C. Representative Jeb Hensarling

Although I commend the Panel and its staff for their efforts in producing the December report, I do not concur with all of the analysis and conclusions presented and, thus, dissent. I would like, however, to thank the Panel for incorporating several of the suggestions I offered during the drafting process.

Executive Summary

The Panel's December report focuses on whether Treasury has properly discharged its Congressional mandate under the Emergency Economic Stabilization Act of 2008 – the enabling statute for the Troubled Asset Relief Program. In my view, it is not possible to assess the overall effectiveness of the TARP without acknowledging and thoughtfully analyzing the intended and unintended consequences of the program and the manner in which it was implemented by Treasury. In making these determinations I analyzed a series of specifically tailored metrics and inquired whether the TARP (i) stabilized the U.S. financial system, (ii) promoted lending, (iii) was implemented in a manner so as to protect the taxpayers, (iv) enhanced systemic, implicit guarantee and moral hazard risks, (v) enhanced political risk, (vi) promoted transparency and accountability, and (vii) was used for economic stimulus instead of financial stability.

Based upon this analysis I conclude that the TARP is failing its mandate and offer the following summary of my findings.

- In order to end the abuses of the TARP as evidenced by the Chrysler, General Motors (GM) and GMAC bailouts, misguided foreclosure mitigation programs and the re-animation of reckless behavior and moral hazard risks, Secretary Geithner should not extend the TARP but permit it to end on December 31, 2009.

- As of today, Treasury has approximately $297.2 billion of TARP authority available to fund existing commitments and new programs. As the EESA statute requires, all recouped and remaining TARP funds should go back into the Treasury general fund for debt reduction. All revenues and proceeds from TARP investments that have generated a positive return should also go for debt reduction.

- If the Secretary extends the TARP to October 31, 2010 I fear the Administration will continue to employ taxpayer resources as a revolving bailout fund to promote its politically favored projects as was clearly evident in the Chrysler, GM and GMAC bailouts.

- While the programs offered by Treasury, the Federal Reserve and the FDIC may very well have *jointly* assisted with the stabilization of the financial system over the past year, it seems quite unlikely that the TARP – unassisted by the Federal Reserve and the FDIC – would have stabilized the U.S. financial system.

- Although some criticize the TARP for its failure to jump start new lending activity and for the creation of dysfunctional financial institutions (zombie banks), others note that lending-for-the-sake-of-lending may sow the seeds of the next asset bubble and lead to another round of non-performing loans and toxic securitized debt instruments. Nevertheless, if the TARP is judged on the basis of whether it successfully restarted the lending market for large and small business credit, it appears that it has again failed to meet such expectation.

- It is difficult to conclude that Treasury has diligently discharged its taxpayer protection obligation given the TARP funds that will most likely be lost with respect to AIG, the auto related bailouts and the various foreclosure mitigation efforts.

- Instead of lessening systemic risk the TARP has exacerbated the "too big to fail" problem by making the federal government the implicit guarantor of the largest American financial institutions as well as an undefined select group of business enterprises the failure of which might impede the Administration's economic, social and political agenda.

- By evidencing its willingness to rescue businesses that engage in excessive risk taking and poor business judgment Treasury has created needless implicit guarantee and moral hazard risks and laid the foundation for another economic crisis. If the Administration provides a safety net from risky behavior no one should be surprised if the intended recipients accept the offer and engage in such behavior. If the participants win their high risk bets they will reap all of the benefits but if they lose the taxpayers will bear the burden of picking up the pieces. It is possible that the TARP not only increased the number of "too big to fail" institutions but the size of such institutions as well.

- I remain troubled that the implementation of the TARP has caused the private sector to incorporate the concept of "political risk" into its analysis before engaging in any direct or indirect transaction with the United States government. The realm of political risk is generally reserved for business transactions undertaken in developing countries and not interactions between private sector participants and the United States government. Following the Chrysler and GM decisions it is possible that private sector participants may begin to view interactions with the United States government through the same jaundiced eye they are accustomed to directing toward third-world governments.

- Treasury has often been less than forthcoming regarding matters of transparency and accountability. Treasury should provide detailed financial statements to the taxpayers and operate its TARP investments in a businesslike manner.

- The TARP was promoted as a way to provide "financial stability," and the American Reinvestment and Recovery Act was promoted as a way to provide "economic stimulus."

Regrettably, the TARP has evolved from a program aimed at financial stability during a time of crisis to one that increasingly resembles another attempt by the Administration to promote its economic, political and social agenda through fiscal stimulus.

- The bankruptcy restructurings of Chrysler and GM and the recapitalization of GMAC were financed with TARP proceeds. These cases serve as the poster child of why the TARP should end on December 31, 2009. The restructurings failed each of the standards noted above by exacerbating implicit guarantee and moral hazard risks, incorporating a heavy dose of political risk into private-public sector interactions, offering little in the way of taxpayer protection, transparency and accountability, and using funds dedicated to financial stability for economic stimulus

- Much like the auto industry interventions, HAMP and the Administration's other foreclosure mitigation efforts to date have been a failure. The Administration's opaque foreclosure mitigation efforts have assisted only a small number of homeowners while drawing billions of involuntary taxpayer dollars into a black hole.

- The best foreclosure mitigation program is a job, and the best assurance of job security is economic growth and the adoption of public policy that encourages and rewards capital formation and entrepreneurial success. Without a robust macroeconomic recovery the housing market will continue to languish and any policy that forestalls such recovery will by necessity lead to more foreclosures.

A. Overview

The Panel's December report focuses on whether Treasury has properly discharged its Congressional mandate under the Emergency Economic Stabilization Act of 2008 (EESA) – the enabling statute for the Troubled Asset Relief Program (TARP).[454] In assessing the overall effectiveness of the TARP I will analyze the program against each of the following metrics:

- stabilization of the U.S. financial system;

- increased lending activity;

- taxpayer protection;

[454] The EESA statute requires COP to accomplish the following, through regular reports:

- Oversee Treasury's TARP-related actions and use of authority;
- Assess the impact to stabilization of financial markets and institutions of TARP spending;
- Evaluate the extent to which TARP information released adds to transparency; and
- Ensure effective foreclosure mitigation efforts in light of minimizing long-term taxpayer costs and maximizing taxpayer benefits.

12 U.S.C. § 5223.

- systemic, implicit guarantee and moral hazard risks;
- political risk;
- transparency and accountability; and
- financial stability v. economic stimulus.

I will also describe what I believe was the primary cause of the financial crisis that the TARP was created to remedy. In addition I will retrace my analyses of the Chrysler and General Motors (GM) restructurings – the TARP's lowest point – and the misguided TARP funded foreclosure mitigation efforts.

Based upon this analysis I conclude that the TARP is failing its mandate and recommend that Secretary Geithner not extend the TARP but allow the program to terminate on December 31, 2009.[455]

Before beginning my analysis of the TARP I thought it would be helpful to provide some perspective regarding the magnitude of the taxpayer resources that have been dedicated to financial stability and economic stimulus over the past year. *The Wall Street Journal* recently

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[455] *Geithner Expects Bailout Program to End Soon*, The Associated Press (Dec. 2, 2009) (online at www.nytimes.com/2009/12/03/business/economy/03derivatives.html?scp=1&sq=geithner%20bailout%20december%202&st=cse) :

> "Treasury Secretary Timothy F. Geithner affirmed Wednesday the administration's intent to end the $700 billion financial bailout program soon.
>
> Although Mr. Geithner did not provide details, he said the government was close to the point at which "we can wind down this program" and end it.
>
> "Nothing would make me happier," he told the Senate Agriculture Committee."

Jackie Calmes, *Repaid Bailout Money May Go to Jobless Benefits*, New York Times (Dec. 3, 2009) (online at http://www.nytimes.com/2009/12/03/us/politics/03jobs.html?scp=3&sq=jobless%20benefits%20december%203%202009&st=cse):

> "Treasury Secretary Timothy F. Geithner, testifying on Wednesday before the Senate Agriculture Committee, warned against shuttering the program just yet, given the continued weakness in the banking, housing and real estate markets. But Mr. Geithner said much of the $700 billion would not be needed, an indication of how far the financial industry has improved since Mr. Obama took office and prepared to ask for up to $500 billion more. On Wednesday, Bank of America announced that it would repay all of its $45 billion in bailout money before the end of the year."

Michael Crittendon and Sarah Lynch, *Geithner Says TARP Is Winding Down, but Date Not Set*, Wall Street Journal (Dec. 3, 2009) (online at online.wsj.com/article/SB125976850821372893.html):

> "The Obama administration will outline its plan to end the government's $700 billion financial rescue program in the next few weeks, a top official said, though that doesn't mean it will expire as scheduled by year end.
>
> "We are close to the point where we can wind down this program and stop making new commitments," Treasury Secretary Timothy Geithner told a U.S. Senate panel Wednesday."

reported that Treasury is considering the investment of up to an *additional* $5.6 billion in GMAC.[456] To date Treasury has invested $12.5 billion in GMAC. I am not aware of any serious claim that the survival of GMAC is necessary for the financial stability of our country. Remarkably, the up to $18 billion that ultimately may be invested in GMAC represents a small drop in a large bucket relative to the trillions of dollars of taxpayer sourced funds presently committed to financial stability and economic stimulus. By comparison, for fiscal year 2010 the National Institute of Health has requested just over $6 billion for cancer research.[457] Although the Panel is not charged with debating the allocation of limited public resources, as taxpayers we may nevertheless question if GMAC merits the equivalent of three years of taxpayer funded cancer research.

B. Primary Cause of the Financial Crisis

Just as a history of bad management decisions did not preclude Chrysler and GM from receiving TARP funds, the same is true of Fannie Mae and Freddie Mac. It should be noted that their financial insolvency materialized after years of mismanagement – and after years of enjoying the gold seal of the government's implicit guarantee. Fannie and Freddie exploited their Congressionally-granted charters to borrow money at discounted rates. They dominated the entire secondary mortgage market and wildly inflated their balance sheets. Because market participants long understood that this government created duopoly was implicitly (and, now, explicitly) backed by the federal government, investors and underwriters chose to believe that if Fannie or Freddie touched something, it was safe, sound, secure, and most importantly "sanctioned" by the government. The results of those misperceptions have had a devastating impact on our entire economy. Given Fannie and Freddie's market dominance, it should come as little surprise that once they dipped into the subprime and Alt-A markets, lenders quickly followed suit. In 1995, HUD authorized Fannie and Freddie to purchase subprime securities that included loans to low-income borrowers and allowed the government sponsored enterprises (GSEs) to receive credit for those loans toward their mandatory affordable housing goals. Fannie and Freddie readily complied, and as a result, subprime and near-prime loans jumped from 9 percent of securitized mortgages in 2001 to 40 percent in 2006. In 2004 alone, Fannie and Freddie purchased $175 billion in subprime mortgage securities, which accounted for 44 percent of the market that year. Then, from 2005 through 2007, the two GSEs purchased approximately

[456] Dan Fitzpatrick and Damian Paletta, *GMAC Asks for Fresh Lifeline*, Wall Street Journal (Oct. 29, 2009) (online at online.wsj.com/article/SB125668489932511683.html?mod=djemalertNEWS).

"The U.S. government is likely to inject $2.8 billion to $5.6 billion of capital into the Detroit company, on top of the $12.5 billion that GMAC has received since December 2008, these people said. The latest infusion would come in the form of preferred stock. The government's 35.4% stake in the company could increase if existing shares eventually are converted into common equity."

[457] Senate Committee on Appropriations, Subcommittee on Labor, Health and Human Services, Education, and Related Agencies, Written Testimony of National Cancer Institute Director John E. Niederhuber, *Budget Request for FY 2010* (May 21, 2009) (online at legislative.cancer.gov/files/appropriations-2009-05-21.pdf).

