds.

The Federal Reserve facilities that provide support to various aspects of the money market mutual fund industry address fundamental problems with liquidity, which reduces the possibility of triggering a guarantee under the Treasury Department's Money Market Program if money market funds are faced with significant redemption requests. However, unlike the Money Market Program, the Federal Reserve's facilities do not provide any type of guarantee for investors.

(3) The extent to which the Treasury Department's obligations to exercise the guarantees under the Program are mitigated by its discretion to withhold payment when there are inadequate funds in the ESF given its requirement under EESA to refund the ESF when it is depleted.

Answer: Section 1(c) of the Guarantee Agreements between Treasury and the participating money market mutual funds provides that "(t)he Guarantee Payment shall in no event exceed the amount available for payment within the ESF on the Payment Date, as determined by the Treasury in its sole and absolute discretion, which amount may be further adjusted as set forth in Section 2(f)." Section 2(f) provides that in the event multiple requests for Guarantee Payments are received by Treasury on the same business day and exceed the amount available within the ESF, as determined by Treasury in its sole and absolute discretion,
certain requests receive priority (Section 2(f)(A)) and others are paid pro rata (Section 2(f)(B)). Section 131 of the EESA did not alter the terms of the Guarantee Agreements. The amount available for payment within the EST on a given payment date would depend on a number of factors, including when EESA reimbursements of the ESF would become available and the extent to which ESF assets are not subject to other commitments.

(4) The amount of TARP funds, if any, the Treasury Department has reserved for the possibility of its obligation to pay the guarantees under the Treasury Guarantee Program.

**Answer:** Section 115(a) of the EESA limits the authority of the Treasury Secretary to "purchase troubled assets under this Act" to specified amounts. In reimbursing the ESF as required by Section 131, Treasury would not be purchasing or holding troubled assets. Therefore reimbursements of ESF authorized under Section 131 of the EESA are not considered in calculating the limits established by Section 115(a). Accordingly, no amounts have been reserved within the Section 115(a) limits for ESF reimbursement.

Section 131 of the EESA requires that Treasury reimburse the ESF "from funds under this Act." Section 118 of the EESA provides a funding mechanism-- in effect a permanent, indefinite appropriation-- "For the purpose of the authorities granted in this Act..." Because there is no other appropriation under the EESA, "funds under this Act" in Section 131 refers to funds made available under Section 118.

(5) The Treasury Department's position on its legal responsibility to reimburse Program participants in the event that TARP money has been totally expended.

**Answer:** See answer above. It is Treasury's view that funds are sufficiently authorized under Section 118 of the EESA to reimburse the ESF for any guarantee payments under the Program.

(6) Whether the Treasury Department has any plans to extend the program beyond September 18, 2009.

**Answer:** Pursuant to the terms of the Guarantee Agreements, the guarantees and Treasury's payment obligations under the Program terminate on September 18, 2009. The Guarantee Agreements do not provide for further extensions of the guarantees. The EESA prohibits the use of the ESF to fund any future money market guarantee programs.
APPENDIX IV: LETTER FROM CHAIR ELIZABETH WARREN TO SECRETARY TIMOTHY GEITHNER AND CHAIRMAN BEN BERNANKE, RE: BANK OF AMERICA, DATED MAY 19, 2009
May 19, 2009

The Honorable Timothy F. Geithner
Secretary of the Treasury
United States Department of the Treasury
Room 3330
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Secretary Geithner and Chairman Bernanke:

The New York State Attorney General, Andrew Cuomo, has sent a letter, dated April 23, 2009, to Senator Christopher Dodd, the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs; Congressman Barney Frank, the Chairman of the House Financial Services Committee; Mary Schapiro, the Chairman of the U.S. Securities and Exchange Commission; and me, in my capacity as Chair of the Congressional Oversight Panel. The letter asserts that the Department of the Treasury and the Federal Reserve Board intervened to alter the course of the then-pending acquisition of Merrill Lynch by Bank of America (“BoA”).

