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Reflections on the Auto Restructurings

Steven Rattner

Federal Reserve Conference

May 10, 2010

I'm sure it's not a coincidence that we are gathered here almost exactly a year since Chrysler and General Motors filed for unprecedented bankruptcies. In that context, this would seem to be a perfect moment to revisit the decisions that were made and the consequences of them.

Let me start with some background on the work of the Auto Task Force. In the course of my Treasury service and since then, I've found myself repeatedly responding to a few seminal questions concerning President Obama's actions surrounding the auto crisis.

Just to review, the auto crisis unfortunately reached a crescendo soon after the 2008 presidential election. You'll recall that Congress declined to act, and President Bush decided in late December of 2008 to provide $17.4 billion of TARP funding to GM and Chrysler.

President Obama and his transition team understood the stop-gap nature of that funding. In that context, incoming Treasury Secretary Tim Geithner and incoming National Economic Council director Larry Summers quickly concluded that given the magnitude of the overall economic crisis, they should create a dedicated team to focus on this critical but discrete problem.

Neither I nor anyone else was an auto czar, a title which would imply that we were some kind of independent force. Rather, all of us working on the auto problem reported to Tim and Larry and only through them to the President, just like our counterparts addressing other economic problems. It's worth noting that the notion of a czar arose largely because the failed legislation that I just referred to would have created a true auto czar. But President Obama's view was to accept responsibility for this problem rather than try to outsource it.

The President created two task forces: A cabinet-level group and an assemblage of sub-cabinet economic thinkers. Our working group, which was mostly based at Treasury, represented in essence a third "task force."

As we were getting underway, the two companies filed mandated "viability plans" on February 17th. Those plans evinced a state of denial as to the magnitude of their problems, the necessary changes and the conditions under which the Administration might provide further assistance.

Both companies needed massive reductions in their costs and liabilities, including their legacy health care obligations, their labor costs, and their manufacturing footprints. The President and his senior advisers were of one mind: No more money except in the context of shared sacrifice and restructurings to become truly viable.

It was frustrating to us that many commentators were suggesting that the government stay on the sidelines and let the companies fend for themselves. With financial markets still frozen, both would have unquestionably run out of cash quickly, slid into bankruptcy, closed their doors and liquidated.

That would have meant the elimination of more than two-thirds of American-owned auto manufacturing capability, cost more than a million jobs in the short run, dramatically deepened and prolonged the nationwide recession and pushed unemployment rates in several states – particularly Michigan -- above 20%.

So the stakes were high. In addition to time with the companies, we met extensively with both industry experts and the various stakeholders. We were startled that each stakeholder meeting invariably included a set of "asks" from the government; we had foolishly assumed that stakeholders eager to help would come with "gives".

We realized that convincing stakeholders that the government wasn't going to be everyone's piggy bank might well necessitate a bankruptcy element. While changes like renegotiating a labor agreement could be done without bankruptcy because only a single point of negotiation was involved, other important steps – such as reducing debt -- involved innumerable individual actors and would be difficult to implement without the cleansing nature of bankruptcy.

But bankruptcy was scary. First of all, and most importantly, we shared the concern of many that consumers might be unwilling to buy such a long-lived product

with important warrantee protection from a bankrupt company. We sought ways of mitigating this risk, such as by having the government guarantee warrantees for GM and Chrysler cars.

Second, we were fearful about the length of a traditional Chapter 11 proceeding. Delphi, the large parts manufacturer that is also based here in Michigan, had been stuck in bankruptcy for more than three years. To address this, we decided to utilize an established but less frequently used part of the bankruptcy code – Section 363 – to achieve the restructurings. Under that section, a newly formed company would buy the desirable assets from the bankrupt entity and immediately begin operating as a solvent corporation. But make no mistake. The timing of this process, though faster than a traditional Chapter 11, was still highly uncertain.

These two risks, consumer unwillingness to buy from a bankrupt company and uncertainty around length of time of the 363 process, could easily have meant a hemorrhaging of cash beyond the means of TARP and certain failure.

As we studied the companies, we realized that GM, while deeply troubled, was still a global company with improving products, the largest market share in the U.S. and strong operations in important countries like China and Brazil. We soon could not imagine this country without an automaker of the scale and scope of General Motors. The task became not whether to save GM but how to save GM.

Chrysler was tougher, having been larded up with debt, hollowed out by years of mismanagement, and operating as just a North American player. Chrysler, for example, did not have a single car that was recommended by Consumer Reports.

