

Yale University

EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Documents

[Browse by Media Type](#)

3-4-2010

Written Testimony of Herbert M. Allison, Jr., Assistant Secretary for Financial Stability Before the Congressional Oversight Panel

United States: Congress: Congressional Oversight Panel (COP)

Herbert M. Allison, Jr.

Follow this and additional works at: <https://elischolar.library.yale.edu/ypfs-documents>

Recommended Citation

United States: Congress: Congressional Oversight Panel (COP) and Allison, Jr., Herbert M., "Written Testimony of Herbert M. Allison, Jr., Assistant Secretary for Financial Stability Before the Congressional Oversight Panel" (2010). *YPFS Documents*. 3733.

<https://elischolar.library.yale.edu/ypfs-documents/3733>

This Document is brought to you for free and open access by the Browse by Media Type at EliScholar – A Digital Platform for Scholarly Publishing at Yale. It has been accepted for inclusion in YPFS Documents by an authorized administrator of EliScholar – A Digital Platform for Scholarly Publishing at Yale. For more information, please contact elischolar@yale.edu.

**Written Testimony of Herbert M. Allison, Jr.,
Assistant Secretary for Financial Stability
Before the Congressional Oversight Panel
March 4, 2010**

Thank you Chair Warren and members Silvers, Neiman, Atkins and McWatters, for the opportunity to testify before you today.

You have asked me to discuss our investments in Citigroup. I will also discuss the Treasury Department's reasons for making these investments and its strategy for exiting these investments.

In mid-September 2008, the nation was in the midst of one of the worst crises in our financial history. The economy was contracting sharply. Fear of a possible depression froze markets. Immediate, strong action was needed to avoid a complete collapse of the financial system. Treasury, the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and other U.S. government bodies undertook an array of unprecedented steps to avert a collapse and the dangers posed to consumers, businesses, and the broader economy. However, additional resources and authorities were needed to help address the severe conditions our nation faced.

Recognizing the need to take difficult but necessary action to confront a financial system on the verge of collapse, Congress enacted the Emergency Economic Stabilization Act of 2008 (EESA) and granted Treasury authority to restore liquidity and stability to the U.S. financial system by purchasing and guaranteeing troubled assets in a wide range of financial institutions.

It was in this context that the U.S. government invested significant amounts of capital for the purpose of stabilizing the financial system and preventing an economic catastrophe. As a component of its capital program, the U.S. government invested a total of \$45 billion in Citigroup under the EESA. This consisted of \$25 billion under the Capital Purchase Program (CPP) and \$20 billion in exceptional assistance under the Targeted Investment Program (TIP). In addition, the U.S. government agreed to share losses on a portfolio of approximately \$301 billion of Citigroup assets under the Asset Guarantee Program (AGP).

Many people questioned these actions at the time. Some asked why Treasury made an investment in 2008 under the CPP only to make an additional investment in Citigroup one month later. Many doubted whether the government would ever be repaid in full. Indeed, in the Congressional Oversight Panel's February 2009 Oversight Report (Valuing Treasury's Acquisitions), Treasury's CPP investment in Citigroup was valued at 57-67% of face value and its TIP investment was valued at 41-59% of face value.

Today, Citigroup has repaid the \$20 billion in exceptional assistance, and the taxpayer has earned a positive return on this investment. The \$25 billion CPP investment has a

current market value which also suggests a positive return—although this valuation could change based on changes in the price of Citigroup’s common stock. The government’s contingent liability for the asset guarantee has been terminated. There was no loss to the government and there has been a positive return to the taxpayer from this guarantee. Additionally, in December Treasury announced that it expected to sell the Citigroup common shares it holds over the following 12 months.

Now, we will review in more detail the history of Treasury’s investments in Citigroup.

Citigroup’s participation in TARP Programs

Capital Purchase Program

Under the authorities granted by EESA, Treasury made investments in preferred stock of Citigroup. Citigroup was included in the first group of participants in the CPP, the primary program established by the prior Administration pursuant to the Troubled Asset Relief Program (TARP) established under EESA. Through this program, Treasury strengthened the capital base of our financial system. Treasury ultimately invested \$205 billion in more than 700 institutions under the CPP, including almost all of the nation’s largest financial institutions as well as hundreds of smaller ones. This program was essential to averting a collapse of our financial system, as has now been acknowledged by many, including this Panel in its December 2009 report.

CPP investment amounts were determined by the size of the bank – no less than one percent and no greater than three percent (five percent for small banks) of the recipient’s risk-weighted assets could be invested, with a maximum possible investment of \$25 billion. Treasury invested \$25 billion in Citigroup in October 2008. In return for its investments under the CPP, Treasury received nonvoting preferred stock that paid an annual dividend of 5% for the first five years. Treasury also received warrants to purchase common stock.