The assertions have not been established or even subjected to formal challenge. But they still raise a critical policy issue, namely, the proper role of the Treasury and the Board in dealing with individual financial institutions during the administration of the Troubled Asset Relief Program (the “TARP”).

There appears to be no dispute that intense discussions took place among Treasury, the Board, and Kenneth Lewis, the Chairman and CEO of BoA, in December 2008, after BoA’s shareholders had approved the acquisition of Merrill Lynch. The discussions came when Treasury and the Board learned that BoA had concluded that it could, and should, stop the transaction because of Merrill Lynch's deteriorating financial condition. Mr. Lewis has indicated in a statement made under oath to the Attorney General’s investigators that he changed his mind about ending the merger after it was strongly suggested that the government would remove BoA’s Board of Directors and

https://op.senate.gov
senior management if the transaction were terminated, but that if it completed the transaction, BofA would receive additional federal assistance to provide a financial cushion for its taking on Merrill Lynch's liabilities. Treasury had made a $25 billion capital infusion into BofA in October 2008, and it made an additional $20 billion infusion into BofA in January 2009, after the Merrill Lynch acquisition was completed.

The fact and nature of the discussions among the Treasury, the Board, and BofA – whatever their exact content - were disclosed neither to the shareholders of BofA nor to the public, whose tax dollars the TARP spends. But for Attorney General Cuomo, the nondisclosure would continue to this day.

The reaction to these disclosures underscores the importance of clear, timely, communication with the American people, to say nothing of affected investors, about the financial stability package. Unexpected disclosures only increase the perception that the government cannot operate openly in administering the TARP, despite the fact that the country's largest banks are being supported with billions of dollars of public funds.

More important, this interaction among Treasury, the Board, and BofA is a warning of the dangers that can arise when the government acts simultaneously as regulator, lender of last resort, and shareholder. (Treasury had purchased $15 billion in convertible preferred stock and warrants of BofA on October 28, 2008; as indicated above, it purchased an additional $20 billion of BofA preferred stock and warrants on January 16, 2009.) The TARP by its very nature creates conflicts of interest for Treasury and the Board. The conflicts can arise not only when the nation's senior financial officials are faced with decisions by a private institution that they believe would adversely affect the stability plan, but also when they are asked to make regulatory decisions that affect the institutions in which the government holds shares. Federal officials can act effectively under these circumstances only if strict controls, transparency, and a disciplined response to situations at all levels, earn the trust of the financial sector, the investment community, and the public.

The Panel is interested in your thoughts on how to manage this inherent conflict and on the controls you have put in place to ensure that your efforts to provide stability to the country's financial system are not undermined by these conflicts.

Very truly yours,

[Signature]

Elizabeth Warren
Chair
Congressional Oversight Panel
APPENDIX V: 2009 LETTER FROM SECRETARY TIMOTHY GEITHNER IN RESPONSE TO CHAIR ELIZABETH WARREN'S LETTER, RE: BANK OF AMERICA, DATED JULY 21, 2009
July 21, 2009

Elizabeth Warren
Chair
Congressional Oversight Panel
732 North Capitol Street, NW
Rooms C-320 and C-617
Mailstop: COP
Washington, DC 20401

Dear Chair Warren:

Thank you for your letter dated May 19 regarding the role of the Department of the Treasury (Treasury) as it relates to financial institutions that participate in the Troubled Assets Relief Program.

As I have said before with respect to Treasury’s relationship with financial institutions in which it holds a financial interest, Treasury is a reluctant shareholder. While the investments made under the Emergency Economic Stabilization Act were necessary during this extraordinary financial crisis, Treasury has taken the view that taxpayer interests will be best protected by minimizing the extent of government involvement in the management of such firms.

On May 31, the Obama Administration announced four core principles that will guide Treasury’s management of its equity and other financial interests in private firms. Articulated in the context of our announcement concerning the restructuring of General Motors, these principles guide the U.S. government’s management of financial interests in private firms generally.

