Testimony of Professor Elizabeth Warren

Chair, Congressional Oversight Panel

before the

House Committee on Financial Services

Subcommittee on Oversight and Investigations

July 22, 2009

Thank you Chairman Moore, Ranking Member Biggert, and members of the Subcommittee for inviting me to testify regarding Troubled Asset Relief Program (TARP) warrant repurchases and the work of the Congressional Oversight Panel. I would like to begin by emphasizing that – although I am the Chair of the Panel – the views I express today are my own and do not necessarily reflect those of the other Panel members.

The Congressional Oversight Panel was created in last year's Emergency Economic Stabilization Act (EESA). The job of the Panel is to "review the current state of the financial markets and the financial regulatory system" and report to Congress every 30 days. We have released eight oversight reports, as well as a special report on regulatory reform required by the legislation and a special report on farm credit, also required by law, which we released yesterday.

The Oversight Panel is one of three organizations to which the TARP legislation gives oversight responsibilities. We work closely with GAO and the Special Inspector General to ensure that all our oversight efforts complement, not duplicate, one another. We all want to make the whole of our work greater than the sum of its parts. Today's topic of warrant repurchases is one example of how coordination between oversight bodies can allow us to build upon one another's work. Through our regular, ongoing meetings, we were able to coordinate our work on warrants and repurchase issues with SIGTARP, allowing their audit to pick up on our report.

The Oversight Panel is the smallest of the three organizations. Although the EESA did not limit our budget, we established and have run the Panel thus far on $2.7 million and approximately twenty employees. Congress gave us the authority to engage experts and contractors and through that we have expanded our reach. We are also the only one of the three authorized to hold hearings. We have held nine hearings around the country and in Washington D.C., and our tenth will be next week in Detroit on issues relating to TARP and the auto industry.

We may be the smallest organization, but we are lean and focused. We see our contribution as fact-based analysis designed to raise issues about the operation and direction of the TARP and about the broader effort to restore stability to the economic system. In the

Emergency Economic Stabilization Act, Congress specifically asked that the Oversight Panel conduct oversight on: the use of Treasury's authority under TARP; the Program's effect on the financial markets, financial institutions, and market transparency; the effectiveness of foreclosure mitigation efforts; and the TARP's effectiveness in minimizing long-term costs and maximizing long-term benefits for the nation's taxpayers. Our ultimate question is whether the TARP is operating to benefit the American family and the American economy. If we believe the answer is no, we will ask "why not," and try to suggest alternatives.

The focus of my testimony today reinforces the need for accountability and transparency in the management of the TARP. I would like to commend the Subcommittee for its continuing work in ensuring effective oversight of the nation's financial system. I am pleased to assist your efforts in any way that I can.

In late 2008, our economy faced an exceptional crisis. The stock market had plummeted. Credit markets had frozen. Our most important financial institutions were teetering on the brink of collapse, threatening to bring the whole economy down. In this challenging moment Congress created the TARP. Under this program Treasury pumped billions of dollars into banks, an emergency action meant to stabilize the financial system.

These actions imposed an enormous risk on taxpayers. If the TARP failed to stabilize the financial system, the entire economy could collapse. Even if the system stabilized after huge infusions of taxpayer funds, if some institutions were unable to recover, taxpayers could be saddled with debt for generations. While these risks were looming, then-Treasury Secretary Henry Paulson argued that TARP assistance could be used to rescue the economy as well as generate a profit for taxpayers. When Congress authorized the commitment of $700 billion to rescue the financial system, it decided that taxpayers should have the opportunity to share in a potential upside if the banks returned to profitability.

The opportunity to profit from TARP investments comes through special securities called warrants, which represent the right to buy shares of a company at a set price at some point in the future. Banks that received financial assistance under the TARP were required to give the government warrants for the future purchase of some of their common shares. Now that the markets have begun to show signs of recovery and many banks want to repay their TARP money, repurchase their warrants, and free themselves from the stigma and stipulations that accompany government bailouts, it is timely to consider the issues involved in the repayment of TARP assistance and the repurchase of warrants.

The Panel's mandate is to examine Treasury's choices, and in our July report we consider whether it makes sense to allow repayment now, and determine if taxpayers are receiving the maximum benefit possible from the TARP. (http://cop.senate.gov/reports/library/report-071009-cop.cfm) Treasury recently chose to allow 10 of the nation's largest banks, holding a third of the nation's banking assets, to exit the TARP. These banks have repaid their government capital infusions, but Treasury still has the warrants that accompanied the TARP assistance. Because these warrants represent the only opportunity for the taxpayer to participate directly in the increase in the share prices of these banks, made possible by public money, the price at which Treasury sells these warrants is critical. We do not know what value Treasury has placed on the warrants it still holds, but the Panel's July report presents an independent valuation to generate a baseline for comparison for when Treasury does sell its warrants, to help determine whether Treasury is in fact maximizing the return on taxpayers' investments in these financial institutions.