$1 trillion in subprime and Alt-A loans, and Fannie's acquisitions of mortgages with less than 10-percent down payments almost tripled. As a result, the market share of conventional mortgages dropped from 78.8 percent in 2003 to 50.1 percent by 2007 with a corresponding increase in subprime and Alt-A loans from 10.1 percent to 32.7 percent over the same period. These non-traditional loan products, on which Fannie and Freddie so heavily gambled as their Congressional supporters encouraged them to "roll the dice a little bit more," now constitute many of the same non-performing loans which have contributed to our current foreclosure troubles. [458] Private sector lenders and securitizers of mortgage backed securities lowered their diligence and underwriting standards in order to compete with the heavily subsidized duopoly resulting in unprecedented levels of mortgage defaults and the near shut-down of our credit markets. Without the reckless behavior of Freddie and Fannie it seems most unlikely that a financial crisis of the magnitude we have experienced over the past year would have developed.[459]

GAO noted in a September 2009 report:

> "While housing finance may have derived some benefits from the enterprises' activities over the years, GAO, federal regulators, researchers, and others long have argued that the enterprises had financial incentives to engage in risky business practices to strengthen their profitability partly because of the financial benefits derived from the implied federal guarantee on their financial obligations."[460]

In September 2008, Treasury put Fannie Mae and Freddie Mac into conservatorship under the Federal Housing Finance Agency (FHFA), effectively making taxpayers liable for their

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[458] Representative Jeb Hensarling, *Additional Views to Congressional Oversight Panel, March Oversight Report: Foreclosure Crisis: Working Towards a Solution* (Mar. 6, 2009) (online at cop.senate.gov/documents/cop-030609-report-view-hensarling.pdf).

[459] In addition, for well over twenty years, federal policy has promoted lending and borrowing to expand homeownership, through incentives such as the home mortgage interest tax exclusion, the FHA, discretionary HUD spending programs, and the Community Reinvestment Act (CRA). CRA is an example of a program with the best of intentions having adverse, unintended consequences on exactly the population it hopes to serve. It was initially authorized to prevent "redlining," a term that refers to the practice of denying loans to neighborhoods considered to be higher economic risks, by mandating banks lend to the communities where they take deposits. Since its passage into law in 1977, however, CRA has advanced at least two undesirable outcomes: (1) some financial institutions completely avoided doing business in neighborhoods and restricted even low-risk forms of credit, and (2) many institutions went the other way and relaxed underwriting standards to meet CRA guidelines, thus opening the door to the development of certain risky products that have contributed to the problem of foreclosures. These lax underwriting standards spread to Fannie and Freddie and ultimately to the private sector as the role of the GSEs morphed from that of a liquidity provider to a promoter of home ownership.

[460] Government Accountability Office, *Analysis of Options for Revising the Housing Enterprises' Long-term Structures* (September 2009) (online at www.gao.gov/new.items/d09782.pdf).

portfolios which now total about $5.46 trillion (including mortgage-backed securities and other guarantees, as well as gross mortgage portfolios).[461]

C. Analysis of the TARP

In my view, it is not possible to assess the overall effectiveness of the TARP without acknowledging and thoughtfully analyzing the intended and unintended consequences of the program and the manner in which it was implemented by Treasury. Any analysis that does not thoroughly consider the issues of implicit guarantee, moral hazard, political risk, transparency and accountability, and financial stability v. economic stimulus is myopic and of limited benefit.

1. Stabilization of U.S. Financial System

Any role that the TARP may have played over the past year in stabilizing the financial system cannot be analyzed to the exclusion of the programs adopted by the Federal Reserve and the FDIC. Although Treasury's maximum exposure under the TARP totals $698.7 billion, the Federal Reserve and the FDIC have maximum exposures of $1.732 trillion and $666.7 billion, respectively.[462]

Any such analysis becomes more challenging when you consider the broad array of programs adopted by Treasury, the Federal Reserve and the FDIC. Treasury – under TARP authority – rolled out a dizzying group of programs including, among others:

- the Capital Purchase Program (CPP-the purchase of preferred stock in approximately 700 financial institutions);
- the Targeted Investment Program (TIP-exceptional assistance to Citigroup and Bank of America);
- the Systemically Significant Failing Institutions Program (SSFI-exceptional assistance to AIG);
- the Asset Guarantee Program (AGP-the guarantee of certain assets of Citigroup);
- the Public-Private Investment Program (PPIP-purchase of toxic assets from financial institutions);
- the Term-Asset Back Securities Loan Facility Program (TALF-restart the securitization market);

[461] Fannie Mae, *Monthly Summary* (July 2009) (online at www.fanniemae.com/ir/pdf/monthly/2009/073109.pdf); Freddie Mac, *Monthly Volume Summary* (July 2009) (online at www.freddiemac.com/investors/volsum/pdf/0709mvs.pdf).

[462] See Figure 27 on pp. 79-80 of the Panel's December report.

- various small business programs;
- the Making Home Affordable Program (MHA-foreclosure mitigation, including the Home Affordable Modification Program (HAMP) and the Home Affordable Refinancing Program (HARP));
- the Automotive Industry Financing Program (AIFP-bailout of Chrysler, GM and GMAC); and
- the Auto Supplier Support Program (bailout of certain auto suppliers).

The Federal Reserve has extended credit to AIG, advanced loans under the TALF program, provided asset guarantees to Citigroup and extended over $1 trillion in credit under, among others, its Term Auction Facility, discount window program, Primary Dealer Credit Facility, commercial paper facility programs, and GSE debt securities and mortgage backed securities programs. The FDIC introduced the Temporary Liquidity Guarantee Program (TLGP-guarantee of debt issued by certain financial institutions), structured a PPIP program for whole loans, guaranteed assets of Citigroup and increased outlays to its deposit insurance fund.[463] The Panel's current and prior reports analyze many of these programs in detail.

While the programs offered by Treasury, the Federal Reserve and the FDIC may very well have *jointly* assisted with the stabilization of the financial system over the past year, it seems quite unlikely that the TARP – unassisted by the Federal Reserve and the FDIC – would have stabilized the U.S. financial system.[464]

Interestingly, some who attribute relative success to certain aspects of the TARP offer only faint praise. Dr. Dean Baker, Co-Director, Center for Economic and Policy Research, provided the following testimony to the Panel:

> "There are many factors that make it difficult to assess the effectiveness of the TARP, most important one being the fact that the TARP was carried through in conjunction with rescue efforts by the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve Board. The money made available to the financial system through these alternative mechanisms was considerably larger than the amount made available through the TARP. Furthermore, there is no

[463] See pp. 74-81 of the Panel's December report.

[464] Because it has served as a barrier to private-sector investment and capital formation, TARP has likely done much more to impede job creation and organic economic growth than it has done to promote them. U.S. unemployment recently surpassed 10 percent for the first time in 26-years and the broader definition of unemployment – including those who are underemployed and have stopped looking for work – recently jumped to 17.5 percent. Although the two metrics have fallen to 10 percent and 17.2 percent, respectfully, such improvements, while encouraging, hardly signal a return to a robust employment market.

publicly available information on the terms or the beneficiaries of the loans issued through the Fed's special lending facilities.

For this reason, there is no easy way to determine the importance of TARP funds in stabilizing the financial system. Clearly, the TARP did play a role in stopping the panic that was driving financial markets last year. Together with the other structures put in place, the TARP did succeed in restoring stability to the financial system.

However, keeping the financial system operating is a rather low bar. There is little doubt that the Federal Reserve Board, with its virtual unlimited ability to print money, can prevent a financial collapse. The relevant question is whether the TARP, along with the other programs put in place, restored stability in a way that best served the real economy and also can be viewed as fair by the American people. By these criteria, the TARP does not score very well."[465]

Roy Smith, Professor of Finance, New York University Stern School of Business, states in his written submission to the Panel that the role of the TARP was relatively small compared to that of the Federal Reserve. In his view, the greatest contribution of the program was its announcement, which signaled that the government intended to act, while the actual accomplishments of the program are "relatively few and unimportant." Professor Smith states that Treasury's highest priority should be to recover the TARP's investment.[466]

William Isaac, chairman of the FDIC, 1981-1985, argues in his written submission to the Panel that the TARP legislation did more harm than good, and that the Federal Reserve, the FDIC and the SEC had the tools necessary to alleviate the financial crisis without taxpayer outlays. In Chairman Isaac's view, Treasury lacked the expertise and personnel to run the capital infusion program, and as a result Treasury should have turned the program over to the FDIC. Isaac criticizes Treasury for (i) forcing banks to participate in the TARP, (ii) publicly announcing the stress tests, and (iii) taking the position that the TARP is a revolving fund.[467]

2. Lending

Dr. Baker offered the following written testimony to the Panel regarding the lending activity of TARP recipients:

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[465] Congressional Oversight Panel, *Written Testimony of Center for Economic and Policy Research Co-Director Dean Baker, Taking Stock: Independent Views on TARP's Effectiveness*, at 1 (Nov. 19, 2009) (online at cop.senate.gov/documents/testimony-111909-baker.pdf).

[466] Roy Smith, Letter to Panel Staff (Oct. 23, 2009).

[467] William Isaac, Letter to Panel Staff (Nov. 6, 2009).

> "The one sector that clearly is having difficulty securing credit is the small business sector. While this is an impediment to recovery, this sort of credit tightening is typical of a recession. The complaints from business owners over being denied credit are not qualitatively different than the complaints that were made in 1990-91 recession. Lenders will also tighten credit to business during a downturn simply because otherwise healthy businesses are much risk[ier] prospects during a recession. There is no reason to believe that the tightening of credit during this downturn is any greater than what should be expected given the severity of the recession. To press banks to make more loans in this context would be to insist that they make loans on which they expect to lose money. This would be questionable economic policy."[468]

Although some criticize the TARP for its failure to jump start new lending activity and for the creation of dysfunctional financial institutions (zombie banks), Dr. Baker notes that lending-for-the-sake-of-lending may sow the seeds of the next asset bubble and lead to another round of non-performing loans and toxic securitized debt instruments. Nevertheless, if the TARP is judged on the basis of whether it successfully restarted the lending market for large and small business credit, it appears that it has again failed to meet such expectation.

3. Taxpayer Protection

Roughly $71 billion of TARP funds have been paid back, mostly from large financial institutions who received equity injections as part of the CPP. In addition, Bank of America recently announced that it will repay the full $45 billion with interest it has accessed from the TARP. As Treasury unwinds several TARP programs where the taxpayers have recouped their investments with interest, the Panel should focus its attention on the new or existing programs that are likely more enduring and costly to the taxpayers. The opportunity cost of not providing rigorous oversight in these areas is high. These programs include taxpayer funds directed to AIG, Chrysler, GM, GMAC, foreclosure mitigation, preferred and common share purchases in Citigroup, Bank of America and hundreds of additional large and small financial institutions and other initiatives. The Panel should undertake to analyze these programs to determine if the investment of taxpayer funds is appropriate, authorized under EESA and adequately protected. This undertaking is particularly important with respect to the TARP funded foreclosure mitigation programs since EESA requires the Panel to "ensure effective foreclosure mitigation efforts in light of minimizing long-term taxpayer costs and maximizing taxpayer benefits." It is difficult to conclude that Treasury has diligently discharged its taxpayer protection obligation given the TARP funds that will most likely be lost with respect to AIG, the auto related bailouts and the various foreclosure mitigation efforts.

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[468] Congressional Oversight Panel, *Written Testimony of Center for Economic and Policy Research Co-Director Dean Baker, Taking Stock: Independent Views on TARP's Effectiveness*, at 4, 5 (Nov. 19, 2009) (online at cop.senate.gov/documents/testimony-111909-baker.pdf).

4. Systemic, Implicit Guarantee and Moral Hazard Risks

Instead of reducing systemic risk the TARP has exacerbated the "too big to fail" problem by making the federal government the implicit guarantor of the largest American financial institutions as well as an undefined select group of business enterprises the failure of which might impede the Administration's economic, social and political agenda.[469] By evidencing its willingness to rescue businesses that engage in excessive risk taking and poor business judgment Treasury has created needless implicit guarantee and moral hazard risks and laid the foundation for another economic crisis. If the Administration provides a safety net from risky behavior no one should be surprised if the intended recipients accept the offer and engage in such behavior. If the participants win their high risk bets they will reap all of the benefits but if they lose the taxpayers will bear the burden of picking up the pieces. It is possible that the TARP not only increased the number of "too big to fail" institutions but the size of such institutions as well.

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[469] The *Financial Times* reports that thirty institutions have made the latest "too big to fail list":

> "The list, which is not public, contains many of the multinational bank names that would be widely expected: Goldman Sachs, JPMorgan Chase, Morgan Stanley, Bank of America Merrill Lynch and Citigroup of the US; Royal Bank of Canada; UK groups HSBC, Barclays, Royal Bank of Scotland and Standard Chartered; UBS and Credit Suisse of Switzerland; France's Société Générale and BNP Paribas; Santander and BBVA from Spain; Japan's Mizuho, Sumitomo Mitsui, Nomura, Mitsubishi UFJ; Italy's UniCredit and Banca Intesa; Germany's Deutsche Bank; and Dutch group ING.
>
> The exercise follows the establishment of the FSB in the summer and is principally designed to address the issue of systemically important cross-border financial institutions through the setting up of supervisory colleges. These colleges will comprise regulators from the main countries in which a bank or insurer operates and will have the job of better coordinating the supervision of cross-border financial groups.
>
> As a spin-off from that process, the groups on the list will also be asked to start drawing up so-called living wills – documents outlining how each bank could be wound up in the event of a crisis.
>
> Regulators are keen to see living wills prepared for all systemically important financial groups, but the concept has split the banking world, with the more complex groups arguing that such documents will be almost impossible to draft without knowing the cause of any future crisis."