These principles include the commitment that, although the government reserves the right to set upfront conditions to protect taxpayers and promote financial stability, the government will manage its financial interests in a hands-off, commercial manner. Specifically, the government will not interfere with or exert control over day-to-day company operations and, in the event the government obtains ownership interests, it will only vote on core governance issues, including the selection of a company’s board of directors and major corporate events or transactions. These principles also include Treasury’s commitment to seek to dispose of its ownership interests as soon as practicable.
I share your views regarding the importance of clear, timely communication with the American people about Treasury’s financial stability programs. Over the last few months, Treasury has launched a reinvigorated communications initiative including the launch of FinancialStability.gov in March. This new website details each of our programs in a straightforward manner, lists how taxpayer dollars are being spent, and provide data on the effectiveness of our programs. My April 15, 2009 letter further outlined other measures we have taken to promote transparency and clear communication both to the American public and to Congress.

I believe the approach and principles outlined here will help ensure that Treasury appropriately manages any potential conflicts of interest that might arise as a result of the government’s position as a shareholder in private firms.

Thank you again for your letter. We are constantly working to create a financial system that will support recovery and to reduce the risk of a future financial crises. I look forward to working with you and the Panel as we seek to achieve these goals.

Sincerely,

Timothy F. Geithner

Enclosure

cc: Rep. Jeb Hensarling
    Sen. John E. Sununu
    Mr. Richard H. Neiman
    Mr. Damon A. Silvers
U.S. TREASURY DEPARTMENT
OFFICE OF PUBLIC AFFAIRS

Sunday, May 31, 2009
EMBARGOED Until 10:00 PM EDT

FACT SHEET: Obama Administration Auto Restructuring Initiative
General Motors Restructuring

On March 30, 2009, President Obama laid out a framework for General Motors to achieve viability that required the Company to rework its business plan, accelerate its operational restructuring and make far greater reductions in its outstanding liabilities. After two months of significant management engagement, General Motors has developed such a plan and has already begun to make progress toward its achievement. The Company has also secured commitments of meaningful sacrifice from all of its major stakeholder groups, sacrifices sufficient for this plan to proceed forward. As a result, the President has deemed GM’s plan viable and will be making available about $30 billion of additional federal assistance to support GM’s restructuring plan. To effectuate its plan, General Motors will use Section 363 of the bankruptcy code to clear away the remaining impediments to its successful re-launch.

For the better part of a century, The General Motors Corporation has been one of the most recognizable and largest businesses in the world. Today will rank as another historic day for the company—the end of an old General Motors, and the beginning of a new one.

General Motors Restructuring – Shared Sacrifice

The President made clear throughout this process that every one of the Company’s stakeholder would be expected to sacrifice, and that none would receive special treatment because of the involvement of the government. The resulting agreement is tough but fair, and has garnered broad support from GM’s major stakeholders:

• Operational restructuring: GM is undertaking a significant operational restructuring that will address past failures, dramatically improve its overall cost structure, and allow the company to move toward profitability even if the auto market recovers slowly. As a result of this restructuring, GM will lower its breakeven point to a 10 million annual car sales
environment. Before the restructuring, GM’s breakeven point was in excess of 16 million annual car sales.

- *The UAW has made important concessions on compensation and retiree health care that, while difficult, will help save jobs for active employees, pensions and health care for retirees, and make GM more competitive.* In virtually every respect, the concessions that the UAW agreed to are more aggressive than what the Bush Administration originally demanded in its loan agreement with GM. Among other things, the UAW’s existing VEBAs - to which GM has a $20bn obligation - will be replaced by a new VEBAs as described below.

- *The Steering Committee to a portion of GM bondholders has confirmed that bondholders representing at least 34% of GM’s unsecured bonds have agreed to exchange their portion of the Company’s $27.1 billion unsecured debt for their pro-rata share of 10% of the equity of new GM, plus warrants for an additional 15% of the new Company.* The Steering Committee confirms that the number of individual and institutional bondholders that support this deal is now over 1,000. The bankruptcy court process will be used to confirm this treatment for those bondholders and other unsecured creditors that failed to accept or did not participate in the offer that was accepted by the aforementioned majority.

