



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

July 1, 2009

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

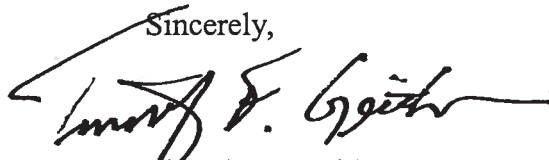
Dear Chair Warren:

Thank you for your letter dated June 12, 2009, regarding the value of the warrants that the Department of the Treasury has acquired in firms as required by section 113(d) of the Emergency Economic Stabilization Act of 2008, as amended ("EESA").

Treasury staff met with panel member Richard Nieman and the panel staff on Thursday, June 18 and reported to me that the discussion was informative and productive. On Friday, June 26, Treasury announced its warrants policy and posted the guidelines on our website along with a set of Frequently Asked Questions (FAQ). Copies of the warrants policy press release and FAQ are enclosed for your convenience. The following Monday, Treasury staff met with panel member Damon Silvers and panel staff. In the attached document, we have provided a written response to each of the questions and information requests in your letter.

Please contact me if you need further information.

Sincerely,



Timothy F. Geithner

Enclosure

cc: Senator John E. Sununu
Representative. Jeb Hensarling
Mr. Richard H. Neiman
Mr. Damon A. Silvers

Written Response to Letter from Chair Warren Dated June 12, 2009

1. *What is the meaning of the term “fair market value” highlighted in bold – that is, without regard to the procedure specified – in the following excerpt from section 4.9(c)(ii) of the “Securities Purchase Agreement – Standard Terms” executed as part of the TARP process:*

“Fair Market Value” means, with respect to any security, the fair market value of such security as determined by the Board of Directors, acting in good faith in reliance on an opinion of a nationally recognized independent investment banking firm retained by the Company for this purpose and certified in a resolution to the [Treasury].

The term “fair market value” is, as you note, defined in the Securities Purchase Agreement by means of prescribing the process for determining such value. No other definition is given. Courts traditionally have accorded undefined contract terms their plain meaning and have looked to secondary sources for definitional guidance. *Black’s Law Dictionary* (8th ed., 2004) defines “fair market value” as “[t]he price that a seller is willing to accept and a buyer is willing to pay on the open market and in an arm’s length transaction.” Other secondary sources provide similar definitions.¹

2. *What is the meaning of the phrase “market price” in section 111(g) of EESA, added to EESA by section 403 of the Helping Families Save Their Homes Act of 2009?*

The term “market price” is not defined in section 111(g) of EESA. Courts have traditionally deferred to an agency’s interpretation of such undefined terms. Although Treasury has not promulgated any guidance concerning the meaning of this term, we believe it is appropriate to consider the plain meaning of the term. The *Merriam-Webster Dictionary* defines market price as “a price actually given in current market dealings.” Similarly, *Black’s Law Dictionary* (8th ed., 2004) defines “market price” as “[t]he prevailing price at which something is sold in a specific market.”

3. *What is the difference between the terms “fair market value” and “market price” as used in the Securities Purchase Agreement and section 111(g) of EESA, respectively? If the two terms have different meanings, which meaning governs the pricing of the warrants to be repurchased when TARP repayments are made by any institutions?*

¹ For instance the *Merriam-Webster Dictionary* states that fair market value “is a price at which buyers and sellers with a reasonable knowledge of pertinent facts and not acting under any compulsion are willing to do business.”

The United States Supreme Court used a similar definition of “fair market value” when considering a mutual fund valuation estate tax case:

“The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.”

United States v. Cartwright, 411 U. S. 546, 551 (1973) (quoting from U.S. Treasury regulations relating to Federal estate taxes, at 26 C.F.R. sec. 20.2031-1(b)).