Patrick Jenkins and Paul J. Davies, *Thirty Financial Groups on Systemic Risk List*, Financial Times (Nov. 30, 2009) (online at www.ft.com/cms/s/0/c680e0da-dd4e-11de-ad60-00144feabdc0.html).

The *Wall Street Journal* recently reported regarding Treasury's AIG exit strategy:

> "The bailout of AIG, owned 80% by taxpayers, is one of the most controversial of the government's unpopular bailouts. Yet with so much taxpayer money at stake, the government is asserting its ownership.
>
> AIG is the best example of why the government should never get itself in the position of even having to make these tradeoffs," said Anil Kashyap, an economics professor at the University of Chicago Booth School of Business. "It's why you don't want the government involved in the private sector in the first place."

Deborah Solomon, *AIG's Rescue Bedevils U.S.*, Wall Street Journal (Nov. 23, 2009) (online at online.wsj.com/article/SB10001424052748703819904574554241356640428.html).

Charles Calomiris, the Henry Kaufman Professor of Financial Institutions, Columbia Business School, stated in written testimony before the Panel:

> "In my judgment, TARP and other interventions were not designed properly, and consequently assistance programs have resulted in less benefit to the economy than they should have (in particular, have resulted in insufficient mitigation of the credit crunch) and they have cost more than they should have (in the form of excessive taxpayer bearing of current losses, and unnecessary moral-hazard incentive costs going forward).
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> . . .
>
> Government loans, guarantees and investments in troubled financial institutions (which even include potential capital infusions into the GSEs), not to mention government purchases of assets (as originally contemplated under the TARP plan, and as executed under the TALF plan) have resulted in huge losses to taxpayers (Fannie and Freddie and FHA subprime lending will account for the lion's share of these losses, as *they alone will approach half a trillion dollars*) and remaining risks of future loss. They also have changed the risk-taking behavior of financial institutions going forward. If financial institutions know that the government is there to share losses, risk-taking becomes a one-sided bet, and so more risk is preferred to less. There is substantial evidence from financial history – including the behavior of troubled financial institutions during the current crisis itself – that this "moral-hazard" problem can give rise to hugely loss-making, high-risk investments that are both socially wasteful and an unfair burden on taxpayers."[470] (emphasis in original.)

In order to avoid the creation of moral hazard risks, Professor Calomiris advises that any government sponsored intervention incorporate the following concepts:

> "(1) Assistance should be offered only under *rare* circumstances. The purpose of assistance is not to prevent the failure of one or a few institutions, per se; assistance is only warranted when asymmetric information about the incidence of losses in the financial system leads to a general breakdown in financial market buying and selling, resulting in a liquidity crisis, which makes it impossible or excessively difficult for otherwise solvent borrowers to roll over their debts, or for banks to prove their solvency to the market in order to access needed capital to shore up their positions.

[470] Congressional Oversight Panel, Written Testimony of Charles Calomiris, Henry Kaufman Professor of Financial Institutions, Columbia Business School, *Taking Stock: Independent Views on TARP's Effectiveness*, at 1, 3 (Nov. 19, 2009) (online at cop.senate.gov/documents/testimony-111909-calomiris.pdf).

(2) The design of assistance is crucial to maximizing its effectiveness and minimizing its social costs; particularly the allocation of the risk of loss between the private sector and the government is crucial to the successful design of assistance. Assistance should be *selective*, targeted toward institutions worth saving, not basket cases. Government should take a *senior* position in loss sharing; in discount window lending that is ensured through collateralization of loans; in preferred stock purchases, seniority is ensured through the adequacy of common equity; in other assistance programs, it is achieved through the structure of guarantees (e.g., their out-of-the-moneyness).

(3) The assistance toolkit must be *diverse*. The proper structure of assistance depends on the severity of the systemic crisis being addressed; discount window lending may be sufficient for dealing with liquidity crises that are not very severe, bank preferred stock purchases by the government may make sense for more severe shocks, and other mechanisms (organized rescues of failed institutions, or guarantees attached to liabilities or assets) may be the only effective tools to employ when the crisis is even more severe. No matter which of the tools is employed, the other principles (*rarity*, *selectivity*, and *seniority*) can and should be adhered to."[471] (emphasis in original).

Dr. Baker submitted the following testimony to the Panel regarding systemic risk:

"The crisis itself led to further concentration in the financial sector, with the largest banks all having been encouraged to buy up bankrupt competitors. As a result, the largest banks now enjoy fairly explicit "too big to fail" protection. There also has been almost nothing done to restrain the speculative practices of the major banks. Goldman Sachs, in particular, stands out by virtue of the fact that it is still acting as an investment bank (arguably, it can better be described as a hedge fund), even though it is now operating under the protective umbrella of the Federal Reserve Board and the FDIC. There does not appear to be any effort to restrain its speculative activity."

Simon Johnson, the Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management, stated in written testimony before the Panel:

"If any country pursues (a) unlimited government financial support, while not implementing (b) orderly resolution for troubled large institutions, and refusing to take on (c) serious governance reform, it would be castigated by the United States and come under pressure from the IMF. At the heart of every crisis is a political

[471] Congressional Oversight Panel, Written Testimony of Charles Calomiris, Henry Kaufman Professor of Financial Institutions, Columbia Business School, *Taking Stock: Independent Views on TARP's Effectiveness*, at 6, 7 (Nov. 19, 2009) (online at cop.senate.gov/documents/testimony-111909-calomiris.pdf).

problem – powerful people, and the firms they control, have gotten out of hand. Unless this is dealt with as part of the stabilization program, all the government has done is provide an unconditional bailout. That may be consistent with a short-term recovery, but it creates major problems for the sustainability of the recovery and for the medium-term. Serious countries do not do this. Seen in this context, TARP has been badly mismanaged."

. . .

"The implementation of TARP exacerbated the perception (and the reality) that some financial institutions are "Too Big to Fail." This lowers their funding costs, enabling them to borrow more and to take more risk."

. . .

"The administration as much as said that the major banks will all pass the stress tests, making it appear that the results were foreordained. Essentially, this was used to signal that the government stood behind the 19 banks in the stress test and would not allow any of them to fail. Effectively, the government signaled which banks were Too Big To Fail."[472]

Viral Acharya and Matthew Richardson, Professors of Finance, New York University Stern School of Business, argue in their written submission to the Panel that the CPP did not include "sufficient strings attached," and as a result created the expectation of "unconditional government support" in the future. Moving forward, Professors Acharya and Richardson highlight the risks of moral hazard, noting "it is not just about fighting the last war, but also about the next one."[473]

Paul Volcker, former Chairman of the Federal Reserve, 1979-1987, and member of the Economic Recovery Advisory Board, states in his written submission to the Panel that Treasury "appears to have done a good job in structuring their capital investments," but questions the extent to which the program is currently having a positive impact on the flow of credit. Chairman Volcker also notes the problems associated with moral hazard, concluding that reform is necessary.[474]

William Poole, Senior Fellow, the Cato Institute, argues in his written submission to the Panel that the core issue in the financial system today is the subsidy to large banks created by the

[472] Congressional Oversight Panel, Written Testimony of Professor Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management, *Taking Stock: Independent Views on TARP's Effectiveness*, at 2, 3, 7 (Nov. 19, 2009) (online at cop.senate.gov/documents/testimony-111909-johnson.pdf).

[473] Viral Acharya and Matthew Richardson, Letter to Panel Staff (received Nov. 6, 2009).

[474] Paul A. Volcker, Letter to Panel Staff (Nov. 6, 2009).

implicit federal guarantee of bank liability. Citing a recent paper by Dean Baker and Travis McArthur, Mr. Poole notes that the implicit subsidy may be as large as $34 billion per year. In addition to this subsidy, the funding advantage enjoyed by large banks permits them to grow larger, increasing the risks posed by banks that are too big to fail. Poole also notes that efforts to control executive compensation are "unwise and will ultimately be ineffective."[475]

In a recent report, SIGTARP addressed the problem of moral hazard, stating that "TARP runs the risk of merely re-animating markets that had collapsed under the weight of reckless behavior."[476] I am concerned that the TARP is again inflating the problem of moral hazard by providing government funded capital to institutions that contributed to the crisis, modifications to homeowners who may have taken on too much risk, and lower-cost loans to spur the purchase of what may be volatile, high-priced asset backed securities.

The SIGTARP report also discussed the cost of the TARP to the government's credibility. It claims, "Unfortunately, several decisions by Treasury – including Treasury's refusal to require TARP recipients to report on their use of TARP funds, its less-than accurate statements concerning TARP's first investments in nine large financial institutions, and its initial defense of those inaccurate statements – have served only to damage the Government's credibility and thus the long-term effectiveness of TARP."[477] I do not see how Treasury will be able to regain the public's trust so long as it continues to employ taxpayer sourced funds to make investments based upon the Administration's economic, political and social agenda where there is diminished promise that such funds will be fully recouped.[478]

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[475] William Poole, Letter to Panel Staff (Oct. 23, 2009).

[476] SIGTARP, *Quarterly Report to Congress*, at 4 (Oct. 21, 2009) (online at sigtarp.gov/reports/congress/2009/October2009_Quarterly_Report_to_Congress.pdf).

[477] SIGTARP, *Quarterly Report to Congress*, at 4 (Oct. 21, 2009) (online at sigtarp.gov/reports/congress/2009/October2009_Quarterly_Report_to_Congress.pdf).

[478] Three recent examples of the problems that may arise with respect to government financed investments in the private sector include:

(i) GAO recently issued a report on the Chrysler and GM bailouts. The GAO report states:

> "As long as Treasury maintains ownership interests in Chrysler and GM, it will likely be pressured to influence the companies' business decisions.
>
> . . .
>
> Treasury officials stated that they established such up-front conditions not solely to protect Treasury's financial interests as a creditor and equity owner but also to reflect the Administration's views on responsibly utilizing taxpayer resources for these companies. While Treasury has stated it does not plan to manage its stake in Chrysler or GM to achieve social policy goals, these requirements and covenants to which the companies are subject indicate the challenges Treasury has faced and likely will face in balancing its roles."

Government Accountability Office, Troubled Asset Relief Program: Continued Stewardship Needed as Treasury Develops Strategies for Monitoring and Divesting Financial Interests in Chrysler and GM (Nov. 2, 2009) (online at www.gao.gov/new.items/d10151.pdf).

In my view and as supported by the above cited economists, the TARP has created substantial and needless implicit guarantee and moral hazard risks. In order to articulate these risks I offer the following analysis from the Panel's November report on the government sponsored guarantee programs which also applies to the broader TARP:

(ii) Thomas E. Lauria, the Global Practice Head of the Financial Restructuring and Insolvency Group at White & Case LLP, represented a group of senior secured creditors, including the Perella Weinberg Xerion Fund ("Perella Weinberg"), during the Chrysler bankruptcy proceedings.

On May 3, the *New York Times* reported:

> "In an interview with a Detroit radio host, Frank Beckmann, Mr. Lauria said that Perella Weinberg 'was directly threatened by the White House and in essence compelled to withdraw its opposition to the deal under threat that the full force of the White House press corps would destroy its reputation if it continued to fight.'
>
> In a follow-up interview with ABC News's Jake Tapper, he identified Mr. [Steven] Rattner, the head of the auto task force, as having told a Perella Weinberg official that the White House 'would embarrass the firm.'"

News/Talk WJR 760 am, *Frank Talks With Tom Lauria, Who Represents a Group of Lenders That Object to the Chrysler Sale* (May 1, 2009) (online at www.760wjr.com/article.asp?id=1301727&spid=6525).

For a further discussion of the interactions between Mr. Rattner and Perella Weinberg seeWilliam D. Cohan, *The Final Days of Merrill Lynch*, The Atlantic (Sept. 2009) (online at www.theatlantic.com/doc/200909/bank-of-america) and Steve Fishman, *Exit the Czar*, New York Magazine (Aug. 2, 2009) (online at nymag.com/news/features/58193/).