Targeted Investment Program and Asset Guarantee Program

In November 2008, Treasury announced further assistance to Citigroup under the TIP and the Asset Guarantee Program (AGP). TIP and AGP were targeted programs designed to stabilize the financial system by providing additional assistance to institutions, such as Citigroup, that were facing particular difficulties. Under the TIP, Treasury invested \$20 billion in Citigroup in return for additional preferred stock paying an 8% dividend. Under the AGP, Treasury, the FDIC, and the Federal Reserve agreed to share losses on a portfolio of \$301 billion of loans, mortgage-backed securities, and other financial assets held by Citigroup, with Treasury’s loss share capped at \$5 billion. Treasury and the FDIC received a fee consisting of preferred stock paying an 8% dividend in return for their commitments and the Federal Reserve was to be paid a fee if its commitment to back up the guarantee with a non-recourse loan was called. Treasury received additional warrants for common stock in both transactions.

Some have questioned why Treasury agreed to invest in Citigroup under the CPP only to have to commit to provide additional assistance less than two months later. When considering this question, it is important to keep in mind the extraordinary circumstances of the fall of 2008. The government was taking a variety of unprecedented actions to contain the crisis, allay the fears of the markets and stabilize the system. Yet the depth of the crisis, the measures needed to address it, and the effects of taking any particular action could not be predicted, since the nation had never faced similar circumstances. In particular, although the announcement of the initial investments under the CPP was well received, the outlook for the U.S. economy and Citigroup continued to deteriorate in subsequent weeks. For example, while the CDS spread on 10 year senior Citigroup debt fell from 354 basis points on October 13, 2008 – the day before the announcement of Treasury’s CPP investment – to 161 basis points the following day, the spread was back up to 378 basis points on November 21, 2008 – the last trading day before the announcement of Citigroup’s TIP and AGP assistance. At the same time, broader measures of risk throughout the financial system were also highly unstable. The VIX Volatility Index fell from 70 on October 10, to 55 on October 14, but was back up to 73 on November 21. Due to the deterioration in confidence, there was concern that, without government assistance, Citigroup would not be able to obtain sufficient funding in the market over the following days.

As the Federal Reserve has observed, a failure to act to reestablish confidence in Citigroup by providing additional liquidity and an asset guarantee program would have had a significant adverse effect on U.S. and global financial markets. A further deterioration of Citigroup would have led investors to doubt the ability and willingness of U.S. policymakers to support U.S. banking institutions and financial markets – notwithstanding Treasury’s recent CPP investments. Investors would have been concerned about direct exposures of other financial firms to Citigroup, and might have begun to doubt the financial strength of other large U.S. financial institutions that might be seen as similarly situated – likely weakening overall confidence in U.S. commercial banks. More generally, given Citigroup’s substantial international presence, global liquidity pressures would likely have increased and confidence in U.S. assets more broadly could have declined. All of these effects would likely have led to a much greater worsening of the global financial and economic turmoil. In light of these extraordinary risks, and keeping in mind the corrosive and damaging uncertainty at the time, Treasury believes that its actions were warranted and necessary.

The Stress Test and Citigroup’s Recapitalization Plan

The Obama Administration took office in the midst of a deep recession. The Administration confronted this situation with a comprehensive plan to get credit flowing again, which included bringing together the government agencies with authority over our nation's major banks to initiate an intensive forward-looking assessment about the risk on banks’ balance sheets in adverse conditions.

Therefore, a key component of the Financial Stability Plan was the stress test. Treasury worked with the Federal banking agencies to design a one-time, forward-looking

assessment – known as the Supervisory Capital Assessment Program (SCAP) – on the nineteen largest U.S. bank holding companies. Federal banking supervisors conducted these assessments to estimate the amount of capital banks would need to absorb losses in a more adverse economic scenario and to provide the transparency necessary for individuals and markets to judge the strength of the banking system. Results of the stress tests were released on May 7, 2009. As a consequence of the SCAP, the banking agencies concluded that Citigroup needed to raise an additional \$5.5 billion in capital to establish a buffer of protection against the more severely adverse conditions that might result if the deterioration in economic conditions exceeded predictions.

In February 2009, Citigroup announced a recapitalization plan to strengthen its capital base. In response to its SCAP requirements, Citigroup announced the expansion of this plan by an additional \$5.5 billion. In the summer of 2009, Citigroup completed the recapitalization plan. Treasury exchanged the preferred stock received under AGP and TIP for an equivalent amount of trust preferred securities, which are senior in right of repayment to preferred stock but otherwise have many similar terms, and exchanged the preferred stock received under CPP for approximately 7.7 billion shares of Citigroup common stock at an exchange rate \$3.25 of per share.

TIP Repayment and AGP Termination

As you know, amendments made to EESA by the American Recovery and Reinvestment Act of 2009 require Treasury to permit a recipient of TARP assistance to repay that assistance subject to consultation with the appropriate Federal banking agency. In December of 2009, the Federal Reserve agreed to allow Citigroup to repay part of the TARP assistance it received and terminate the AGP, provided that Citigroup raised an acceptable amount of private capital to replace the government assistance. The capital plan included (i) raising approximately \$20 billion in the private market through the issuance of common shares and tangible equity units that will convert into common stock and (ii) providing \$1.7 billion in 2009 compensation to its employees in the form of common stock or a common stock equivalent rather than cash. On December 22, 2009, Citigroup completed the offerings of common stock and tangible equity units, and the next day it repurchased the \$20 billion of TIP trust preferred securities. Treasury, the FDIC, the Federal Reserve Bank of New York and Citigroup agreed to terminate Treasury's guarantee commitment. In consideration for early termination of the guarantee, Treasury and the FDIC agreed with Citigroup that they would keep \$5.2 billion of the \$7 billion of Citigroup trust preferred securities issued under the AGP.