- *Painful but necessary restructuring steps will also be implemented.* In order to size GM’s footprint to its current share but also allow for volume growth when the economy and the automotive market rebound, GM has planned to reduce its plant operations. Today GM is announcing its intention to close 11 facilities and idle another 3 facilities.

**Details on the Creation of New GM:**

The newly organized GM will purchase substantially all of the assets of the old GM needed to implement its business plan out of a chapter 11 in exchange for the U.S. Government relinquishing the majority of its loans to GM.

- *This new GM will establish an independent trust (VEBA) that will provide health care benefits for GM’s retirees.* The VEBA will be funded by a note of $2.5 billion payable in three installments ending in 2017 and $6.5 billion in 9% perpetual preferred stock. The VEBA will also receive 17.5% of the equity of New GM and warrants to purchase an additional 2.5% of the company. The VEBA will have the right to select one independent director and will have no right to vote its shares or other governance rights.

- *The GM qualified pension plans for both hourly and salaried employees will be transferred to the New GM as part of the purchase process.*

- *The U.S. Treasury is prepared to provide approximately $30.1 billion of financing to support GM through an expedited chapter 11 proceeding and transition the new GM through its restructuring plan.* The U.S. Treasury does not anticipate providing any additional assistance to GM beyond this commitment. In exchange for funds already committed by the U.S. Treasury and the new injection of $30.1 billion, the U.S. government will receive approximately $8.8 billion in debt and preferred stock in the new GM and approximately 60% of the equity of the new GM. The U.S. Treasury will also have the right to appoint the
initial directors other than those that will be selected by the VEBA and the Canadian government.

- The Governments of Canada and Ontario will participate alongside the U.S. Treasury by lending $9.5 billion to GM and New GM. The Canadian and Ontario governments will receive approximately $1.7 billion in debt and preferred stock, and approximately 12% of the equity of the new GM. Based on its substantial financial contribution, the Canadian government will also have the right to select one initial director.

- Based on these steps, the new GM will have far less debt and a world class balance sheet. This will allow the company the financial stability to weather future market downturns and generate significant excess free cash flow to invest in the business.

- The new GM will also pursue a commitment to build a new small car in an ideal UAW factory, which when in place will increase the share of U.S. production for U.S. sale from its current level of about 65% to over 70%.

Principles for Managing Ownership Stake

Consistent with the goal of clearly limiting the government’s role as a reluctant equity owner but careful steward of taxpayer resources, the Obama Administration has established four core principles that will guide the government’s management of ownership interests in private firms. These principles will apply to the U.S. government’s equity stake in GM:

- The government has no desire to own equity stakes in companies any longer than necessary, and will seek to dispose of its ownership interests as soon as practicable. Our goal is to promote strong and viable companies that can quickly be profitable and con tribute to economic growth and jobs without government involvement.

- In exceptional cases where the U.S. government feels it is necessary to respond to a company’s request for substantial assistance, the government will reserve the right to set upfront conditions to protect taxpayers, promote financial stability and encourage growth. When necessary, these conditions may include restructurings similar to that now underway at GM as well as changes to ensure a strong board of directors that selects management with a sound long-term vision to restore their companies to profitability and to end the need for government support as quickly as is practically feasible.

- After any upfront conditions are in place, the government will protect the taxpayers’ investment by managing its ownership stake in a hands-off, commercial manner. The government will not interfere with or exert control over day-to-day company operations. No government employees will serve on the boards or be employed by these companies.

- As a common shareholder, the government will only vote on core governance issues, including the selection of a company’s board of directors and major corporate events or transactions. While protecting taxpayer resources, the government intends to be extremely disciplined as to how it intends to use even these limited rights.


Warrantees:

- GM will continue to honor consumer warranties. This past week, the U.S. Treasury made available the Warranty Support Program to GM and $361 million was funded to a special vehicle available to provide a backstop on the orderly payment of warranties for cars sold during this restructuring period.

The Bankruptcy Process

During this process, GM will continue operating in the ordinary course. From an operating perspective, the day after the filing will not be materially different from the day before the filing. The following parties will be treated as described below:

- **Employees:** Employees will get paid in the ordinary course, including salary, wages and ordinary benefits. Assuming the sale moves forward as expected, Pension Plan and VEBA funding will be transferred to New GM.