I requested Secretary Geithner to investigate the allegation and, to my disappointment, he declined. Specifically, I submitted the following question for the record to the Secretary:

> "Will you agree to conduct a prompt and thorough investigation of this matter by contacting Mr. Rattner, Mr. Lauria and representatives of Weinberg Perella and submit your findings to the Panel?"

The Secretary responded:

> "SIGTARP will determine the appropriate actions with regard to this issue. But as noted above, I would reiterate that Mr. Rattner categorically denies Mr. Lauria's allegations."

Again, I ask the Secretary to investigate this matter and report his findings to the Panel.

See my dissent from the September report on the auto bailouts. Representative Jeb Hensarling, *Additional Views to Congressional Oversight Panel, September Oversight Report: The Use of TARP Funds in the Support and Reorganization of the Domestic Automotive Industry* (Sept. 9, 2009) (online at cop.senate.gov/documents/cop-090909-report-additionalviews.pdf).

(iii) *The Wall Street Journal* recently reported.

> "Federal support for companies such as GM, Chrysler Group LLC and Bank of America Corp. has come with baggage: Companies in hock to Washington now have the equivalent of 535 new board members – 100 U.S. senators and 435 House members.
>
> Since the financial crisis broke, Congress has been acting like the board of USA Inc., invoking the infusion of taxpayer money to get banks to modify loans to constituents and to give more help to those in danger of foreclosure. Members have berated CEOs for their business practices and pushed for caps on executive pay. They have also pushed GM and Chrysler to reverse core decisions designed to cut costs, such as closing facilities and shuttering dealerships."

Neil King, Jr., *Politicians Butt In at Bailed-Out GM*, Wall Street Journal (Oct. 29, 2009) (online at online.wsj.com/article/SB125677552001414699.html#mod=todays_us_page_one).

"A larger issue arises when one considers the implicit guarantees, those that are paid for by neither party, but whose cost is borne by the taxpayer. The [government sponsored guarantee programs] carry fees paid for by the financial institutions. But their existence, and the existence of the other elements of the bailout of the financial system, could imply that there is a permanent, and "free," insurance provided by the government, especially for those institutions deemed "too big to fail," or "too connected to fail." There is an implication that, in the case of another major economic collapse, the government will again step in to prop up the financial system, especially the "too big to fail" institutions. This moral hazard creates a real risk to the system.

This "free" insurance causes a number of distortions in the marketplace. On the financial institution side, it might promote risky behavior. On the investor and shareholder side, it will provide less incentive to hold management to a high standard with regard to risk-taking. By creating a class of "too big to fail" institutions, it has provided these institutions with an advantage with respect to the pricing of credit:

> Creditors who believe that an institution will be regarded by the government as too big to fail may not price into their extensions of credit the full risk assumed by the institution. That, of course, is the very definition of moral hazard. Thus the institution has funds available to it at a price that does not fully internalize the social costs associated with its operations. The consequences are a diminution of market discipline, inefficient allocation of capital, the socialization of losses from supposedly market-based activities, and a competitive advantage for the large institution compared to smaller banks.[479]

The implied guarantee of "too big to fail" institutions might also result in a concentration of risk in this group, resulting in greater danger to the taxpayer if and when the government must step in again."

5. Political Risk

In addition to the implicit guarantee and moral hazard issues discussed above, I am troubled that the implementation of the TARP has caused the private sector to incorporate the concept of "political risk" into its analysis before engaging in any direct or indirect transaction with the United States government. While private sector participants are accustomed to operating within a complex legal and regulatory environment, many are unfamiliar with the

[479] Board of Governors of the Federal Reserve System, Speech: Federal Reserve Board Governor Daniel K. Tarullo at the Exchequer Club, Washington D.C., *Confronting Too Big to Fail* (Oct. 21, 2009) (online at www.federalreserve.gov/newsevents/speech/tarullo20091021a.htm).

emerging trend of public sector participants to bend or restructure rules and regulations so as to promote their economic, social and political agenda as was clearly evident in the Chrysler and GM bankruptcies (described in more detail below). The realm of political risk is generally reserved for business transactions undertaken in developing countries and not interactions between private sector participants and the United States government. Following the Chrysler and GM decisions it is possible that private sector participants may begin to view interactions with the United States government through the same jaundiced eye they are accustomed to directing toward third-world governments. It's disingenuous for the Administration to champion transparency and accountability for the private sector but neglect such standards when conducting its own affairs. How is it possible for directors and managers of private sector enterprises to discharge their fiduciary duties and responsibilities when policy makers legislate and regulate without respect for precedent and without thoughtfully vetting the unintended consequences of their actions?

6. Transparency and Accountability

Although improvements have been made, Treasury has often been less than forthcoming regarding matters of transparency and accountability. I agree with Alex Pollock, a Resident Fellow with the American Enterprise Institute, that Treasury should provide detailed financial statements to the taxpayers and operate its TARP investments in a businesslike manner. Mr. Pollock provided the following testimony to the Panel:

> "The principal goal should be to run [TARP] in a businesslike manner to return as much of the involuntary investment as possible to its owners, along with a reasonable overall profit. The predominant discipline should be that of investment management, not politics."
>
> …
>
> "In my view, TARP should have full, regular, audited financial statements, which depict its financial status and results, exactly as if it were a corporation. There should be a balance sheet, with all assets, liabilities, accumulated profits or losses, and contingencies. There should be a profit and loss statement and a statement of cash flows. The expenses should include the interest cost of the Treasury debt required to fund its disbursements, and like every financial operation, TARP management should be estimating probable losses on investments and reserving accordingly.
>
> Had TARP been organized as a corporation, it would have facilitated this accountability. But even with its status as a "program", we should insist on appropriate and regular accounting. Everybody must agree with this basic requirement for financial responsibility.

> Moreover, TARP's financial statements should include line of business reporting. Logical separate profit and loss reporting units would include: the Capital Purchase Program; automotive program; Citigroup; AIG; mortgage modification (of course a total loss from the TARP point of view); and small business and consumer programs."[480]

7. Financial Stability v. Economic Stimulus

The TARP was promoted as a way to provide "financial stability," and the American Reinvestment and Recovery Act (ARRA) was promoted as a way to provide "economic stimulus." In testimony on the still-nascent TARP, former Treasury Secretary Henry Paulson reminded Congress, "[t]he rescue package was not intended to be an economic stimulus or an economic recovery package; it was intended to shore up the foundation of our economy by stabilizing the financial system…"[481] Regrettably, the TARP has evolved from a program aimed at financial stability during a time of crisis to one that increasingly resembles another attempt by the Administration to promote its economic, political and social agenda through fiscal stimulus. If the TARP is not being used for "economic stimulus," then how else is it possible to explain the $81 billion bankruptcy restructuring of Chrysler and GM, neither of which qualifies as a "financial institution" as required under EESA? In addition, the United States government has agreed to transfer to Fiat part of the equity it received in Chrysler if Fiat assists Chrysler in building a car that produces 40 miles per gallon. What does this transfer of United States government owned Chrysler stock to Fiat have to do with "financial stability"? No transparent end-game is in sight for the TARP's commitment to support Chrysler, GM and GMAC.

D. Chrysler and GM Bankruptcies[482]

The bankruptcy restructurings of Chrysler and GM and the recapitalization of GMAC were financed with TARP proceeds. These cases serve as the poster child of why the TARP should end on December 31, 2009. If the TARP is extended to October 31, 2010, I fear the Administration will continue to employ taxpayer resources as a revolving bailout fund to promote its economic, social and political agenda as was clearly evident in the Chrysler, GM and GMAC bankruptcy restructurings. These restructurings failed each of the standards noted above by exacerbating implicit guarantee and moral hazard risks, incorporating a heavy dose of

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[480] Congressional Oversight Panel, Written Testimony of American Enterprise Institute resident fellow Alex J. Pollock, *Taking Stock: Independent Views on TARP's Effectiveness* (Nov. 19, 2009) (online at aei.org/docLib/Pollock-Testimony-11192009.pdf).

[481] U.S. Department of the Treasury, *Testimony of Treasury Secretary Paulson before the House Financial Services Committee* (Nov. 18, 2008) (online at www.treasury.gov/press/releases/hp1279.htm).

[482] In this section I borrow extensively from my dissent to the Panel's September report on the auto bailouts. Representative Jeb Hensarling, *Additional Views to Congressional Oversight Panel, September Oversight Report: The Use of TARP Funds in the Support and Reorganization of the Domestic Automotive Industry* (Sept. 9, 2009) (online at cop.senate.gov/documents/cop-090909-report-additionalviews.pdf).

political risk into private-public sector interactions, offering little in the way of taxpayer protection, transparency and accountability, and using funds dedicated to financial stability for economic stimulus.[483]

1. Policy Issues and Fundamental Questions Arising from the Use of TARP Proceeds in the Chrysler and GM Bankruptcies

Over the past year taxpayers have involuntarily "invested" over $81 billion[484] in Chrysler, GM, GMAC and the other auto programs. According to a recent estimate from the CBO, the investment of TARP funds in the auto industry is expected to add $40 billion more to the deficit than CBO calculated just five months earlier in March 2009.[485] A reasonable interpretation of such an estimate provides that the American taxpayers may suffer a loss of over 50 percent of the TARP funds invested in Chrysler, GM and the other auto programs.[486]

By making such an unprecedented investment in Chrysler and GM[487] the Administration by definition chose not to assist other Americans who are in need. With the economic suffering

[483] Edward Niedermeyer, *Taking Taxpayers for a Ride*, New York Times (Nov. 22, 2009) at www.nytimes.com/2009/11/23/opinion/23niedermayer.html?_r=1&sq=taking taxpayers for a ride niedermeyer november 22&st=cse&adxnnl=1&scp=1&adxnnlx=1259856084-RhEqA9+sraJEUegFNAcvew).

[484] According to the Panel's December report, $2.2 billion of the funds advanced under the Auto Industry Financing Program have been repaid. See Figure 25 of this Report, *supra*.

[485] Congressional Budget Office, *The Budget and Economic Outlook: An Update August 2009*, at 55-56 (online at www.cbo.gov/ftpdocs/105xx/doc10521/08-25-BudgetUpdate.pdf) (accessed Dec. 8, 2009). The report provides in part:

> "*The improvement in market conditions results in a reduction in the subsidy rate associated with the Capital Purchase Program (CPP)* – a major initiative through which the government purchases preferred stock and warrants (for the future purchase of common stock) from banks. CBO has dropped the projected subsidy for the remaining investments in that program from 35 percent in the March baseline to 13 percent. The decrease in the estimated CPP subsidy cost also reflects banks' repurchase of $70 billion of preferred stock through June. Similarly, the estimated subsidy cost for other investments in preferred stock (for example, that of American International Group) has also been reduced. *Partially offsetting those reductions in projected costs is the expansion of assistance to the automotive industry; CBO has raised its estimate of the costs of that assistance by nearly $40 billion relative to the March baseline.*" (emphasis added).

In addition, our country faces a staggering deficit of $1.6 trillion in 2009, and a debt that more-than-*triples* in ten years.

[486] How is it possible that with the economic challenges facing our nation the Administration chose to allocate such a significant share of the TARP to such questionable investments? How much additional funding will be provided by the Administration for Chrysler and GM? What is the strategy and timeline for recouping taxpayer dollars? Keith Bradsher, *G.M. is Said to Agree to Sell Stakes to China Partner*, New York Times (Dec. 3, 2009) (online at www.nytimes.com/2009/12/04/business/global/04gm.html?hp). What are the metrics for determining whether or not Chrysler and GM are "successful," and will the Administration continue to provide assistance until this is attained?

[487] In the bankruptcy proceedings for Chrysler and GM, (i) "Old Chrysler" sold substantially all of its assets to "New Chrysler" and (ii) "Old GM" sold substantially all of its assets to "New GM," each pursuant to Section 363 of the United States Bankruptcy Code. For purposes of simplicity, I generally refer to these entities as "Chrysler" or "GM," but occasionally employ other terms as appropriate.

the American taxpayers have endured during the past two years one wonders why Chrysler and GM merited such generosity to the exclusion of other taxpayers. Why, indeed, did the United States government choose to reward two companies that have been arguably mismanaged for many years at the expense of other hard working taxpayers? More poetically, *The New York Times* on July 25 asked: "Why, after all, should the automakers receive the equivalent of a Technicolor dreamcoat, giving them favorite-son status, when other industries, like airlines and retailers, also have suffered from the national recession?" More bluntly, the September 2009 issue of *The Atlantic* simply cut to the bottom line: "Essentially, the government was engineering a transfer of wealth from TARP bank shareholders to auto workers, and pressuring other creditors to go along."[488] The Chrysler and GM reorganizations represent a sad day for the rule of law, the sanctity of commercial law principles and contractual rights, long term economic growth, and the ideal that the United States government should not pick winners and losers.