The question for us – and ultimately, the President – was whether any restructuring could save Chrysler. This most difficult decision was debated at great length with Secretary Geithner, Director Summers and several members of the sub-cabinet task force that I described earlier.

Those who felt Chrysler should be allowed to liquidate noted that buyers of Chrysler's most attractive vehicles – Jeeps, minivans and trucks – were likely to turn to Ford and GM. Thus, the substitution effect would eventually reduce the net job losses substantially.

Equally importantly, these additional sales would translate into additional profits for GM, significantly increasing the value of the company and the government's stake.

The group was torn and so were Tim, Larry and I. We intuited that the substitution analysis was more right than wrong and that from a highly theoretical point of view, the correct decision could be to let Chrysler go. But facing a short-term job loss of 300,000 amidst the worst downturn since the Great Depression, a liquidation felt like an unacceptable risk if Chrysler could be viable.

However, to underwrite Chrysler's viability, we believed it needed a strong corporate partner. The only apparent possibility was Fiat, which had been recently revived by its own new management team. Fiat also had stylish small cars and fuel sipping engines.

At GM, we faced a bigger management challenge than even its reputation led us to expect. Take, for example, the lack of financial discipline. We saw no indication of the finance staff pushing back on the operating divisions to achieve better results, as is customary. Analyses seemed engineered to support pre-ordained conclusions. Symbolically, we never heard the words "shareholder value."

The cultural deficiencies were equally stunning. At GM's Renaissance Center headquarters just a few blocks from here, the top brass was sequestered on the uppermost floor, behind locked and guarded glass doors. Executives housed on that floor had elevator cards that allowed them to descend directly to their private garage without mixing with lower ranking colleagues.

In that insular world, Chairman and CEO Rick Wagoner and his team appeared to believe that virtually all their problems resulted from some combination of the financial crisis, oil prices, the yen-dollar exchange rate and the UAW.

It seemed obvious that any CEO who had burned through $31 billion of cash in 15 months should not continue. Less clear was whether GM would be better off with Rick's deputy, Fritz Henderson or with an outsider, as Ford had done in bringing in Boeing executive Alan Mullaly.

On one hand, few major companies have effected the cultural change GM needs without fresh blood. At the same time, we were exceedingly nervous about the likelihood of recruiting a thoroughbred outside player, particularly in the midst of the turmoil.

Meanwhile, the government had recently forced Citigroup to replace a majority of its board. If ever a board needed changing, it was GM's, which had been utterly docile in the face of looming disaster.

After much discussion, Secretary Geithner and Director Summers decided to recommend a package that would include replacing Wagoner with Henderson, changing at least half of the board and making an outside director chairman (which I believe should be a universal practice).

On March 26th, members of the task forces had two meetings with the President and his most senior advisers for him to make his decisions.

The President had absorbed his previous briefings and read our memos carefully, allowing the conversation to move quickly to Chrysler. After reviewing the arguments, the President came down where Tim, Larry and I were: Chrysler had the potential to be viable within a Fiat alliance, and given that the state of the economy was so fragile – particularly in the industrial Midwest – the right decision was to make TARP funds available.

The President's March 30th speech consisted of a set of extraordinarily tough and muscular steps. The departure of Rick Wagoner leaked first. I was stunned by the suggestion that the government was somehow out of bounds for asking a CEO who had lost $13 billion of taxpayer money in three months and was now asking for more to step aside. In addition, it was commonplace in the private sector for a large investor to tie a new capital infusion to a management change. Moreover, the previous Administration had made similar changes at Fannie Mae, Freddie Mac and AIG in the context of providing assistance.

The more important news, of course, was the President's willingness to have both companies go through bankruptcy if necessary. While that critical decision caused much angst – including among strong supporters of the President's here in Michigan and elsewhere – it dramatically changed the nature of the discussions that we were having with the stakeholders, particularly the senior lenders to Chrysler.

These secured lenders had been insisting that they were entitled to repayment of their entire $6.9 billion. From the outset, that had struck us as ridiculous. The debt was trading at about 15 cents on the dollar and according to Chrysler's analysis, the

liquidation value of the company was around $1 billion. Clearly, the secured creditors didn't believe that the government would push back and let the lenders have the company.

Until the President spoke. Immediately, the tone of the lenders – and all the stakeholders changed – reinforcing the correctness of the President's decision to take a firm line.

