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Testimony of Damon A. Silvers

Deputy Chairman

Congressional Oversight Panel

"TARP Accountability and Oversight: Achieving Transparency"

Joint Economic Committee

United States Congress

March 11, 2009

Good morning. I am Damon Silvers, and I am the Deputy Chair of the Congressional Oversight Panel. I am also Associate General Counsel of the AFL-CIO. I would like to express my thanks to the Chair, Representative Maloney, for inviting me to appear today before the Committee. I should note at the outset that my testimony today is mine alone, and does not necessarily reflect the views of the Congressional Oversight Panel as a whole, its staff, or its Chair, Professor Elizabeth Warren.

I am going to speak briefly about the general role of the Congressional Oversight Panel, and then address the Panel's work in valuing the preferred stock purchased by the Treasury Department under the TARP. My fellow Panel member Richard Neiman will focus his testimony on our most recent report on the mortgage crisis.

The Congressional Oversight Panel was created as part of the TARP in last year's Emergency Economic Stabilization Act ("EESA"). The job of the Panel is to "review the current state of the financial markets and the financial regulatory system" and report to Congress every 30 days. The Panel has submitted reports to Congress on December 10, January 9, and February 6, and March 6, and is beginning now to prepare its fifth report for early April. The Panel also submitted a special report on regulatory reform to Congress, as required by the legislation, at the end of January.

The Oversight Panel is one of three organizations to which the TARP legislation gives oversight responsibilities: the Panel, the Special Inspector General, and the GAO. The Special Inspector General for the TARP has a broad responsibility, and matching authority, to audit and investigate any part of the Program. GAO is given an even more detailed set of instructions for "ongoing oversight of the activities and performance of the TARP," as well as responsibility for an annual audit of the TARP's financial statements. Panel staff meets regularly with IG staff and with GAO staff assigned to TARP in an effort to see that we are coordinated and that the results of our efforts are more than the sum of our parts. The Oversight Panel sees our role in this landscape as oriented toward broad policy considerations. In the Emergency Economic Stabilization Act, Congress specifically asked that the Oversight Panel conduct oversight on: the use of Treasury authority under the TARP; the Program's effect on the financial markets, financial

institutions, and market transparency; the effectiveness of foreclosure mitigation efforts; and the TARP's effectiveness in minimizing long-term costs and maximizing long-term benefits for the nation's taxpayers. Our ultimate question is whether the TARP is operating to benefit the American family and the American economy.

The Panel began our work in our first report issued in December by asking ten basic questions about TARP—starting with the question, "what is Treasury's strategy?," and including the question,"(i)s the public receiving a fair deal?" This first report had one substantive recommendation-- that "the public has a right to know how financial institutions that have received public money are using that money" and "that Treasury should be responsible for holding individual institutions accountable for how they use the public's money." While the Treasury Department has committed to the concept of tracking the use of TARP money in principle, the specific plans for doing so have not been released.

In asking these questions, we were influenced by statements by then Treasury Secretary Henry Paulsen at the time of the first nine major TARP transactions that "(t)his is an investment, not an expenditure, and there is no reason to expect this program will cost taxpayers anything." [1]

The Panel recognized in asking these questions that they raised complex issues, and that the answers would be multilayered. However, we thought it was not possible to begin to answer questions like "did the public get a fair deal," without understanding exactly what deal the public did get in the transactions completed under TARP last year.

The Panel sought the advice of leading valuation experts, and concluded that the way to ask the question "what did the public get" was to ask what was the value of the preferred stock purchased by the Treasury on the date it was purchased, based on the prices of related securities and based on transactions undertaken by the TARP recipient institutions with private parties. The Panel did a search for valuation firms that had minimal conflicts and the requisite expertise and resources to undertake this task, and we retained Duff and Phelps, the world's largest specialty valuation firm. Duff and Phelps were supervised by a team of experts consisting of Adam M. Blumenthal, Managing Partner in Blue Wolf Capital Management and the former Deputy Comptroller of New York City, William N. Goetzmann, the Edwin J. Beinecke Professor of Finance and Management Studies and the Director of the International Center for Finance at the Yale School of Management, and Deborah J. Lucas, Donald C. Clarke HSBC Professor of Consumer Finance at the Kellogg School of Management at Northwestern University and the former Chief Economist of the Congressional Budget Office.

In parallel, the Panel engaged a legal team with experience in both bank rescues and preferred stock transactions to review the legal terms of the TARP transactions. The Panel sought to compare those terms with the terms obtained by private parties during the

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

same period, the terms typically obtained by private parties making preferred stock investments, and the terms obtained by the British government during its parallel efforts to support its banking system during the last quarter of 2008. The legal effort was led by Catherina Celosse, an attorney formerly with the firm of Davis Polk and Wardwell, with experience representing the Indonesian government during the Indonesian bank crisis, and Timothy Massad, a senior partner at Cravath, Swaine and Moore who took a leave to assist the Panel on a pro bono basis.

The valuation and legal analysis had a limited purpose—to understand and place before the public the extent to which the TARP transactions had been investments that obtained fair value for the taxpayer, and the extent to which they were subsidies to the recipient banks and their shareholders. We did not attempt to answer the question of whether subsidies were a good idea or a bad idea—whether the TARP transactions created public benefit that made them worthwhile, or whether that same public benefit could have been created without the subsidy. The Panel continues to do work in the area of trying to formulate ways of answering these much more complicated and vitally important questions.

Duff and Phelps used three methods of valuing the preferred stock—(1) a discounted cash flow methods, where the likely payments over time are discounted at a rate reflecting the risks of not receiving those payments derived from market yields, (2) a discounted cash flow analysis where the likely payments over time are discounted based on survival probabilities derived from Credit Default Swap spreads, and (3) a contingent claims method, that treated the preferred stock as a claim against the assets of the TARP firms, a claim whose value is determined by the volatility of those assets, much as the price of an option does. Duff and Phelps then looked for the convergence of the values derived from each method to set a valuation range for each security.