Given the unorthodox reordering of the rights of the Chrysler and GM creditors, a fundamental question arises as to whether the Administration directed that TARP funds be used to advance its economic, social and political objectives rather than to stabilize the American economy as required by EESA. It has long been my view that the United States government should not engage in the business of picking winners and losers and certainly should not allocate its limited resources to favor one group of taxpayers over another. Following the Chrysler and GM bankruptcies one has to question what's next in the Administration's playbook – a bailout of the airline industry and its unionized workforce? What about Starbucks?

2. Transfer of TARP Proceeds and Retirement Saving of Indiana School Teachers and Police Officers to the UAW and the VEBAs

On a "before" v. "after" basis the Chrysler and GM bankruptcy cases make little legal or economic sense.[489] How is it possible that the Chrysler and GM VEBAs[490] – unsecured creditors

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[488] William D. Cohan, *The Final Days of Merrill Lynch*, The Atlantic (Sept. 2009) (online at www.theatlantic.com/doc/200909/bank-of-america).

[489] The Chrysler and GM bankruptcy rearranged the rights of the creditors and equity holders as follows:

Chrysler. Pursuant to the Chrysler bankruptcy, the equity of New Chrysler was allocated as follows:

(i) United States government (9.846 percent initially, but may decrease to 8 percent),

(ii) Canadian government (2.462 percent initially, but may decrease to 2 percent),

(ii) Fiat (20 percent initially, but may increase to 35 percent), and

(iii) UAW (comprising current employee contracts and a VEBA for retired employees) (67.692 percent, but may decrease to 55 percent).

The adjustments noted above permit Fiat to increase its ownership interest from 20 percent to 35 percent by achieving specific performance goals relating to technology, ecology and distribution designed to promote improved fuel efficiency, revenue growth from foreign sales and US based production.

Some, but not all, of the claims of the senior secured creditors were of a higher bankruptcy priority than the claims of the UAW/VEBA.

– received a greater allocation of proceeds than the Chrysler senior secured creditors or the GM bondholders? In other words, why did the United States government spend tens of billions of dollars of taxpayer money to bailout employees and retirees of the UAW to the detriment of other non-UAW employees and retirees – such as retired school teachers and police officers from the State of Indiana[491] – whose pension funds invested in Chrysler and GM indebtedness?[492]

The Chrysler senior secured creditors received 29 cents on the dollar ($2 billion cash for $6.9 billion of indebtedness).

The UAW/VEBA, an unsecured creditor, received (x) 43 cents on the dollar ($4.5 billion note from New Chrysler for $10.5 billion of claims) and (y) a 67.692 percent (which may decrease to 55 percent) equity ownership interest in New Chrysler.

GM. Pursuant to the GM bankruptcy, the equity of New GM was allocated as follows:

(i) United States government (60.8 percent),

(ii) Canadian government (11.7 percent),

(iii) UAW (comprising current employee contracts and a VEBA for retired employees) (17.5 percent), and

(iv) GM bondholders (10 percent).

The bankruptcy claims of the UAW/VEBA and the GM bondholders were of the same bankruptcy priority.

The equity interest of the UAW/VEBA and the GM bondholders in New GM may increase (with an offsetting reduction in each government's equity share) to up to 20 percent and 25 percent, respectively, upon the satisfaction of specific conditions. It is important to note, however, the warrants received by the UAW/VEBA and the GM bondholders are out of the money and it's possible they will not be exercised. As such, it seems likely that the UAW/VEBA and the GM bondholders will hold 17.5 percent and 10 percent, respectively, of the equity of New GM.

The GM bondholders exchanged $27 billion in unsecured indebtedness for a 10 percent (which may increase to 25 percent) common equity interest in New GM*, while the UAW/VEBA exchanged $20 billion in claims for a 17.5 percent (which may increase to 20 percent) common equity interest in New GM and $9 billion in preferred stock and notes in New GM.*

[490] The Chrysler and GM VEBAs (voluntary employee benefit associations) administer and fund the health and retirement plans of Chrysler and GM retirees.

[491] The Chrysler senior secured debt and the GM bonds were held by pension funds (for the benefit of retirees such as the Indiana school teachers and police officers), individuals (including the retirees who have contacted my office to ask why they lost their savings but UAW employees benefited) as well as different types of business entities.

[492] If you trace the funds, TARP money was employed by New Chrysler and New GM to purchase assets of the old auto makers, yet a substantial portion of the equity in the new entities was transferred to the VEBAs and, thus, not retained for the benefit of the American taxpayers (who funded the TARP) or shared with other creditors of Old Chrysler and Old GM. Accordingly, it's hardly a stretch to conclude that TARP funds were transferred to the UAW and the VEBAs after being funneled through New Chrysler and New GM. In addition, New Chrysler and New GM entered into promissory notes and other contractual arrangements for the benefit of the VEBAs, but not for the benefit of the other creditors of Old Chrysler and Old GM. Why did the United States government—the controlling shareholder of New Chrysler and New GM--direct New Chrysler and New GM to make an exclusive gift of taxpayer funds to the VEBAs? Why didn't New Chrysler and New GM transfer more of their equity interests to the creditors of Old Chrysler and Old GM? Why were Indiana school teachers and police officers and other investors in the Chrysler senior secured indebtedness and the GM bonds in effect forced by the Administration to transfer a portion of their claims against Chrysler and GM, respectively, to the UAW and the VEBAs? That is, why did the Administration orchestrate two bankruptcy plans whereby one group of employees and retirees was preferred to another?

What message do the Chrysler and GM holdings send to non-UAW employees whose pension funds invested in Chrysler and GM indebtedness – you lose part of your retirement savings because your pension fund does not have the special political relationships of the UAW? What message do the Chrysler and GM bankruptcies send to the financial markets – contractual rights of investors may be ignored when dealing with the United States government?

In written testimony submitted to the Panel, Barry E. Adler, Professor of Law and Business at New York University, noted:

> "There are at least two negative consequences from the disregard of creditor rights. First, at the time of the deviation from contractual entitlement, there is an inequitable distribution of assets. Take the Chrysler case itself, where the approved transaction well-treated the retirement funds of the UAW. If such treatment deprived the secured creditors of their due, one might well wonder why the UAW funds should be favored over other retirement funds, those that invested in Chrysler secured bonds. Second, and at least as importantly, when the bankruptcy process deprives a creditor of its promised return, the prospect of a debtor's failure looms larger in the eyes of future lenders to future firms. As a result, given the holding in Chrysler, and the essentially identical holding in the General Motors case, discussed next, one might expect future firms to face a higher cost of capital, thus dampening economic development at a time when the country can least well afford impediments to growth."[493]

In an article analyzing the Chrysler and GM bankruptcies, Mark J. Roe and David A. Skeel, Professors of Law at Harvard University and the University of Pennsylvania, respectively, noted:

> "Warren Buffett worried in the midst of the reorganization that there would be "a whole lot of consequences" if the government's Chrysler plan emerged as planned, which it did. If priorities are tossed aside, as he implied they were, "that's going to disrupt lending practices in the future." "If we want to encourage lending in this country," Buffett added, "we don't want to say to somebody who lends and gets a secured position that the secured position doesn't mean anything."[494]

In an op-ed in *The Wall Street Journal*, Todd J. Zywicki, Professor of Law at George Mason University, noted:

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[493] Congressional Oversight Panel, Written Testimony of Barry E. Adler, *Field Hearing on the Auto Industry* (July 27, 2009) (online at cop.senate.gov/documents/testimony-072709-adler.pdf).

[494] Mark Roe and David Skeel, *Assessing the Chrysler Bankruptcy* (Aug. 12, 2009) (online atssrn.com/abstract=1426530).

> "By stepping over the bright line between the rule of law and the arbitrary behavior of men, President Obama may have created a thousand new failing businesses. That is, businesses that might have received financing before but that now will not, since lenders face the potential of future government confiscation. In other words, Mr. Obama may have helped save the jobs of thousands of union workers whose dues, in part, engineered his election. But what about the untold number of job losses in the future caused by trampling the sanctity of contracts today?"[495]

In the September 2009 issue of *The Atlantic*, William D. Cohan notes:

> "'The rules as to how the government will act are not what we learned,' explained Gary Parr, the deputy chairman of Lazard and one of the leading mergers-and-acquisitions advisers to financial institutions. 'In the last 12 months, new precedents have been set weekly. The old rules often don't apply as much anymore.' He said the recent examples of the government's aggression are 'a really big deal,' but adds, 'I am not sure it is going to last a long time. I sure hope not. I can't imagine the markets will function properly if you are always wondering if the government is going to step in and change the game.'"[496]

Richard A. Epstein, the James Parker Hall Distinguished Service Professor of Law, The University of Chicago, the Peter and Kirsten Bedford Senior Fellow, The Hoover Institution, and a visiting law professor at New York University Law School, offered the following analysis in the May 12, 2009 issue of Forbes:

> "The proposed bankruptcy of the now defunct Chrysler Corp. is the culmination of serious policy missteps by the Bush and Obama administrations. To be sure, the long overdue Chrysler bankruptcy is a welcomed turn of events. But the heavy-handed meddling of the Obama administration that forced secured creditors to the brink is not.
>
> A sound bankruptcy proceeding should do two things: productively redeploy the assets of the bankrupt firm and correctly prioritize various claims against the bankrupt entity. The Chrysler bankruptcy fails on both counts.
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> …

[495] Todd Zywicki, *Chrysler and the Rule of Law*, Wall Street Journal (May 13, 2009) (online at online.wsj.com/article/SB124217356836613091.html).

[496] William D. Cohan, *The Final Days of Merrill Lynch*, The Atlantic (Sept. 2009) (online at www.theatlantic.com/doc/200909/bank-of-america).

In a just world, that ignominious fate would await the flawed Chrysler reorganization, which violates these well-established norms, given the nonstop political interference of the Obama administration, which put its muscle behind the beleaguered United Auto Workers. Its onerous collective bargaining agreements are off-limits to the reorganization provisions, thereby preserving the current labor rigidities in a down market.

Equally bad, the established priorities of creditor claims outside bankruptcy have been cast aside in this bankruptcy case as the unsecured claims of the union health pension plan have received a better deal than the secured claims of various bond holders, some of which may represent pension plans of their own.

President Obama – no bankruptcy lawyer – twisted the arms of the banks that have received TARP money to waive their priority, which is yet another reason why a government ownership position in banks is incompatible with its regulatory role. Yet the president brands the non-TARP lenders that have banded together to fight this bogus reorganization as "holdouts" and "speculators."

Both charges are misinformed at best. A holdout situation arises when one party seeks to get a disproportionate return on the sale of an asset for which it has little value in use. Thus the owner of a small plot of land could hold out for a fortune if his land is the last piece needed to assemble a large parcel of land. But the entire structure of bankruptcy eliminates the holdout position of all creditors, secured and unsecured alike, by allowing the court to "cram" the reorganization down their throats so long as it preserves the appropriate priorities among creditors and offers the secured creditors a stake in the reorganized business equal to the value of their claims. Ironically, Obama's Orwellian interventions have allowed unsecured union creditors to hold out for more than they are entitled to.

His charge of "speculation" is every bit as fatuous. Speculators (who often perform a useful economic function) buy high-risk assets at low prices in the hope that the market will turn in their favor. By injecting unneeded uncertainty into the picture, Obama has created the need for a secondary market in which nervous secured creditors, facing demotion, sell out to speculators who are better able to handle that newly created sovereign risk. He calls on citizens to buy Chrysler products, but patriotic Americans will choose to go to Ford, whose own self-help efforts have been hurt by the Chrysler and GM bailouts.

Sadly, long ago Chrysler and GM should have been allowed to bleed to death under ordinary bankruptcy rules, without government subsidy or penalty.