The Panel's July report presents a detailed technical valuation of Treasury's warrants using the most widely-accepted mathematical model for warrant valuation. The assumptions employed in the use of any model are crucial, and the report offers a range of estimates based on high, low and best estimate assumptions for certain key variables, particularly the volatility of the underlying stock of the bank in question The Panel's estimates for the value of the warrants Treasury held on July 6, 2009 range from $4.7 billion to $12.3 billion, with its best estimate being $8.1 billion.

The Panel was aided in its valuation efforts by three renowned finance experts, Professor Robert Merton, Professor Daniel Bergstresser, and Professor Victoria Ivashina, all of the Harvard Business School. The professors reviewed both the technical valuation model and the assumptions that were built into the model; they concluded that the approaches reported here were reasonable and that they produced reliable estimates. However, the actual calculations contained in the Panel's July report are solely the work of the Panel and the Panel takes complete responsibility for them.

As of the date of our report (July 10th) eleven small banks had repurchased their warrants from Treasury for a total amount of only 66 percent of the Panel's best estimate of their value. If the warrants had been sold for the Panel's estimation of market value, taxpayers would have recovered $10 million more. In these sales, liquidity discounts – applied to reflect the difficulty in trading securities of small institutions – have been a major factor in a way not likely to apply to the warrants of large, publicly-traded institutions. However, if Treasury continues to accept only 66 percent of the Panel's estimated market value for the rest of warrants it holds, the shortfall to taxpayers could be as much as $2.7 billion.

It should be noted that Treasury is just beginning its warrant repurchase program. It is possible that policymakers may conclude that other objectives should override the goal of maximizing taxpayer returns. For example, Treasury has said that it wants to allow banks to operate again without TARP assistance as soon as they are strong enough to do so. The determination of whether they are in fact financially sound and able to repay their assistance remains critical, especially in light of ongoing concerns about the macroeconomic environment and the possibility of further credit losses down the road. As discussed in the Panel's June report, the stress tests provide some comfort in this regard but the fact that the key economic assumptions used in those tests continue to deteriorate remains a cause for concern.

Banks have bought back only a fraction of one percent of all warrants issued, and the prices paid thus far may not be representative of what is to come. In fact, in the weeks since our report was published, Treasury seems to have begun conducting its warrant negotiations more aggressively. U.S. Bancorp, which recently paid back its $6.9 billion in TARP assistance, repurchased its warrants from Treasury for $139 million dollars. This figure was actually higher than that given by the Panel's best estimate model – which would be good news for taxpayers if it is indicative of how future warrant negotiations with large institutions will play out. Additionally, as has been widely reported, banks like JPMorgan Chase and Goldman Sachs have thus far been unable to reach agreement with Treasury on a price for their warrants. Reports in the media also indicate that these two banks believe Treasury is asking too much for their warrants and that JPM Chase is urging Treasury to conduct an auction for them.

Treasury is obligated under the terms of the contracts it initially signed as part of the Capital Purchase Program to enter into negotiations with the banks to repurchase warrants once they have repaid their CPP investments. Only if the price ultimately negotiated is rejected by the bank in question can Treasury then move to an auction procedure to dispose of its warrants.

Nevertheless, because warrant valuation is a difficult task, the Panel explores the possibility that Treasury should leave it to the markets by selling the warrants in an open, public auction. This has the benefit of stopping any speculation about whether Treasury has been too tough or too easy on the banks that want to repurchase their own warrants. It also permits the banks to bid for their own warrants – in direct competition with outsiders.

As always, it is critical that Treasury make the process – the reason for its decisions, the way it arrives at its figures, and the exit strategy from or future use of the TARP – absolutely transparent. If it fails to do so, the credibility of the decisions it makes and its stewardship of the TARP will be in jeopardy.

I would like to briefly mention the Panel's other reports, which cover a wide range of important topics.

In December, we issued our very first report, identifying a series of ten primary questions regarding Treasury's goals and methods. (http://cop.senate.gov/reports/library/report-121008-cop.cfm) These questions must be answered in order for Treasury to be successful:

- What is Treasury's strategy?
- Is the strategy working to stabilize markets?
- Is the strategy helping to reduce foreclosures?
- What have the financial institutions done with the taxpayers' money received so far?
- Is the public receiving a fair deal?
- What is Treasury doing to help the American family?
- Is Treasury imposing reforms on financial institutions that are taking taxpayer money?
- How is Treasury deciding which institutions receive the money?
- What is the scope of Treasury's authority?
- Is Treasury looking ahead?

