Testimony of Paul Atkins

Member, Congressional Oversight Panel

before the

House Financial Services Committee

Subcommittee on Oversight and Investigations

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Chairman Moore, Ranking Member Biggert, and distinguished members of the Subcommittee: I am Paul Atkins, a member of the Congressional Oversight Panel. I appreciate this opportunity to testify about the Congressional Oversight Panel's work assessing the performance of the Treasury Department in managing and disposing of the stock warrants it has acquired in conjunction with the Troubled Asset Relief Program (TARP). I should note that the views expressed in this testimony are my own. I will do my best to convey the Panel's views, but my statements cannot always reflect the opinions of our five diverse thinkers.

The Panel is charged by statute to "review the current state of the financial markets and the financial regulatory system" and provide monthly reports to Congress assessing the effectiveness of the Treasury's implementation of the TARP, including its disposition of stock warrants. When Congress authorized the commitment of $700 billion to rescue the financial system through the Emergency Economic Stabilization Act of 2008 (EESA), it also required that taxpayers participate in the upside if assisted financial institutions returned to profitability. This is achieved through Treasury's receipt of warrants to purchase common stock or other securities from the banks party to any transaction in which financial institutions receive TARP capital.

The Congressional Oversight Panel performed an in-depth analysis of Treasury's management of TARP warrants in its July 2009 report. Treasury acquired most of its warrants in conjunction with the major TARP financial rescue initiative, the Capital Purchase Program (CPP), under which it invested $205 billion in 707 financial institutions. These warrants represented 15 percent of the value of the Treasury investment under the CPP. Additionally, Treasury received warrants from Bank of America and Citigroup due to the capital infusion from the Targeted Investment Program (TIP). Treasury's 150 million TIP-related warrants in Bank of America were auctioned in March of this year, while the 188 million TIP-related Citigroup warrants remain within Treasury's TARP holdings

In May 2009, CPP-assisted banks began to repay their TARP assistance. Once an institution has repaid its TARP assistance by redeeming the CPP preferred shares held by the Treasury, the institution may elect to negotiate the repurchase of its warrants as well by submitting a bid within 15 days of repayment. If the Treasury and the bank are unable to agree on the terms of a warrant repurchase transaction or the bank does not elect to bid on their repurchase, Treasury may sell the warrants through a public auction. At the time of the Panel's July Report, 11 smaller banks with an average TARP investment of $75 million had redeemed their CPP preferred shares and successfully repurchased their warrants from Treasury.

The Panel evaluated the prices that Treasury negotiated for these 11 banks to repurchase their warrants. We used the industry standard Black-Scholes option pricing model adjusted to reflect the particular characteristics of the warrants that Treasury received under the CPP, specifically the dividend yield and 10-year duration. The Panel's analysis concluded that the Treasury had received approximately 66 percent of our best estimate of the value of the TARP warrants for these banks. However we acknowledged as well that these repurchases represented less than one quarter of one percent of our best estimate of the value of all the CPP warrants that Treasury had acquired as of that time. We also noted that Treasury's own valuation of the warrants of these smaller institutions incorporated an adjustment for the likely relative illiquidity of the stock of these banks, a step that the Panel did not apply because of the subjectivity of this factor.

The Panel's analysis included estimates of a low, most likely and highest reasonable valuation for each bank's warrants. Volatility is a significant input to option, and thus warrant, pricing, and the volatility swings of recent years can produce wide-ranging estimates.

The Panel's July report noted that warrant repurchases can occur only after Treasury has agreed to allow a CPP recipient bank to repay its TARP assistance. Maximizing the government's return on its TARP investment, of which the disposition strategy for the warrants is an important element, must necessarily be tempered by the public policy goal of assuring the health of the banks that have received TARP assistance.

The report also recommended that Treasury give serious consideration to employing auctions to dispose of warrants rather than relying heavily upon one-on-one negotiations with the individual banks. Using a public auction for warrant repurchases would leave no room for speculation that Treasury was too tough or too easy on a TARP-recipient institution while allowing banks to repurchase their warrants in competition with other market participants. The report noted the need for greater transparency in the Treasury warrant valuation and negotiation process and called for Treasury to publish periodic reports that provide details on the value determinations for warrants that have been sold.

Shortly after the Panel issued its July Report, a number of larger banks began to repay their TARP assistance and redeem their CPP shares. J.P. Morgan Chase announced it would end its negotiations with Treasury and allow their warrants to be sold at public auction. During the month of June, eight large banks, including Goldman Sachs and Morgan Stanley, repaid their TARP funds and repurchased their warrants in July and August. The amounts that Treasury received for the warrants increased dramatically at this point, with Goldman Sachs, for example, paying 98 percent of the Panel's best estimate of the value of their warrants at repayment date. Repayments of CPP investments and repurchases or auctions of TARP warrants have continued at a steady pace since that time. As of the end of last week, 70 institutions have completely repurchased their CPP preferred shares for an aggregate $137 billion. Of these institutions, 36 have repurchased their warrants for common shares that Treasury received in conjunction with its preferred stock investments, while Treasury has sold the warrants for common shares for nine other institutions at auction. The remaining 26 institutions are comprised of eight private banks whose warrants were immediately exercised for additional preferred shares and 17 institutions whose warrants have not been sold or repurchased, including Wells Fargo and Hartford Financial Services Group.

In total, Treasury has received $6.15 billion from the disposition of its TARP acquired warrants, $2.9 billion from negotiated repurchases and $3.2 billion from auctions. The total received represents slightly more than 102 percent of our best estimate of the value of the warrants at the time they were sold or auctioned. Treasury's use of auctions to dispose of warrants has produced returns of 110 cents on the dollar to Panel valuations, compared to 93 cents on the dollar for repurchases. The Panel's best estimate of the value of the TARP warrants that Treasury continues to hold is currently $5.3 billion.

In addition to the warrants received under the Capital Purchase Program and the Targeted Investment Program, Treasury also received stock warrants in conjunction with the Auto Industry Financing Program. Warrants received as part of the initial assistance to GM and Chrysler were extinguished as part of the credit bid process in bankruptcy. As in the case of other private institutions, the warrants Treasury received in relation to GMAC for a variety of preferred securities were immediately exercised on the investment date.

Conclusion

The requirement that the government receive stock warrants as part of its compensation for the provision of financial assistance during the recent financial crisis allowed American taxpayers to participate in the financial upside experienced by TARP-recipient institutions. As these banks returned to profitability, the public received an additional return on their investment. The Panel has been pleased to see that Treasury's performance in this area has improved dramatically since we first analyzed its initial warrant dispositions. The use of public auctions has clearly allowed for taxpayers to receive a solid return on their investments in these institutions and the transparency provided by public auctions allows the transactions to take place in full public view. Treasury has worked to improve its transparency in this program but more remains to be done in this regard. The Panel has urged the Department to continue publishing the details of its internal valuations for each warrant disposition transaction, as it did most recently in January of this year. The Panel also has urged Treasury to provide more assurance that it is achieving consistency in the negotiated warrant sale price process. The issues of transparency and consistency of outcomes will become even more important as Treasury moves to dispose of the warrants for the many remaining TARP-assisted small banks whose stocks are thinly traded. Taxpayers expect – and deserve – no less for the integrity of the process.

I appreciate the opportunity to share my views. I would be pleased to provide more details on the Panel's assessment of Treasury's warrant disposition efforts or to answer any questions. Thank you.