> Libertarians have often remarked on these twin dangers in isolation. The Chrysler fiasco confirms their deadly synergistic effect."[497]

In his testimony before the Judiciary Committee of the United States House of Representatives, Andrew M. Grossman, Senior Legal Policy Analyst, The Heritage Foundation, stated:

> "Also detrimental to General Motors and Chrysler is the difficulty that they will have accessing capital and debt markets. Lenders know how to deal with bankruptcy – it's a well understood risk of doing business. But the tough measures employed by the Obama Administration to cram down debt on behalf of the automakers were unprecedented and will naturally make lenders reluctant to do business with these companies, for fear they could suffer the same fate. Even secured and senior creditors, those who forgo higher interest rates to protect themselves against risks, suffered large, unexpected losses. So nothing that either company can offer, no special status or security measure, can fully assuage lenders' fears that, in an economic downturn, they could be forced to accept far less than the true value of their holdings. At best, if General Motors and Chrysler have access to debt markets at all, they will have to pay dearly for the privilege. At worst, even high rates and tough covenants will not be enough to attract interest.
>
> …
>
> The Obama Administration's transparent favoritism toward its political supporters in the United Auto Workers Union may lead other unions to demand the same: hefty payouts and ownership stakes in exchange for halfhearted concessions. Lenders know now that the Administration is unable to resist such entreaties. As one hedge fund manager observed, "The obvious [lesson] is: Don't lend to a company with big legacy liabilities, or demand a much higher rate of interest because you may be leapfrogged in bankruptcy."
>
> Perhaps the most affected will be faltering corporations and those undergoing reorganization – that is, the enterprises with the greatest need for capital. Lending money to a nearly insolvent company is risky enough, but that risk is magnified when bankruptcy ceases to recognize priorities or recognize valid liens. With private capital unavailable, larger corporations in dire straits will turn to the government for aid – more bailouts – or collapse due to undercapitalization, at an enormous cost to the economy.

[497] Richard Epstein, *The Deadly Sins Of The Chrysler Bankruptcy*, Forbes (May 12, 2009) (online at www.forbes.com/2009/05/11/chrysler-bankruptcy-mortgage-opinions-columnists-epstein.html).

…

> Financial institutions – enterprises that the federal government has already spent billions to strengthen – will also be affected. Many hold debt in domestic corporations that could be subject to government rescue, rendering their obligations uncertain. It is that uncertainty which transforms loans into impossible-to-value toxic assets and blows holes in balance sheets across the economy.
>
> Finally, there are the investors, from pension funds and school endowments to families building nest eggs for their future. General Motors bonds, like the debt of other long-lived corporations, has been long regarded as a refuge from the turmoil of equity markets. The once-safe investment held directly by millions of individuals and indirectly, through funds and pensions, by far more, are now at risk, which will be reflected in those assets' values." [498]

3. The Use of TARP Funds in the Chrysler and GM Bankruptcies

> Section 101(a)(1) of the EESA states that:
>
> "The Secretary [of the Treasury] is authorized to…purchase, and to make and fund commitments to purchase, troubled assets from any *financial institution*, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures development and published by the Secretary." (emphasis added).

A plain reading of the statue would necessarily preclude the employment of TARP funds for the benefit of the auto industry because, among other reasons, neither Chrysler nor GM qualifies as a "financial institution." If Chrysler and GM are somehow deemed to qualify as "financial institutions," then what business enterprise will fail to so qualify? If Congress had intended for the TARP to cover all business enterprises it would not have incorporated such a restrictive term as "financial institution" into EESA.

Further, a funding bill specifically aimed at assisting the auto industry was not approved by Congress. Nevertheless, the Bush Administration extended credit to Chrysler and GM and the Obama Administration orchestrated the Chrysler and GM bankruptcies which resulted in an investment of over $81 billion in the auto industry.

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[498] Andrew M. Grossman, *Bailouts, Abusive Bankruptcies, And the Rule of Law, Testimony before the Judiciary Committee of the United States House of Representatives* (May 21, 2009) (online at www.heritage.org/Research/Economy/tst052209a.cfm).

Since the authority for such an investment remains unclear, I requested that the Administration provide the Panel with a formal written legal opinion justifying:[499]

(i) the use of TARP funds to support Chrysler and GM prior to their bankruptcies;

(ii) the use of TARP funds in the Chrysler and GM bankruptcies;

(ii) the transfer of equity interests in New Chrysler and New GM to the UAW/VEBAs; and

(iii) the delivery of notes and other credit support by New Chrysler and New GM for the benefit of the UAW/VEBAs.[500]

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[499] In a written response to the Panel the Administration stated:

"The Treasury described the authority to use TARP funds to finance the old Chrysler and GM in bankruptcy court filings made on its behalf by the Department of Justice, specifically in the Statement of the United States of America Upon The Commencement of General Motors Corporation's Chapter 11 Case filed June 10, 2009, a copy of which has been provided to the Congressional Oversight Panel. In Judge Gerber's final sale order in the GM bankruptcy case dated July 5, 2009, also provided to the Congressional Oversight Panel, he wrote:

> "The U.S. Treasury and Export Development Canada ("EDC"), on behalf of the Governments of Canada and Ontario, have extended credit to, and acquired a security interest in, the assets of the Debtors as set forth in the DIP Facility and as authorized by the interim and final orders approving the DIP Facility (Docket Nos. 292 and 2529, respectively). Before entering into the DIP Facility and the Loan and Security Agreement, dated as of December 31, 2008 (the "Existing UST Loan Agreement"), the Secretary of the Treasury, in consultation with the Chairman of the Board of Governors of the Federal Reserve System and as communicated to the appropriate committees of Congress, found that the extension of credit to the Debtors is "necessary to promote financial market stability," and is a valid use of funds pursuant to the statutory authority granted to the Secretary of the Treasury under the Emergency Economic Stabilization Act of 2008, 12 U.S.C. §§ 5201 et seq. ("EESA"). The U.S. Treasury's extension of credit to, and resulting security interest in, the Debtors, as set forth in the DIP Facility and the Existing UST Loan Agreement and as authorized in the interim and final orders approving the DIP Facility, is a valid use of funds pursuant to EESA."

The rationale and determination of the ability to use TARP funds applies equally to the financing provided to the new Chrysler. There was no new financing provided to New GM. Instead, cash flowed from old GM to new GM as part of the asset sale, and new GM assumed a portion of the loan that Treasury had made to old GM.

The interests received by other stakeholders of Chrysler and GM including the UAW/VEBAs were a result of negotiations between all stakeholders as described in detail by myself and Harry Wilson in our depositions in the bankruptcy cases, transcripts of which have been provided to the Congressional Oversight Panel."

I find the response unhelpful and ask the Administration to provide a formal written legal opinion supporting its position. Since Congress specifically rejected the bailout of Chrysler and GM, under what theory and precedent did the Executive unilaterally invest $81 billion in these non-financial institutions?

[500] The promissory notes issued to the UAW/VEBAs are senior to the equity issued to the United States government. Since the government controlled New Chrysler and New GM at the time the notes were issued, it's apparent that the government agreed to subordinate the TARP claims held by the American taxpayers to the claims

Such opinions have not been delivered.

4. Analysis of the Chrysler and GM Cases by Bankruptcy Scholars and Pressure on TARP Recipients

A number of bankruptcy academics at top-tier law schools have questioned the holdings in the Chrysler and GM bankruptcies. In the Chrysler and GM proceedings, Section 363 of the United States bankruptcy code was used by the Administration to upset well established commercial law principles and the contractual expectations of the parties. As Professors Adler, Roe and Skeel note, the Chrysler and GM bankruptcy courts required each Section 363 bidder to assume certain obligations of the UAW/VEBAs as part of its bid. This means that potential purchasers could not simply acquire the assets free and clear of the liabilities of the seller, but, instead, were also required to assume certain of those liabilities. This requirement most likely chilled the bidding process and precluded the determination of the *true* fair market value of the assets held by Chrysler and GM. By disrupting the bidding process it's entirely possible that TARP proceeds were misallocated away from the Chrysler senior secured creditors and the GM bondholders to the UAW/VEBAs.[501] Although I do not concur that EESA authorized the use of

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held by the UAW/VEBAs. What was the purpose of the subordination except perhaps to prefer the claims of a favored class over the claims of the taxpayers who funded the TARP?

[501] A summary of the analysis of Professors Adler, Roe and Skeel as well as a set of examples are included in Appendix A to my Dissenting Views to the Panel's September Auto Report. Representative Jeb Hensarling, *Additional Views to Congressional Oversight Panel, September Oversight Report: The Use of TARP Funds in the Support and Reorganization of the Domestic Automotive Industry* (Sept. 9, 2009) (online at cop.senate.gov/documents/cop-090909-report-additionalviews.pdf).

The following example illustrates how the Administration used Section 363 of the bankruptcy code to achieve its economic, social and political objectives at the expense of the American taxpayers and the Chrysler senior secured creditors and GM bondholders.

> Assume Oldco (i.e., Old Chrysler or Old GM) has (i) assets with a fair market value (FMV) of $70, (ii) secured debt (with liens on $40 FMV of assets) in an outstanding principal amount of $90 held by Creditor 1, and (iii) unsecured debt in an outstanding principal amount of $50 held by Creditor 2. Creditor 1 in effect holds two claims, a $40 secured claim (equal to the FMV of the assets securing Creditor 1's claim) and a $50 unsecured claim (which together equal Creditor 1's total claim of $90); and Creditor 2 holds a $50 unsecured claim. Any distribution on the unsecured claims should be shared 50/50 percent (because each creditor holds a $50 unsecured claim) under the "no unfair discrimination" rule of Chapter 11.
>
> If, in a Section 363 sale, Newco (i.e., New Chrysler or New GM) purchased the Oldco assets (with no assumption of Oldco liabilities) for $70 FMV, then the $70 cash proceeds would be distributed as follows: Creditor 1 would receive $55 ($40 secured position, plus $15 unsecured position), and Creditor 2 would receive $15.
>
> Conversely, if in the Section 363 sale the bankruptcy court required Newco to assume Creditor 2's debt of $50, then Newco would only pay $20 cash for the Oldco assets ($70 FMV of assets, less $50 required assumption of Creditor 2's debt). In such event, Creditor 1 would only receive $20 (representing 100 percent of the cash sales proceeds from the Section 363 sale, but leaving a shortfall of $70 ($90, less $20)). Creditor 2 would receive no proceeds *from the Section 363 sale, but would quite possibly receive $50 in the future from Newco* (the amount of Creditor 2's debt assumed by Newco).

TARP proceeds in the Chrysler and GM bailouts, it's nevertheless important to follow the TARP funds once they were committed.

The technical bankruptcy laws issues are exacerbated because the winning purchaser in the Chrysler and GM cases – entities directly or indirectly controlled by the United States government – had virtually unlimited resources, which is certainly not the case in typical private equity transactions. The matter becomes particularly muddled when you consider that a majority in interest of the Chrysler senior secured debt was held by TARP recipients at a time when there was much talk in the press about "nationalizing" some or all of these institutions. It is not difficult to imagine that these recipients felt direct pressure to "get with the program" and support the Administration's proposal.[502]

> Thus, without the required assumption of the $50 claim by Newco, Creditor 1 (the senior creditor) would receive $55 and Creditor 2 (the junior creditor) would receive $15. This result is consistent with commercial law principles and the contractual expectations of the parties. With the required assumption, however, Creditor 1 would only receive $20 and Creditor 2 would receive $50. The required assumption results in a shift of $35 from Creditor 1 to Creditor 2, a result that is not consistent with commercial law principles, the contractual expectations of the parties and the Chapter 11 reorganization rules.

[502] TARP recipients who were also Chrysler senior secured creditors included Citigroup, JP Morgan Chase, Morgan Stanley and Goldman Sachs.