Duff and Phelps looked at each of the ten initial major TARP investments separately, and the 700 plus page report they provided the Panel contains a detailed analysis of the market conditions associated with each major recipient bank at the time of the transaction. Duff and Phelps also examined each feature of the preferred stock designed by Treasury, including the impact of several options embedded within the terms of the security.

Duff and Phelps found that the 2008 TARP transactions ranged from preferred stock purchases that delivered close to full value to the government in the case of the strongest banks at the time (5% and 7% discounts in the case of U.S. Bancorp and Wells Fargo), to purchases that at the time they were made delivered less than 50% or less of their face value to the government in the case of the purchase of AIG preferred stock and the second purchase of Citigroup preferred stock in November 2008.

I should emphasize here that the Panel's findings reflected the value of the preferred stock Treasury purchased on the date the transactions were announced. We have not attempted to value these securities on an ongoing basis, but it seems very likely that they

have declined in value since then, and in the case of Citigroup and Bank of America, declined precipitously.

Duff and Phelps found that by comparison, private parties received somewhat better deals. Mitsubishi obtained essentially 88-94% of face value for its investment in Morgan Stanley, compared to 58% for the Treasury Department's investment in the same firm. Warren Buffett, not surprisingly, was able to get above market value (108-112%) for his investment in Goldman Sachs, while Treasury's investment in Goldman Sachs was worth 75% of what Treasury paid for it on the transaction date.

The Panel found that the key structural reason for the failure to obtain securities that were worth their purchase price on a market value basis was the decision to offer the same price to all the banks in the initial purchase, and the apparent decision to only vary the terms of the second Citigroup investment to a small degree from the terms of the investments in "healthy banks" made under the Capital Purchase Program. Once the decision was made to offer all banks the same terms, in order to attract the participation of relatively healthy banks, those terms had to be ones that would be attractive to healthy banks. Offering the same terms to much weaker institutions like Citigroup and AIG ensured that those firms would receive a substantial subsidy.

Duff and Phelps extrapolated from its findings with respect to the nine largest transactions, and extended the same total subsidy rate to the smaller transactions under the Capital Purchase Program. Using this methodology, the Panel estimated that in total through the end of December the TARP program had involved an $78 billion subsidy to all 311 Capital Purchase Program recipient banks at the time of the report. However, Duff and Phelps found that more than half of the subsidy in the program as a whole went to two institutions—AIG and Citigroup.

This analysis has clear implications for future TARP transactions with weak financial institutions. Currently, the preferred stock of weak banks like Citigroup is trading at prices that imply a market interest rate in excess of 20%. Since the purpose of TARP is to strengthen financial institutions, and not to drain cash from them, there is no way to protect value for taxpayers by charging interest in the form of preferred dividends adequate to compensate taxpayers for the very real risk of further losses in the preferred. The only way to do so is to take a larger percentage of the upside in the form of common stock, warrants for common stock or other equity linked instruments. In the case of the weakest banks, it appears to me that even if the government took 100% of the future upside we would still not be able to receive securities worth the value of the funds we would infuse into such weak banks. It may still be in the public interest to do such transactions, but we should not fool ourselves or the public that we are receiving in the form of securities full value for the public's money. And the less we ask in terms of common equity, the greater the subsidy will be.

The legal review found that Treasury modeled its term sheet for Capital Purchase Plan transactions on the deal documents used by Warren Buffett in his investment in Goldman Sachs. We found that the terms were consistent across the Capital Purchase Plan

transactions. However, the Panel's legal analysis found that the terms obtained by the Treasury were in places both more and less advantageous than the Buffett terms, and than the terms typically found in preferred stock deals. There were however a number of major areas where the terms obtained by the Treasury were not as favorable to the government as terms obtained by the British government in the course of their bank rescue efforts.

Our valuation report relied entirely on publicly available data. The Panel did make a broad document request of the Treasury Department pursuant to our authority under Section 125 of the EESA on December 17, 2008. Our purpose was to obtain any non-public information that Treasury possessed that would go to issues of valuation, in addition to contributing to our general ability to oversee the TARP program. In a letter dated December 24, 2008, the Treasury Department declined to provide the material we requested, and raised concerns about our newly formed Panel's internal controls over confidential documents. Despite extensive discussions between our staff and the Treasury Department, Treasury has only produced a small number of the documents the Panel requested. The Panel ultimately concluded it was unlikely, in view of TARP recipients' legal obligations to disclose material financial information to the public, that the accuracy of the valuation report would be affected by the Treasury Department's failure to produce the requested documents.

This matter relates to a matter of concern to this Committee. Although it was not the primary purpose of our document request, I had expected that the request would result in the Panel being informed as to the identities of the counterparties to derivative transactions who were made whole as a result of the funds provided both by the Federal Reserve Bank of New York and the TARP to AIG. The Panel currently does not know the identity of those counterparties or the amounts they received. We are aware of press accounts of this matter, which have not been consistent with respect to issues such as how much money Goldman, Sachs, a direct recipient under TARP's Capital Purchase Program, received indirectly through the AIG TARP transaction.

The Congressional Oversight Panel is seeking to expand the scope of its analysis of the larger impact of TARP and related programs. The Panel is particularly interested in looking at transactions under the Term Asset Backed Securities Loan Facility (TALF) and potential transactions involving public-private partnerships. The Panel is also working to define its role in relation to activities undertaken by the Board of Governors of the Federal Reserve that are linked to actions undertaken by the Treasury Department pursuant to the EESA. Thank you.