Although we believe the terms “fair market value” and “market price” are quite similar in meaning (indeed, *Black’s Law Dictionary’s* definition for “market price” refers to the definition for “fair market value”), the question of whether they have the “same” meaning is a question that can only properly be answered by considering the context in which the terms are used. We believe that examining the contexts in which these particular terms are used is therefore the proper way to address your question. The term “fair market value” is defined in the Securities Purchase Agreement by reference to a process, and such term is relevant to the pricing of the warrants in the event that a bank exercises its contractual right to repurchase the warrants. The contract dictates how fair market value will be established. The term “market price” is used in Section 111(g) and pertains to the liquidation by Treasury of the warrants generally. We do not read Section 111(g) to amend or pre-empt the use of “fair market value” in the Securities Purchase Agreement, or the process for deciding fair market value, in the event a bank exercises such right to repurchase.

4. The June 9, 2009 Treasury announcement states that:

Under the CPP investment agreements, firms that repay their preferred stock have the right to repurchase the warrants Treasury holds in their firms at fair market value.

At the same time amended section 111(g) of EESA, as amended as described above, states that:

[W]hen such assistance is repaid, the Secretary, at the market price, may liquidate warrants associated with such assistance.

(Emphasis added).

a. Does section 111(g) of EESA permit Treasury to continue to hold the warrants issued by the financial institutions that repay TARP funds until it can obtain maximum value for those warrants? If not, why not?

b. If section 111(g) does permit Treasury to continue to hold those warrants, why has it decided to permit the ten institutions that are the subject of the June 9, 2009 announcement to repurchase their warrants now?

Section 111(g) of EESA was added by the American Recovery and Reinvestment Act of 2009 (“ARRA”), which provided that “when [the] assistance [provided under TARP] is repaid, the Secretary shall liquidate warrants associated with such assistance at the current market price.” Section 403 of the Helping Families Save Their Homes Act of 2009 amended Section 111(g) of EESA by deleting the phrase “shall liquidate warrants associated with such assistance at the current market price.” In their place, Section 403 added “, at the market price, may liquidate warrants associated with such assistance.”

This has been generally interpreted to eliminate the ARRA’s requirement for liquidation

of the warrants upon repayment of TARP assistance by a bank. Indeed, Section 403 was titled "Removal of Requirement to Liquidate Warrants Under the TARP."

Therefore, in answer to your first question, we believe the amendment of Section 111(g) eliminated the requirement to liquidate the warrants upon repayment by a bank of TARP assistance. Section 111(g) does not require that the Secretary dispose of the warrants at any particular time nor does that provision or any other provision of EESA require that the Secretary hold the warrants for any particular period of time. Instead, Section 111(g) permits the Secretary to dispose of the warrants at any time.

In answer to your second question, each bank that repays TARP assistance has a contractual right to repurchase the warrants. Treasury is contractually obligated to sell the warrants to a bank if it elects to repurchase the warrants pursuant to the contractually specified repurchase procedure.

In the event the bank does not repurchase the warrants pursuant to the contractually specified procedure, Treasury is permitted under Section 111(g) to liquidate the warrants, and the Secretary of the Treasury is given the discretion to determine the time period for liquidating the warrants. To ensure that government interventions in individual companies are consistent with the President's principle of preserving the private market system, we must ensure that any interventions are as brief as possible. Thus, the Administration has publicly stated that it "will seek to dispose of its ownership interests as soon as practicable." Treasury believes that this broad policy should apply to both common stock and warrants and will therefore auction the warrants within several months if the bank does not repurchase. Treasury is currently in the process of establishing guidelines for the auctions, and will make details about the auctions public on www.financialstability.gov.

5. *Please provide any information relating to Treasury's internal valuations of warrants not yet exercised or repurchased.*

It is not Treasury's policy to publish estimates of the fair market value of its investments made under the Troubled Asset Relief Program ("TARP"). In the present case, Treasury believes it would not be in the taxpayer's interest for Treasury to disclose any valuations it has performed in connection with warrants whose repurchase is currently pending or that may be repurchased in the near term.