Michael J. de la Merced, *Dissident Chrysler Group to Disband*, New York Times (May 8, 2009) (online at dealbook.blogs.nytimes.com/2009/05/08/oppenheimer-withdraws-from-dissident-chrysler-group/?scp=1&sq=TARP%20lender%20Chrysler%20pressure&st=cse). The article provides:

> ""After a great deal of soul-searching and quite frankly agony, Chrysler's non-TARP lenders concluded they just don't have the critical mass to withstand the enormous pressure and machinery of the US government," Thomas E. Lauria, a partner of Mr. Kurtz's and the lead lawyer for the group. "As a result, they have collectively withdrawn their participation in the court case."
>
> With the group's disbanding, a little over a week since it made itself public, a vocal obstacle to Chrysler's reorganization has subsided. The committee's membership has shrunken by the day as it faced public criticism from President Obama and others. That continued withdrawal of firms led Oppenheimer and Stairway to conclude that they could not succeed in opposing the Chrysler reorganization plan in court, the two firms said in separate statements.
>
> In its first public statement last week, the ad hoc committee said that it consisted of about 20 firms holding $1 billion in secured debt. But hours after Mr. Obama criticized the firms as "speculators," the group lost its first major member, Perella Weinberg Partners, which changed its mind and signed onto the Chrysler plan."
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> In the September 2009 issue, The Atlantic reported:
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> "As the crisis has receded this year, the government has remained aggressive, seeking business outcomes it finds desirable with some apparent indifference to contractual rights. In Chrysler's bankruptcy negotiations in April, for example, Treasury's plan offered the automaker's senior-debt holders 29 cents on the dollar. Some debt holders, including the hedge fund Xerion Capital Partners, believed they were contractually entitled to a much better deal as senior creditors holding secured debt. But four TARP banks—JPMorgan Chase, Citigroup, Morgan Stanley, and Goldman Sachs—which owned about 70 percent of the Chrysler senior debt at par (100 cents on the dollar), had agreed to the 29-cent deal. By getting these banks and the other senior-debt holders to accept the 29-cent deal and give up their rights to push for the higher potential payout they were entitled

Based upon the analysis of Professors Adler, Roe and Skeel, the bankruptcy courts should have called a time-out and changed the bidding procedure (i.e., no assumption of liabilities required), extended the time to submit a bid[503] and applied the protections afforded under the Chapter 11 reorganization rules. With those changes the judicial holdings would have most likely appeared fair and reasonable and could have served as a model for high-pressure bankruptcies that followed. Without such changes, however, the process was inherently flawed because we will never know if another bidder would have paid more for the gross assets

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> to, the government could give Chrysler's workers, whose contracts were general unsecured claims – and therefore junior to the banks' – a payout far more generous than would otherwise have been possible or likely. Essentially, the government was engineering a transfer of wealth from TARP bank shareholders to auto workers, and pressuring other creditors to go along.
>
> …
>
> A somewhat similar story played out during GM's bankruptcy – the government again put together a deal that looked to many like a gift to the United Auto Workers at the expense of bondholders, who were pressed hard to quickly take a deal that would leave them with 10 percent of the equity of the reorganized company (plus some out-of-the-money warrants) when they likely would have been able to negotiate for more in a less well-orchestrated bankruptcy proceeding." (Emphasis added.)

William D. Cohan, *The Final Days of Merrill Lynch*, The Atlantic (Sept. 2009) (online at www.theatlantic.com/doc/200909/bank-of-america).

In the Panel's September Report I requested that SIGTARP investigate this matter.

[503] Mr. Richard E. Mourdock, the Indiana State Treasurer, whose pension funds invested in Chrysler senior secured indebtedness, provided the following testimony to the Panel:

> "The principal restriction was imposed by the time requirement that mandated the bankruptcy be completed by June 15, 2009. Throughout the bankruptcy process, the government maintained if the deal was not completed by that date that Fiat would walk away from its "purchase" of 20% of the Chrysler assets. From the beginning, the June 15 date was a myth generated by the federal government. Fiat was being given the assets at no cost at a minimum value of $400,000,000. Why would Fiat establish or negotiate such a date when they were to receive such a bonanza? On the very day that the Chrysler assets were transferred to Fiat, the company's chairman stated to the media that the June 15th date never originated from them. The artificial date drove the process in preventing creditors from having any opportunity to establish true values, prepare adequate cases, and therefore failed to protect their rights to the fullest provisions of the law. The artificial date also forced the courts to act with less than complete information.
>
> The U.S. [Second Circuit] Court of Appeals in its written opinion of August 9th, 2009, denied our pensioners standing pursuant to the argument that we could not prove, under any other bankruptcy plan, we could have received more than the $0.29 we were offered. We believe this was an error because the court used a liquidation value for the company rather than an 'on-going concern' basis. We received written notice from the U.S. Bankruptcy Court of New York by certified letter of our rights to file a claim on Monday, May 18, 2009, at 10:00 a.m. We were advised in the letter that any evidence we wished to submit to make a claim against the submitted plan, (in part, the $0.29), would have to include trade tickets, depositions, affidavits, documents of evidence to substantiate claims, and etc. and would have to be filed with the bankruptcy court on Tuesday, May 19, 2009, by 4:00p.m. The bankruptcy of Chrysler was frequently referred to as "the most complex bankruptcy in American history," and yet we were given thirty hours to respond. We feel this was clearly an error in the process that helped to reduce the wealth of our beneficiaries."

(without the assumption of any liabilities) of Chrysler or GM.[504] As intentionally structured by the Administration, the bidding procedures ultimately adopted for the Section 363 sales necessarily precluded the determination of the *true* fair market value of the assets held by Chrysler and GM. Without such determination, the appropriateness of the price paid for the assets of Old Chrysler and Old GM as well as the appropriateness of the distribution made by Old Chrysler and Old GM to the Chrysler senior secured creditors and GM bondholders will remain in doubt.

E. TARP and Foreclosure Mitigation[505]

Much like the auto industry interventions, HAMP and the Administration's other foreclosure mitigation efforts to date have been a failure.[506] The Administration's opaque foreclosure mitigation efforts have assisted only a small number of homeowners while drawing billions of involuntary taxpayer dollars into a black hole.[507]

1. 100 percent Loss to the Taxpayers from the Administrations Foreclosure Mitigation Efforts

While the CBO estimates that taxpayers will lose 100 percent of the $50 billion in TARP funds committed to the Administration's foreclosure relief programs, the Administration appears

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[504] It is also important to note that for these purposes it's irrelevant if certain Chrysler or GM creditors happened to have purchased their securities at a cheap price. The substantive legal issue concerns whether their contractual rights were honored. Courts should not abrogate well established commercial law principles and contractual expectations simply because an investor has earned a "reasonable return" on its investment. That's not the rule of law, but the law of political expediency.

[505] In this section I borrow extensively from my dissent to the Panel's October report on foreclosure mitigation. Representative Jeb Hensarling, *Congressional Oversight Panel, October Oversight Report: An Assessment of Foreclosure Mitigation Efforts After Six Months* (Oct. 9, 2009) (online at cop.senate.gov/documents/cop-100909-report-hensarling.pdf).

[506] Taxpayer protection is a guiding principle of EESA interwoven throughout the legislation, including for foreclosure mitigation efforts. EESA gives the Panel a clear duty to provide information on foreclosure mitigation programs, but with the following caveat. Reports must include:

> "The effectiveness of foreclosure mitigation efforts and the effectiveness of the program from the standpoint of minimizing long-term costs to the taxpayers and maximizing the benefits for taxpayers."

12 U.S.C. § 5223(b)(1)(A)(iv).

[507] Housing GSEs – Government Sponsored Enterprises – Fannie Mae and Freddie Mac play key roles in the Administration's new housing policies. Funds from the Preferred Share Purchase Agreements, which allow the GSEs to draw up to $400 billion from Treasury, are being deployed for foreclosure mitigation and refinancing efforts. Since Fannie Mae and Freddie Mac are now under the conservatorship of the Federal Housing Finance Agency (FHFA), their concerns are now officially the taxpayer's concerns – any losses they experience through MHA should be a carefully considered part of a cost-benefit analysis.

Fannie Mae and Freddie Mac should be more forthcoming with respect to their foreclosure mitigation efforts and use of taxpayer funds.

inclined to commit additional taxpayer funds in hopes of helping distressed homeowners – both deserving and undeserving – with a taxpayer subsidized rescue.[508]

While there may be some positive signals in our economy, recovery remains in a precarious position. The unemployment rate hovers around 10 percent and the broader definition of unemployment exceeds 17 percent. This is unfortunate because the best foreclosure mitigation program is a job, and the best assurance of job security is economic growth and the adoption of public policy that encourages and rewards capital formation and entrepreneurial success. Without a robust macroeconomic recovery the housing market will continue to languish and any policy that forestalls such recovery will by necessity lead to more foreclosures.

To date, despite the commitment of some $27 billion,[509] only a modest number of underwater homeowners have received a permanent modification of their mortgage.[510] If the Administration's goal of subsidizing up to 9 million home mortgage refinancings and modifications is met, the cost to the taxpayers will possibly exceed the $75 billion already

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[508] Dealbook, *Treasury Pushes Mortgage Firms for Loan relief*, New York Times (Nov. 30, 2009) (online at dealbook.blogs.nytimes.com/2009/11/30/treasury-presses-banks-for-mortgage-relief/?scp=1&sq=Treasury%20Goodman%20November%2030&st=cse):

> "The administration said Monday that it would increase the pressure on banks to help troubled homeowners permanently lower mortgage payments.
>
> Monday's push was the latest evidence that a $75 billion taxpayer-financed effort aimed at stemming foreclosures was struggling. Even as lenders have accelerated the pace at which they are reducing mortgage payments for borrowers, most loans modified remain in a trial stage lasting up to five months, and only a fraction have been made permanent.
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> In its statement on Monday, the Treasury Department said that more than 650,000 borrowers have received trial modifications under the program, called Making Home Affordable, and that about 375,000 borrowers were scheduled to convert to permanent modifications by the end of the year.
>
> That would represent a sharp turnaround – last month, an oversight panel created by Congress reported that fewer than 2,000 of the 500,000 loan modifications then in progress had become permanent."

Jim Kuhnhenn, *Strong Banks, Weak Credit: Treasury Rethinks TARP*, ABC News (Nov. 24, 2009) (online at abcnews.go.com/Business/wireStory?id=9161503). Determination of costs is especially important if, as Treasury Secretary Geithner has stated, TARP is interpreted to be a "revolving facility." Given the likelihood that he will extend TARP to October 31, 2010, it's possible that a substantial portion of the $700 billion TARP facility could be directed to foreclosure mitigation efforts.

[509] Number as defined by the current "Total Cap" for the Home Affordable Modification Program, $27,382,460,000. U.S. Department of the Treasury, *Transactions Report* (Nov. 30, 2009) (online at www.financialstability.gov/docs/transaction-reports/11-30-09%20Transactions%20Report%20as%20of%2011-25-09.pdf).

[510] See Section One, C.3. of the Panel's December report.

allocated to the MHA--Making Home Affordable--program,[511] and it is likely that most (if not all) of it will be not be recovered.

2. Mortgage Holders Profit from *Private* Sector Foreclosure Mitigation Efforts

Professor Alan M. White, an expert retained by the Panel, notes in a paper attached to the Panel's October Report the effectiveness of non-subsidized voluntary foreclosure mitigation when he states:

> "Nevertheless, there is convincing evidence that successful modifications avoided substantial losses, while requiring only very modest curtailment of investor income. In fact, the typical voluntary modification in the 2007-2008 period involved no cancellation of principal debt, or of past-due interest, but instead consisted of combining a capitalization of past-due interest with a temporary (three to five year) reduction in the current interest rate. Foreclosures, on the other hand, are resulting in losses of 50% or more, i.e. upwards of $124,000 on the mean $212,000 mortgage in default."[512]

Significantly, he also quantifies the overall benefit of voluntary foreclosure mitigation to investors by concluding:

> "The bottom line to the investor is that any time a homeowner can afford the reduced payment, with a 60% or better chance of succeeding, the investor's net gain from the modification could average $80,000 per loan or more. Two million modifications with a 60% success rate could produce $160 billion in avoided losses, an amount that would go directly to the value of the toxic mortgage-backed securities that have frozen credit markets and destabilized banks."[513]

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[511] The Making Home Affordable program presently consists of the HAMP – Home Affordable Modification Program – and the HARP – Home Affordable Refinancing Program – programs.

[512] Since these numbers apparently include up to $9,000 of incentive payments it appears that the total cost to the taxpayers of all interest rate and principal adjustments is approximately $10,000 per modification, or approximately $2,000 per year ($167 per month) for the full five-year HAMP modification period. Perhaps this is correct, but I question whether mortgage loans may be successfully modified at such a relatively modest cost to the taxpayers under the HAMP program. It appears that Professor White did not independently calculate these amounts, but, instead, generally relied upon estimates provided by Treasury. It is unclear what methodology Treasury employed except, perhaps, to divided the $50 billion of TARP funds initially allocated to HAMP by 2.5 million modifications, or $20,000 per mortgage modification. Treasury's approach, although employed by Professor White, should be augmented by the application of a more comprehensive methodology. Alan M. White, *Annex B to Congressional Oversight Panel, October Oversight Report: An Assessment of Foreclosure Mitigation Efforts After Six Months Potential Costs and Benefits of the Home Affordable Modification Program*, at 118 (Oct. 9, 2009) (online at cop.senate.gov/documents/cop-100909-report.pdf).