In the ensuing negotiations, the lenders were particularly aggrieved that the UAW's health care trust (known as the VEBA), which ranked below the secured creditors, was slated to exchange a $8 billion existing claim for $4.6 billion in notes and 55% of the equity in the reorganized company.

Fairly valued, we believed the VEBA was receiving a bit more than half of its prior claim, a higher percentage recovery than we were offering to the more senior secured lenders. These lenders felt that this represented a tilt by the Obama Administration in favor of labor and against capital.

That was simply not the case. At no time did the White House ever ask us to favor or punish any stakeholder. Indeed, we were encouraged to approach the restructurings from a private sector perspective. Ironically, the governmental pressures we faced ultimately came not from within the Administration but from Congress and local officials.

And while many highlighted the disparate treatment between the senior lenders and the VEBA, they chose to ignore the fact that many other unsecured creditors – notably, suppliers and consumers holding warrantees – received 100 cents on the dollar. The fact was, Chrysler needed workers, suppliers and customers to succeed and therefore needed to give them more.

This situation was hardly unique to Chrysler. For example, in the steel industry bankruptcies, stakeholders were regularly afforded disparate treatment for analogous reasons.

Moreover, if we had given the VEBA or other stakeholders less, we wouldn't have given the lenders more; the $2 billion that they ultimately received represented a generous premium over both the trading value and the liquidation value of their holdings.

In short, the outcome of the Chrysler restructuring had almost nothing to do with the heavy hand of government and everything to do with the fact that Treasury was the investor of last resort.

We were also accused of having run roughshod over bankruptcy law and precedent. Not true either. While I'm proud of the creativity of our team, every step proceeded normally through the legal system and followed existing bankruptcy law. In fact, early on we had considered and rejected as unnecessary many suggestions that we seek special bankruptcy law.

Equally importantly, the White House never tried to use the auto restructurings to achieve any other policy goals. While we were at work, new fuel efficiency standards were negotiated by the Administration with all automakers – without any involvement on our part. And we were never asked (or ordered) to impose any new technology mandates on the companies.

With respect to the companies' restructurings, we believed that they needed to assume that U.S. car sales, which had hovered around 16 to 17 million for most of the decade, might well not get much above 10 million for the next several years.

In the case of GM, it ultimately produced a plan that accelerated the plant closings, eliminated the Pontiac brand, increased the job and dealer reductions, and added white collar job cuts. And like Chrysler, GM reached a new agreement with the UAW that put labor costs on a competitive trajectory.

All told, GM's liabilities were reduced by $83 billion and $8 billion a year of North American structural costs were eliminated. These painful cuts lowered GM's break even point from a 16.5 million car sales rate to a 10 million car sales rate. Only through amputation could GM be saved.

Both companies also had a "brand equity" problem. Their cars often sold for several thousand dollars less than comparable models made by the Asian "transplants." Time and good products can solve this problem and an important part of our investment thesis was that GM's cars were better than the market gave it credit for.

Perhaps because of its lack of financial discipline, GM was in important ways in worse shape than Chrysler. One simple indicator of that was the amount of capital the U.S. government ended up injecting: $12 billion into Chrysler and $50 billion into GM,

even though GM's revenues were only roughly three times the size of Chrysler's. So we were faced with a tough decision as to how to contribute that capital. If we made our investment as a loan, GM would continue to be saddled with unmanageably large obligations. The only realistic alternative was to inject most of our capital as equity.

All of us – especially Tim Geithner and Larry Summers – hated the idea of the U.S. Government owning equity in these companies, let alone a majority interest in GM. But we ultimately concluded that it is better to get something for something than to get nothing for something. To mitigate the obvious risks, the Administration developed a set of principles for the "USG as shareholder" that would add strict limits on government involvement post-restructuring to the existing edict that we not ever meddle in day-to-day management decisions.

Among the ideas that was explicitly rejected was putting any government employees or official representatives on these boards. This underscored the need to put in place capable independent boards of directors and strong chairmen. Once again, there was no political interference. Working with Secretary Geithner and Director Summers, we looked particularly for strong former CEO's of significant companies and also wanted to have at least one leading private equity person on each board. I don't believe I have seen even one criticism of the resulting choices.

In addition to GM and Chrysler, we knew that we would need to address the interconnected web of suppliers, finance companies and the like. We agonized over this. Thousands of suppliers have been devastated and more jobs have been lost in the auto sector during this recession than in any other category. But we ultimately concluded that Washington could not solve the problems of every company in every part of this industry. We limited our assistance to guaranteeing payment of GM's and Chrysler's obligations to suppliers willing to pay a fee.