6. *Please provide detailed information regarding the assumptions and methodologies Treasury has used to value warrants, or on whose basis it accepted the price set for the warrants, repurchased by Old National Bancorp, FirstMerit Corp., Sun Bancorp, IberiaBank Corp., Independent Bancorp, and any other warrants repurchased by the date of the U.S. Treasury's response to this request. Please provide the same information relating to pending negotiations for the repurchase of warrants issued by the ten institutions that have been approved to repay TARP funds and indicate the status of such negotiations, in each case.*

At the June 18, 2009 meeting, Treasury staff briefed representatives of the Panel on Treasury's general approach and methodology for valuing warrants. We would be pleased to provide more detail on our valuation methodology and would suggest scheduling a meeting for next week where we can walk interested Panel staff through more detailed documentation regarding our methodology. We can also provide staff with copies of the valuation analysis used in connection with warrants that have already been repurchased, provided that this analysis remains confidential.

7. *Have any of the warrants been subject to a reduction due to a qualified equity offering by the institution that issued the warrants? Please specify the name of the institution and the amount of the reduction. Has Treasury calculated the probability of such a reduction for other institutions in which warrants continue to be held by Treasury? If so, what was the methodology used, and on what assumptions did it rely?*

Yes, three institutions have utilized the Securities Purchase Agreement provision allowing for a 50% reduction in warrants upon a Qualified Equity Offering (as such term is defined in the Securities Purchase Agreement). The institutions are Iberiabank, First Niagara, and State Street.

Treasury has not calculated the probability of reductions by other institutions in the number of warrants it holds.

As requested, we have sent your office the data requested in items 8) to 12) of your letter in an Excel Spreadsheet.

Treasury Announces Warrant Repurchase and Disposition Process for the Capital Purchase Program

June 26, 2009

Today, Treasury is announcing its policy with respect to the disposition of the warrants received in connection with investments made under the Capital Purchase Program (CPP). In the case of investments in publicly-traded institutions, Treasury received warrants to purchase common shares which have not been exercised. (In the case of institutions that are not publicly-traded, Treasury received warrants to purchase preferred stock or debt and these warrants were exercised immediately upon closing the initial investment so they are no longer outstanding.)

Repurchasing Warrants under the CPP Contract

When a publicly-traded institution repays Treasury's CPP investment, the original contract under the CPP provides the bank a right to repurchase the warrants at fair market value via an independent valuation process. The relevant sections of the transaction documentation describing this process can be found in the Warrants FAQ on www.financialstability.gov.

The warrant repurchase process works as follows:

- Step 1:** Within 15 days of repayment, a bank wishing to repurchase the warrants should submit a determination of fair market value to Treasury.
- Step 2:** Treasury will ensure that taxpayers' interests are protected by conducting a process (described below) to determine whether or not to accept the bank's initial determination. Under the contract, Treasury has 10 days to respond to the initial determination.
- Step 3:** If Treasury objects to the bank's determination and cannot reach agreement with the bank regarding fair market value, the transaction documents outline an appraisal procedure by which the two parties will reach a final price. In this appraisal procedure, the bank and Treasury will each select an independent appraiser. These independent appraisers will conduct their own valuations and attempt to agree upon the fair market value.
- Step 4:** If these appraisers fail to agree, a third appraiser is hired, and subject to some limitations, a composite valuation of the three appraisals is used to establish the fair market value.

In order to protect taxpayers in this process, Treasury has developed a robust set of procedures for evaluating repurchase offers in Step 2 above. Treasury's determination of value is based on three categories of input:

1. Market Prices

When available, observable market prices are used. However, Treasury has warrants that are not listed on a securities exchange nor otherwise traded. These warrants do vary from typical listed warrants, mostly due to their long term (10 years). Therefore, the only observable market prices are for securities that have similar characteristics. The prices of these comparable securities can be used to assess the fair market value of the warrants held by Treasury.

- Comparable securities for the warrants held by Treasury include: traded warrants, traded options, and common equity issued by the institution as well as similar securities of peer institutions. Generally speaking, the largest institutions in the CPP have a broad array of comparable securities with observable market prices. Mid-sized institutions have fewer comparable securities and those securities may trade somewhat infrequently. Many of the smallest CPP participants have no meaningful comparable securities with observable market prices, so Treasury will rely on other valuation methods.
- Treasury will also obtain quotations for the warrants from 5 - 10 relevant market participants that may include investment banks regularly trading options or other securities with embedded options (e.g. convertible bonds) or asset management firms focusing on the financial sector.