[513] If this is indeed the case, then why is it not in the best interest of each mortgage holder to modify the mortgage loans in its portfolio? Why would a mortgage holder risk breaching its fiduciary duties to its investor group by foreclosing on mortgaged property instead of restructuring the underlying loans? Why should the taxpayers subsidize the restructuring of mortgage loans – whether through the HAMP program or otherwise – if the

Notwithstanding the complexity injected into the foreclosure mitigation debate by the Administration, a solution appears relatively straightforward. If, as Professor White suggests, mortgage holders stand to realize a net gain of approximately $80,000 from restructuring each mortgage loan instead of foreclosing on the underlying property, the mortgage holders themselves should undertake to subsidize the "contracting failure" of their servicers out of such gains. I appreciate that mortgage holders may not wish to remit additional fees to their servicers, but, between mortgage holders and the taxpayers, why should the taxpayers – through TARP or otherwise – bear such burden? Taxpayers should not be required to subsidize mortgage holders or servicers when foreclosure mitigation efforts appear to be in their own economic best interests.

The Administration by enticing mortgage holders and servicers with the $75 billion HAMP and HARP programs (with a reasonable expectation that additional funds may be forthcoming) has arguably caused them to abandon their market oriented response to the atypical rate of mortgage defaults in favor of seeking hand-outs from the government.[514] All of the false starts with HAMP and the other government programs may have in effect exacerbated the foreclosure mitigation process by keeping private sector servicers and mortgage holders on the sidelines waiting on a better deal from the government. By creating a perceived safety net, the foreclosure mitigation efforts advocated by the Administration may encourage economically

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mortgage holders may independent of such subsidy realize a net gain of approximately $80,000 per loan by voluntarily restructuring their distressed mortgage loans?

Professor White seems to imply that without taxpayer funded subsidies the mortgage servicers would be economically disinclined to modify distressed mortgage loans because of unfavorable terms included in typical pooling and servicing agreements – the contracts pursuant to which servicers discharge their duties to mortgage holders. Professor White writes:

> "While modification can often result in a better investor return than foreclosure, modification requires "high-touch" individualized account work by servicers for which they are not normally paid under existing securitization contracts (pooling and servicing agreements or "PSAs".) Servicer payment levels were established by contracts that last the life of the mortgage pools. Servicers of subprime mortgages agreed to compensation of 50 basis points, or 0.5% from interest payments, plus late fees and other servicing fees collected from borrowers, based on conditions that existed prior to the crisis, when defaulted mortgages constituted a small percentage of a typical portfolio. At present, many subprime and alt-A pools have delinquencies and defaults in excess of 50% of the pool. The incentive payments under HAMP can be thought of as a way to correct this past *contracting failure*.
>
> …
>
> Because mortgage servicers are essentially contractors working for investors who now include the GSE's, the Federal Reserve and the Treasury, we can think of the incentive payments under HAMP as *extra-contractual compensation* for additional work that was not anticipated by the parties to the PSAs at the time of the contract." (emphasis added).

Is the purpose of the HAMP program to bailout servicers from their "contracting failure" through the payment of "extra-contractual compensation"? The taxpayers should not be charged with such a responsibility and I am disappointed that the Administration and Professor White would advocate such an approach.

[514] It is difficult to fault mortgage holders and servicers for their rational behavior in accepting bailout funds that may enhance the overall return to their investors.

inefficient speculation in the residential real estate market with its adverse bubble generating consequences.

3. Taxpayer Protection and Shared Appreciation Rights

It is my understanding that the foreclosure mitigation programs announced by Treasury do not provide Treasury or the mortgage lenders with the ability to participate in any subsequent appreciation in the fair market value of the properties that serve as collateral for the modified or refinanced mortgage loans. Since one of Treasury's fundamental mandates is taxpayer protection, the incorporation of a shared appreciation right or equity kicker feature would appear appropriate. Homeowners should not receive a windfall at the expense of the taxpayers and mortgage lenders who suffered the economic loss from restructuring their distressed mortgage loans.

For example, a $100,000, 6 percent home mortgage loan may be modified by reducing the principal to $90,000 and the interest rate to 5 percent. If the house securing the mortgage loan subsequently appreciates by, say, $25,000, the taxpayers and the mortgage lender who shared the cost of the mortgage modification will not benefit from any such increase in value. Such result seems inappropriate and particularly unfair to the taxpayers. By modifying the mortgage loan and avoiding foreclosure the taxpayers and the mortgage lender have provided a distinct and valuable financial benefit to the distressed homeowner that should be recouped to the extent of any subsequent appreciation in the value of the house securing the modified mortgage. A simple filing in the local real estate records should make the shared appreciation feature self-effectuating upon the sale or exchange of the applicable residence. In order to ensure the integrity of the shared appreciation right, limitations should apply regarding the ability of homeowners to obtain home equity loans except when the proceeds of the loans are used to repay the taxpayers for the costs incurred with respect to the mortgage modifications.

In addition, as I noted in my dissent to the Panel's October report on foreclosure mitigation,[515] it would also seem productive if modified home mortgage loans were treated as recourse loans to the homeowners instead of as in effect non-recourse loans under the "anti-deficiency" laws of many jurisdictions.[516]

4. Equity and Moral Hazard

Regardless of whether one believes foreclosure mitigation can truly work, taxpayers who are struggling to pay their own mortgage should not be forced to bail out their neighbors through

[515] Representative Jeb Hensarling, *Congressional Oversight Panel, October Oversight Report: An Assessment of Foreclosure Mitigation Efforts After Six Months,* at 158-61 (Oct. 9, 2009) (online at cop.senate.gov/documents/cop-100909-report-hensarling.pdf).

[516] Edward Pinto, *Saving More Homes for the Same Money*, Wall Street Journal (Dec. 6, 2009) (online at online.wsj.com/article/SB10001424052748704342404574577853961145272.html).

such an inefficient and transparency-deficient program. The Administration appears to prioritize good intentions and wishful thinking over taxpayer protection.

Any foreclosure mitigation effort must appear fair and reasonable to the American taxpayers. It is important to remember that the number of individuals in mortgage distress reaches beyond individuals who have experienced an adverse "life event" or been the victims of fraud. This complicates moral hazard issues associated with large-scale modification programs. Distinct from a moral hazard question there is an inherent question of fairness as those who are not facing mortgage trouble are asked to subsidize those who are facing trouble.

In light of current statistics regarding the overall foreclosure rate, an essential public policy question that must be asked regarding the effectiveness of any taxpayer-subsidized foreclosure mitigation program is: "Is it fair to expect approximately 19 out of every 20 people to pay more in taxes to help the 20th person maintain their current residence?" Although that question is subject to individual interpretation, there is an ever-increasing body of popular sentiment that such a trade-off is indeed not fair.[517]

Since there is no uniform solution for the problem of foreclosures, a sensible approach should encourage multiple private sector mitigation programs that do not amplify taxpayer risk or require government mandates. Subsidized loan refinancing and modification programs may provide relief for a select group of homeowners, but they work against the majority who shoulder the tax burden and make mortgage payments on time. Based upon the analysis of Professor White, little reason exists for government sponsored programs since it is in the best economic interest of the mortgage holders to restructure troubled loans rather than to pursue a foreclosure remedy.

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[517] State anti-deficiency laws also create significant moral hazard risks that will be exacerbated if Congress passes a cramdown amendment to the bankruptcy code. With these laws in effect, the risk-reward mix underlying each mortgage and home equity loan will be bifurcated with lenders assuming substantially all of the risks regarding the underlying value of the mortgaged property and homeowners receiving substantially all of the rewards. These laws may have the unintended consequence of encouraging homeowners to reject their contractual responsibilities and service their mortgage obligations only when it's in their economic self-interest. Since option contracts are inherently more risky to lenders than traditional mortgage contracts, lenders may have little choice but to incorporate such risks into the interest rates and fees charged on mortgage loans. The Administration should refrain from suggesting that Congress enact legislation that encourages individuals and families to invest in the housing market for speculative purposes while permitting them to avoid their contractual obligations upon the occurrence of adverse market conditions.

It is worth noting that the decision of individuals and families to speculate in the housing market, while perhaps unwise, is not entirely irrational. While some may contend that the average consumer is too unskilled to comprehend seemingly sophisticated financial products, I would argue to the contrary. With anti-deficiency, single-action and, perhaps, bankruptcy cramdown laws in effect, borrowers will receive the bulk of any equity appreciation while lenders will bear substantially all of the risk of loss arising from home mortgage loans. Most consumers are rational and react favorably to incentives that reward particular behavior. Providing economic and legal incentives that encourage inappropriate speculation in the housing market is unwise and fraught with adverse unintended consequences. That a bankruptcy cramdown law could help re-inflate a housing bubble by encouraging reckless speculation and cause lenders to raise mortgage interest rates and fees justifies its rejection.

F. Secretary Geithner Should Not Extend the TARP but Permit it to End on December 31, 2009

In order to end the abuses of EESA as evidenced by the Chrysler and GM bankruptcies, misguided foreclosure mitigation programs and the re-animation of reckless behavior and moral hazard risks, Secretary Geithner should not extend the TARP but permit it to end on December 31, 2009. As of today, Treasury has approximately $297.2 billion of TARP authority available to fund existing commitments and new programs.[518] As the EESA statute requires, all recouped and remaining TARP funds should go back into the Treasury general fund for debt reduction. All revenues and proceeds from TARP investments that have generated a positive return should also go to the general fund. Neither the letter nor the spirit of the law allow for TARP funds to be used as offsets for future spending programs, such as those currently being considered by the Administration and Majority leadership.

Further, the TARP should be terminated due to:

- the desire of the taxpayers for TARP recipients to repay all TARP related investments sooner rather than later;
- the troublesome corporate governance and regulatory conflict of interest issues raised by Treasury's ownership of equity and debt interests in the TARP recipients;
- enhanced implicit guarantee and moral hazard risks;
- an increase in the number and size of "too big to fail" financial institutions;
- the absence of appropriate standards of transparency and accountability in TARP-related disclosure by Treasury;
- the stigma associated with continued participation in the TARP by the recipients;[519] and
- the use of the TARP (i) for economic stimulus instead of EESA mandated financial stability and (ii) to promote the Administration's economic, social and political agenda as evidenced by, among others, the Chrysler and GM bankruptcies.

Some of the adverse consequences that have arisen for TARP recipients include, without limitation:

[518] See Section One, C.5.b.i. of the Panel's December report.

[519] Dealbook, *Bank of America's TARP Move Helps Shed Stigma*, New York Times (Dec. 3, 2009) (online at dealbook.blogs.nytimes.com/2009/12/03/move-to-repay-aid-helps-bank-of-america-shed-stigma/?scp=2&sq=stigma%20bank%20of%20america&st=cse).

- the private sector must now incorporate the concept of "political risk" into its due diligence analysis before engaging in any transaction with the United States government;

- corporate governance and conflict of interest issues; and

- the distinct possibility that TARP recipients – including those who have repaid all CPP advances but have warrants outstanding to Treasury – and other private sector entities may be subjected to future adverse rules and regulations.

A recent report issued by SIGTARP provides an insightful analysis of the actual cost of the TARP.[520]

- Assuming that most financing for the TARP comes from short-term Treasury bills, Treasury estimates the interest cost for TARP funds spent to be about $2.3 billion, although SIGTARP says a blended cost would double this amount and an "all-in" estimate would triple or quadruple it.[521]

- Were the TARP to reach its $699 billion potential, it would mean a $5,000 expenditure for each taxpayer.[522] The TARP represents five percent of 2008 GDP.

- Other costs identified by SIGTARP include (i) higher borrowing costs in the future as a result of increased Treasury borrowing levels, (ii) a potential "crowding out effect" on prospective private sector borrowers, potentially driving private sector borrowers out of the market, (iii) moral hazard, or unnecessary risk-taking in the private sector due to the bailout, and (iv) costs incurred by the other financial-rescue-related federal agencies that have not yet been quantified.

I introduced legislation – H.R. 2745 – to end the TARP on December 31, 2009. In addition, the legislation:

- requires Treasury to accept TARP repayment requests from well capitalized banks;

- requires Treasury to divest its warrants in each TARP recipient following the redemption of all outstanding TARP-related preferred shares issued by such recipient and the payment of all accrued dividends on such preferred shares;

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[520] SIGTARP, *Quarterly Report to Congress* (Oct. 21, 2009) (online at sigtarp.gov/reports/congress/2009/October2009_Quarterly_Report_to_Congress.pdf).

[521] A blended cost combines short- and medium-term Treasury securities, while an "all-in" cost balances those with longer-term Treasury securities. If TARP is a medium- to longer-term program, either approach would seem more sensible than Treasury's current short-term interest estimate.

[522] The $5,000 "cost" per taxpayer assumes 138.4 million taxpayers are covering the full $699 billion.

- provides incentives for private banks to repurchase their warrant preferred shares from Treasury; and
- reduces spending authority under the TARP for each dollar repaid.