We also knew that saving the two automakers would be insufficient if we did not attend to the problems of their related finance companies. Chrysler Financial and GMAC's issues were more closely related to those of the banking sector and my sympathy grew for those who had been navigating the banking crisis. We ultimately recapitalized GMAC so that it could support new sales by both Chrysler and GM. By the

end of some of the toughest discussions of the entire project, the need for financial services regulatory reform was inescapable to me.

We were fortunate to be operating under TARP rules, which allowed us to allocate capital flexibly, without having to return to Congress for additional legislation. As a result, we encountered relatively little Congressional intrusion -- until the two companies virtually simultaneously announced their dealer reduction plans. Every congressional district had dealers, many of whom were well connected politically.

We patiently worked through each grievance and explained that the companies – not the government – made these decisions. But the episode left an indelible impression on me: If we had not had TARP money available and had had to seek Congressional approval for each use of capital, I am convinced that one or both of the automakers would have been forced to liquidate.

Fortunately, the restructurings survived and the companies began to operate as private enterprises, just as the President had outlined and just as we had hoped.

Like any patient that undergoes major surgery, a successful recovery is far from assured. But by dramatically lowering the break even point for both companies, we believed we were creating a healthy margin for error. Most importantly, we based our projections on conservative projections for car sales. Adjusted for new drivers, about 15 million cars a year need to be sold in the U.S. just to keep the fleet from aging. Consumers can certainly postpone their purchases for a while but the fleet is not going to age indefinitely and no one has yet invented a substitute for the automobile.

I have been heartened by the progress that both companies have made since they emerged from bankruptcy. First, it is important to recognize that both have benefited from the gradual but unambiguously positive upturn in sales that has occurred.

From an annual rate of sales of 9.5 million cars in the first quarter of 2009, total domestic sales have risen to a rate of more than 11 million cars a year. I would cite two reasons for this upturn. First, as I noted, car sales were artificially depressed by the recession and the loss of available financing for consumers as a result of the financial meltdown. While it was important that our investment case for GM and Chrysler be very conservative in our assumption about the rate of car sales, we believed that some upturn in sales was almost surely inevitable.

Secondly, I would argue that the steps taken by the Obama Administration to lift the economy out of recession have had a salutary effect on both the ability and willingness of consumers to purchase automobiles. Notwithstanding recent stock market gyrations, all indicators – whether you look at employment, GDP or almost anything else -- suggest that the economy is once again growing. I firmly believe that auto sales will continue to grow in tandem with the broader economy. Most analysts currently forecast total car sales in the U.S. for 2010 of about 12 million. That seems to me to be a reasonable estimate but even more important, I believe that sales will continue to grow until they reach at least a rate of 15 million cars a year and potentially more.

The impact of both our direct assistance to the automobile industry as well as the overall growth of the economy have had a striking impact on the fortunes of all of the car companies. Ford, which of course addressed its structural challenges without government assistance, recently reported a pre-tax profit of $2 billion compared to a loss of $2 billion during the same quarter a year ago.

Similarly, Chrysler recently announced a first quarter operating profit of $143 million, compared to a significant loss during the same quarter a year earlier. It also operated on a cash flow positive basis during the quarter. Finally, its market share increased to 9.1% from 8.1% during the fourth quarter of 2009.

Finally, while GM will not report its first quarter numbers for another week it may well turn its first quarterly profit since second quarter of 2007.

Beyond these headline numbers there is more good news about both GM and Chrysler. Let me start with GM. First and most importantly, the governance changes that we put in place have worked very much as we had hoped. While I suspect that several of the new board members who graciously were willing to serve may have found themselves spending a lot more time in Detroit than they expected, the new oversight and discipline that they have brought to the company has been invaluable.

Most central of course has been the leadership of Ed Whitacre. I can say from first hand experience that Ed definitely had no intention of signing up for full time duty but when the board determined that fresh leadership would be necessary, Ed did not shirk from the request that he serve. He has approached the challenges with toughness and kindness, two characteristics that not every leader possesses in equal measure as Ed does.

His changes have essentially revolved around two areas. First, he has shaken up the leadership team. Some long standing executives have been eased out; others have been promoted. A handful of talented outsiders have been recruited at senior levels. From everything that I have heard, Ed is approaching the personnel decisions with a clear vision and superb judgment.