- **Suppliers:** GM will seek authority at its “first day” hearing to continue to pay suppliers in the ordinary course. In addition, the U.S. Treasury’s Supplier Support Program will continue to operate, and GM suppliers benefiting from the program will continue to receive that support.

- **Dealers:** GM will seek authority at its “first day” hearing to honor its customer warranties in the ordinary course. Moreover, GM will seek to continue to honor its dealer incentives for those dealers who are expected to continue to be part of GM’s distribution network going forward. There are some dealers that GM has identified that will not continue with GM. It is expected that the terminated dealers will be offered an agreement to orderly wind down their operations over the next 18 months.

- **UAW:** The modified labor agreement reached between the UAW and GM will be operative and will be assumed by the New GM.

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APPENDIX VI: LETTER FROM CHAIR ELIZABETH WARREN AND PANEL MEMBER RICHARD NEIMAN TO SECRETARY TIMOTHY GIEITHNER, RE: FORECLOSURE DATA, DATED JUNE 29, 2009
June 29, 2009

The Honorable Timothy F. Geithner
Secretary of the Treasury
United States Department of the Treasury
Room 3330
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Dear Mr. Secretary:

On behalf of the Congressional Oversight Panel (Panel), I am writing to request your assistance with the Panel’s oversight of federal foreclosure mitigation efforts. I am joined in this request by Panel member Richard Neiman, who has led the Panel’s efforts on this issue.

The Panel was created pursuant to section 125 of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343 (EESA). EESA expressly vested the Panel with broad oversight authority and duties, including the requirement to make regular reports to Congress on the effectiveness of foreclosure-mitigation efforts.

As you are aware, on February 18, 2009, President Obama announced the Making Home Affordable (MHA) program, intended to prevent unnecessary foreclosures and strengthen affected communities. As noted in the Panel’s March oversight report entitled Foreclosure Crisis: Working Towards a Solution, inadequate mortgage market data has hampered policy decisions. The report specifically noted the need for federal data collection going forward. You are to be commended for including data collection requirements for loans participating in MHA.

As part of its ongoing effort to evaluate the effectiveness of foreclosure mitigation efforts, the Panel requests copies of the data collected under the MHA program, as well as relevant reports. The panel would appreciate receiving this information on July 31, 2009, as well as the end of every subsequent month.

The information sought by this letter is necessary for the Panel to carry out section 125 of EESA. This information request is made pursuant to section 125(c)(3) of that Act.
Thank you for your attention to this matter. If you have any questions or would like additional information, please contact me or have a member of your staff contact Tewana Wilkerson at [Redacted].

Sincerely,

[Signature]

Elizabeth Warren
Chair
Congressional Oversight Panel

Cc:
Rep. Jeb Hensarling
Sen. John E. Sununu
Mr. Richard H. Neiman
Mr. Damon A. Silvers
APPENDIX VII: LETTER FROM ASSISTANT SECRETARY HERBERT ALLISON IN RESPONSE TO CHAIR ELIZABETH WARREN'S LETTER, RE: FORECLOSURE DATA, DATED JULY 29, 2009
July 29, 2009

Elizabeth Warren, Chair
Congressional Oversight Panel
732 N. Capitol Street, N.W.
Room C-320
Washington, DC 20401

Dear Ms. Warren:

Thank you for your June 29 letter requesting copies of the data and relevant reports collected under the Making Home Affordable (MHA) program. We understand from a subsequent conversation with Tewana Wilkerson, the Panel’s contact person for this request, that the request for data does not include personally identifiable information such as a borrower’s name, address, or Social Security Number.

It is important to us that we provide the Panel with the information it needs, and we plan to work with the Panel to ensure that your request is met in full. The Department of the Treasury’s contacts for this matter are Bruce Turner and Jay Warden. They will contact Tewana Wilkerson to work out the detailed process needed to allow data access and report distribution.

Sincerely,

Herbert M. Allison, Jr.
Assistant Secretary for Financial Stability