As I've mentioned, the government incurred no losses under the AGP, and has made a positive return on the premium Citigroup paid for this ten-year insurance. As a result, Treasury will realize a positive return on both the TIP investment and the asset guarantee. Treasury has earned \$2.8 billion in dividends as of December 2009 on these investments and will realize additional returns on sale of the remaining trust preferred securities as well as the warrants.

Some have questioned whether Citigroup should have been allowed to repay Treasury.

As noted above, Treasury cannot refuse repayment if the regulator approves it. But more importantly, Treasury believes replacing taxpayer dollars with private capital is exactly what it should be doing. TARP has provided the temporary support that has stabilized the financial system. Banks are now more able to access the equity markets. To date, Treasury has received \$170 billion in TARP repayments and large banks have raised more than \$140 billion in private capital since the SCAP results were released. Citigroup's capital levels have improved since fall 2008. Citigroup's Tier 1 Common Ratio as of September 30, 2008 was 3.7% - as of December 31, 2009, it was 9.8%.

In addition, it should be remembered that the existing shareholders have been substantially diluted as a result of both the government's actions, the recapitalization and the offering. The existing shareholders of Citigroup have seen their interests diluted by more than 80% since 2008, and now own less than 20% of the firm. Today, Treasury holds more than 27% of the common stock of Citigroup.

Treasury's Current Holdings; Exit Strategy

The U.S. government is a shareholder reluctantly and out of necessity. The TARP investments were not made to make money but to help avert a collapse of our financial system. Because financial conditions have started to improve, Treasury is winding down TARP programs that helped put large banks on a sounder footing, and these institutions have begun exiting from these investments. Treasury wants these institutions to exit these investments, and return TARP funds to Treasury, as soon as permitted under EESA.

Based on current market valuations, Treasury's current holdings from the original \$25 billion CPP investment would represent a positive return. If Treasury were able to sell all its Citigroup common shares at the current market price, taxpayers would realize a positive return on this CPP investment. I should also note that if Treasury were to incur a loss on its investment, the Administration's proposed Financial Crisis Responsibility Fee, if enacted, would ensure that every penny of taxpayer assistance from TARP is paid by large financial institutions and the cost of the rescue to taxpayers is zero.

Conclusion – Successes and Need for Financial Reform

Treasury and other institutions of government have accomplished a great deal in a short amount of time to stabilize the financial system, a necessary precondition to the resumption of economic growth. Action taken by Treasury, the Federal Reserve, the FDIC, and other government agencies averted a catastrophic collapse of our financial system, which is far stronger today than it was a year ago. But the key question is: how does Treasury avoid having to provide assistance to institutions like Citigroup again?

Today, the financial system is operating under the same rules that led to its near-collapse and to this deep recession. These rules must be changed to address the moral hazard posed by large, interconnected financial institutions considered "too big to fail." The Administration has proposed comprehensive financial reforms that seek to address this

moral hazard by forcing these institutions to internalize the risks they impose on our financial system and to remove expectations of government support.

First, the government needs the ability to limit risk-taking by institutions that threaten the overall stability of the system and can cause extraordinary damage to the American economy. Under the Administration's proposals, major financial firms would be required to report regularly to supervisors the nature and extent to which other major financial firms are exposed to it, as well as firm-wide risk concentrations, so that the government can identify firms whose failure could pose a threat to overall financial stability and our economy. Major financial firms would be subject to more stringent capital requirements, tough new liquidity requirements, and constraints on interconnectedness with other major firms. Higher levels and quality of capital would be required for all banking firms. To prevent the emergence of firms whose relative size alone could pose a threat to financial stability, the proposals supplement the existing cap on insured deposit concentration with a broader cap that would apply to all categories of liabilities for the largest financial firms. And, to ensure that the taxpayer-backed safety net for banking firms is not extended to high-risk activities unrelated to the core business of banking, banking firms would be prohibited from engaging in proprietary trading—trading for the banking firm's own account and not in connection with client business—and from investing in or sponsoring hedge funds and private equity funds.

Second, the government must have the ability to seize and wind down failing major financial institutions in an orderly manner, minimizing the company's risk to our financial system, economy, and taxpayers. The Administration's proposals provide this resolution authority, subject to strict governance and control procedures, with losses absorbed not by taxpayers but by equity holders, unsecured creditors and, if necessary, through a fee on other major financial institutions, similar to the Financial Crisis Responsibility Fee.

As we look ahead, we must not forget the lessons we have learned from this period. We need to reform our nation's laws to provide stronger, more effective regulation of our financial system and to protect consumers. Doing so will decrease the need for future intervention. Reforming our regulatory system in a way that is stronger and better suited to manage risk and ensure safety and soundness must be our highest priority.

Thank you.