2. Financial Modeling

Treasury will also use a set of well-known financial models to assess the fair value of the warrants. These models will include, but will not be limited to, binomial and Black-Scholes option-pricing models, and are widely used in financial markets to value options and warrants.

- These models depend on known inputs (the expiration date, interest rates, and the current stock price) and on assumptions about the future volatility and dividends of the underlying common stock.
- Assumptions about future volatility will be based on both the historical volatility and the option-implied volatility for a given stock and, where necessary, adjustments will be made for the expected mean-reversion of volatility over time. Treasury uses the average 60-day trailing volatility for the last ten years to determine a stock's historical volatility. Some larger publicly-traded institutions have existing short-dated options and longer-dated options (with maturities of up to two years) that provide data on option-implied volatility, so we use these also.

- Assumptions about future dividends will be based on current, historical, and option-implied dividend yields. These assumptions will be limited by the parameters of the dividend protections outlined in the warrant documents.
- The value of the warrants will be calculated for a range of different assumptions about the future volatility and dividends.
- Deviations between market prices and the output from these models may occur due to model biases. Many of these biases are well-documented, and Treasury will make appropriate adjustments to correct for any potential biases.

3. **Outside Consultants/Financial Agents**

Treasury has retained 3 asset managers and intends to use other outside consultants to assist Treasury in enhancing its process and independently assessing value of each repurchasing bank's warrants. Each of these outside asset managers will provide full independent valuations for each repurchase, including key assumptions affecting their value determinations to inform Treasury's decision process.

Alternate Disposition of Warrants

If an issuer chooses not to repurchase the warrants according to its existing contractual rights, Treasury has the discretion to dispose of the warrants as it sees fit over time. In these instances, Treasury will sell the warrants through an auction process over the next few months. Treasury is currently establishing guidelines for these auctions, which it will publish on www.financialstability.gov.

The President has clearly stated that his objective is to dispose of the government's investments in individual companies as quickly as is practicable. In reaching the judgment to dispose of the warrants in the manner described, Treasury considered a range of options including holding the warrants for a longer term or until their expiration. Under those alternate scenarios, there was no certainty that we would realize higher values, and it was not appropriate for the government to be exercising discretionary judgment on timing market sales.

Accordingly, a fully transparent auction as described above provides the best method for the Treasury to realize the market value of the warrants in the near term on behalf of taxpayers.

Transparency

Treasury publishes information on all CPP transactions, including investments, repayments and warrant repurchases, in the TARP Transactions Reports within 2 business days of closing. All Transaction reports are available on our website at www.financialstability.gov.

Further, Treasury will begin publishing additional information on each warrant that is repurchased, including a bank's initial and subsequent determinations of fair market value, if applicable. Following the completion of each repurchase, Treasury will also publish the independent valuation inputs used to assess the bank's determination of fair market value. All of this information will be available www.financialstability.gov.

Background on Warrants and the Capital Purchase Program (CPP) Frequently Asked Questions (FAQ)

Q: What is a warrant?

A: A warrant is an option that grants the holder the right to buy another security at a specified price on a specific date or during a specified period of time. A warrant is very similar to a call option, but differs in that the firm itself is the seller of the option, rather than an outside party. Warrants for common stock give investors the right to buy new shares in the firm, which has a dilutive effect not associated with typical call options.

Q: Why does Treasury take warrants?

A: EESA mandates that Treasury take warrants in conjunction with the purchase of troubled assets from any institution for more than \$100 million.

Q: Does Treasury always take warrants?

A: Yes, except in the case of a Community Development Financial Institution that receives less than \$50 million from Treasury.

Q: Do the warrants look the same for all banks?

A: No.

- For publicly-traded institutions, Treasury receives warrants to purchase common shares. Treasury has not exercised these warrants.
- For all other institutions (private companies, S corporations, and some mutual organizations) Treasury receives warrants to purchase additional preferred shares or subordinated debentures. Treasury immediately exercised these warrants upon receipt.

Q: How many warrants does Treasury get?