Sergio Marchionne, Chrysler's new CEO, has taken similar steps at that automaker and should be commended for the energy, drive and vision that he has brought to fixing that automaker.

Secondly, beyond the financial results and the management changes lay other important changes in how both companies do business. For example, the historic propensity of the Detroit automakers to pad sales by pushing extra cars onto dealers has been curbed. Instead of bloated inventories, the days supply of unsold cars has dropped to 58 days at Chrysler and 57 days at GM. In fact, a recent survey of dealers by a research analyst showed that most Chrysler and GM dealers now think that their current inventory levels are either "appropriate" or "too low". None think that inventory levels are "too high".

Similarly, the companies have curbed their use of incentives – known in industry parlance as "cash on the hood" – to sell cars. Everyone is aware of Ford's great performance in this regard over the last year. But GM has also turned a corner. In April, GM's incentives were down $1,100 versus a year ago. And GM's average transaction price was up $2,500 versus a year ago, which, in fact, stood $4,000 above the industry average.

The rise in average transaction prices suggest that the gap in brand equity with the Japanese transplants is beginning to be eroded. (I should note that these positive developments are for the most part, unrelated to the issues surrounding Toyota. None of us should take any joy in the troubles of any company employing American workers.)

Beyond the Big Three, the news from the auto sector has turned positive for the first time in many years. Since GM exited bankruptcy in early July of last year, the industry has added about 45,000 new jobs, the strongest nine month period of auto industry job growth since 2000.

Both GM and Chrysler have been part of this growth. GM has added or brought back more than 4,000 jobs and Chrysler has done the same with 1,000 workers.

Notwithstanding this good news, both companies still have work ahead of them. For Chrysler, the biggest challenges are its need to regenerate its product line up and to manage a significantly leveraged balance sheet.

In the case of GM, the overarching question mark will be the ability of the GM board to identify and select a top flight replacement for Ed Whitacre. No one touched by GM can afford to see the company lapse back into its old ways.

As everyone here probably knows, GM recently paid back the balance of the $6.7 billion in loans that it received from the Treasury. Of course, as I mentioned, those loans only represented a small portion of the total of $50 billion that was infused into GM by the Federal government. Most of the balance is represented by the 61% of the equity in GM that the Treasury owns.

Because the bonds of old GM continue to trade publicly, it is possible to provide an up to date scorecard on where the taxpayers stand on recouping this $50 billion. Until the swoon in markets of the past week, those trading levels implied a total value of the government's holdings of a bit more than $40 billion. In the past week, that number has dropped by about $5 billion.

While both of these figures are short of the $50 billion of capital invested, I would make three points:

First, approximately $20 billion of the capital was invested in late 2008 and early 2009, outside of the fundamental restructuring of GM that took place through the bankruptcy process in June.

Second, the final score is not yet in. The value of the Treasury's holdings can easily go up – or down – as both the industry and the company move forward.

Finally, when we made the capital infusions into GM, we never anticipated a full recovery of them. While protecting the taxpayers was an important part of our work, the President did not approach this decision solely as if he were a private investor. As I outlined earlier in this talk, he recognized that there were broad equities to be considered.

Accordingly, I would argue that if the final cost of the GM bailout ends up in the same range as it stands today, our initiative should be viewed as a success. For around

$10 billion, we would have succeeded in avoiding all of the economic and human calamities that I described earlier. That is a pretty effective cost of economic stimulus.

Of course, the $50 billion that we put into GM only represented a portion of the total of $81 billion that was committed to the auto sector. The balance went to Chrysler, to the affiliated finance companies – Chrysler Financial and GMAC – to suppliers and to guarantee warrantees for Chrysler and GM customers.

We don't yet have a final score or even a reasonable way to measure where we stand on much of this $31 billion of additional capital. However, I would note that both the warrantee and supplier programs – a total capital commitment of $10 billion – have now been concluded at a profit to the U.S. taxpayer.

We anticipated that the recovery of these companies will take time, particularly that of Chrysler. While extraordinary progress has been made in the past year in the face of every pessimistic prediction, there may well be bumps in the road to full recovery. Be patient. Give these companies the time and space that they need – and that we factored into their recapitalizations – to remake themselves into successful companies.

In conclusion, I am proud to have been a part of this critical element of President Obama's economic recovery plan. I believe that the President made tough, courageous and correct decisions at the moment of greatest economic uncertainty in our country. Because of his actions, GM and Chrysler have been given a fresh start and every tool needed to again be profitable industry leaders.

Thank you.