A: For publicly traded institutions, the number of common shares that underlie the warrants were calculated by taking 15% of the original investment amount, and dividing it by the exercise price. The exercise price was set at the average of the stock price during the 20 day period preceding the day that Treasury granted preliminary approval to participate in the CPP program.

- **Example:** Bank A was approved for \$100 million on December 1. Over the 20 days prior to December 1, the average stock price was \$10. Treasury would have received a warrant to purchase 1,500,000 shares at \$10 each. (15% of \$100 million is 15,000,000. 15,000,000 divided by 10 is 1,500,000)

For all other institutions, Treasury received a warrant for an additional 5% of the original investment.

- **Example:** Bank B is approved for \$100 million on December 1. Treasury will receive a warrant to purchase an additional 5% of preferred shares or subordinated debentures. Treasury will exercise this warrant immediately after closing the transaction. Thus, Treasury will have \$105 million of preferred shares.

A small bank participating in the CPP under the new terms (Small Bank program) announced on May 13, 2009 will not be required to give warrants for any incremental investment above 3% of RWA (they may get up to 5% of RWA under the CPP expansion).

Q: Is the number of warrants subject to reduction or adjustment?

A: Yes, a bank can reduce the number of warrants it issued to Treasury by 50% if it completes a qualified equity offering. This is a sale of common stock or certain types of preferred stock for cash in an amount at least equal to the original amount of Treasury's investment.

- **Example:** Bank A issues \$150 million of common equity to market participants. Since it raised at least 100% of the original investment amount of \$100 million, the warrant is cut in half. Treasury now has a warrant to purchase 750,000 shares at \$10 (1,500,000 shares multiplied by .5).

The warrants are also subject to customary "anti-dilution" adjustments in the event of other changes to the Company's capital structure, which is designed to ensure that Treasury's interest is not "diluted" by such changes.

Q: Can the exercise price change?

A: Yes, the exercise price can be revised pursuant to the anti-dilution adjustments so that the value of what Treasury is entitled to receive is not affected by certain changes in the capital structure.

Q: Where can I find the relevant sections of the Securities Purchase Agreement ("SPA")?

A: The entire SPA for publicly traded institutions can be found at <http://www.financialstability.gov/docs/PPP/spa.pdf>. The relevant sections mentioned above are copied below:

- Section 4.9 (c)(i): "*Appraisal Procedure*" means a procedure whereby two independent appraisers, one chosen by the Company and one by the Investor, shall mutually agree upon the Fair Market Value. Each party shall deliver a notice to the other appointing its appraiser within 10 days after the Appraisal Procedure is invoked. If within 30 days after appointment of the two appraisers they are unable to agree upon the Fair Market Value, a

third independent appraiser shall be chosen within 10 days thereafter by the mutual consent of such first two appraisers. The decision of the third appraiser so appointed and chosen shall be given within 30 days after the selection of such third appraiser. If three appraisers shall be appointed and the determination of one appraiser is disparate from the middle determination by more than twice the amount by which the other determination is disparate from the middle determination, then the determination of such appraiser shall be excluded, the remaining two determinations shall be averaged and such average shall be binding and conclusive upon the Company and the Investor; otherwise, the average of all three determinations shall be binding upon the Company and the Investor. The costs of conducting any Appraisal Procedure shall be borne by the Company.

- Section 4.9 (c)(ii): “*Fair Market Value*” means, with respect to any security, the fair market value of such security as determined by the Board of Directors, acting in good faith in reliance on an opinion of a nationally recognized independent investment banking firm retained by the Company for this purpose and certified in a resolution to the Investor. If the Investor does not agree with the Board of Director’s determination, it may object in writing within 10 days of receipt of the Board of Director’s determination. In the event of such an objection, an authorized representative of the Investor and the chief executive officer of the Company shall promptly meet to resolve the objection and to agree upon the Fair Market Value. If the chief executive officer and the authorized representative are unable to agree on the Fair Market Value during the 10-day period following the delivery of the Investor’s objection, the Appraisal Procedure may be invoked by either party to determine the Fair Market Value by delivery of a written notification thereof not later than the 30th day after delivery of the Investor’s objection.