These questions were posed to then-Treasury Secretary Paulson in a letter. They were further expanded with subsidiary questions seeking additional information.

In January, the Secretary's response provided the basis for our report. (http://cop.senate.gov/reports/library/report-010909-cop.cfm) An analysis of the response revealed that many answers were non-responsive or incomplete. It was disappointing that the answers were, and in some cases continue to be, elusive, given that the questions are basic and should have been answered when initially framing the program. It was disconcerting, to say the least, having hundreds of billions of dollars spent seemingly without a plan. The report found that, in particular, Treasury needed to provide additional information on bank accountability, transparency, asset valuation, foreclosures, and strategy.

The special report on regulatory reform found that financial crises occur on a regular basis, and it is necessary to study the lessons of the past in order to restore a proper balance between free markets and the regulatory framework necessary to ensure the operation of those markets to protect the economy, honest market participants, and the public. (http://cop.senate.gov/reports/library/report-012909-cop.cfm) The present regulatory system has failed to effectively manage risk, require sufficient transparency, and ensure fair dealings, three areas that, had they been given adequate attention by regulators, could have averted the worst aspects of the current crisis. The Panel identified eight specific areas most urgently in need of reform:

- Identify and regulate financial institutions that pose systemic risk
- Limit excessive leverage in American financial institutions
- Increase supervision of the shadow financial system
- Create a new system for federal and state regulation of mortgages and other consumer credit products
- Create executive pay structures that discourage excessive risk taking
- Reform the credit rating system
- Make establishing a global financial regulatory floor a U.S. diplomatic priority
- Plan for the next crisis

In February, the Panel returned to the central question of whether the public was receiving a "fair deal" when Treasury used TARP funds to make capital infusions into financial institutions. (http://cop.senate.gov/reports/library/report-020609-cop.cfm) We worked with recognized independent experts to develop multiple valuation models to determine whether the securities Treasury received had a fair market value equal to the dollar amount of the infusions. With minimal variation, the models all demonstrated that Treasury made its infusions at a substantial discount. Treasury received securities that were worth substantially less than the amounts it had paid in return. In all, Treasury overpaid by an estimated $78 billion. For each $100 Treasury invested in these financial institutions, it received on average stock and warrants worth only about $66 at the time of the transaction.

While there may have been good reasons to subsidize the banks last fall, it is critical that Treasury be clear in explaining its goals in these transactions, a finding echoed in the call for transparency in Treasury's valuation of the warrants.

In March, the Panel examined the foreclosure crisis, as directed in the statute. (http://cop.senate.gov/reports/library/report-030609-cop.cfm) In considering mortgage foreclosure mitigation, we gave particular consideration to impediments to mitigation efforts. We offered a checklist of items to evaluate the likely effectiveness of any proposal to halt the cascade of mortgage foreclosures.

- Will the plan result in modifications that create affordable monthly payments?
- Does the plan deal with negative equity?
- Does the plan address junior mortgages?
- Does the plan overcome obstacles in existing pooling and servicing agreements that may prevent modifications?
- Does the plan counteract mortgage servicer incentives not to engage in modifications?
- Does the plan provide adequate outreach to homeowners?
- Can the plan be scaled up quickly to deal with millions of mortgages?
- Will the plan have widespread participation by servicers and lenders?

We were pleased to see that the Administration's Homeowner Affordability and Stability Plan addressed many of these issues, although the Panel noted serious concern with areas left unaddressed in the original plan, including lack of a safe harbor for mortgage servicers that results in impediments to restructuring mortgages, incomplete consideration of second mortgages, unclear enforcement, and a failure to address seriously underwater mortgages. It is encouraging to see that the initiative is evolving to deal with some of these concerns. The Panel plans follow up work over the coming months to measure progress in foreclosure mitigation.

In April the Panel further analyzed the evolving strategy of Treasury. (http://cop.senate.gov/reports/library/report-040709-cop.cfm) We focused on lessons from the previous financial crises, both foreign and domestic, to help inform our analysis of the current situation. The report examined four case studies of particular relevance: the Japanese "Lost Decade" of the 1990s; the Swedish experience with bank nationalization in the 1990s; the establishment of the Resolution trust Corporation (RTC) in response to the American Savings and Loan collapse in the late 1980s; and the actions taken to stabilize the financial and housing sectors during the Great Depression. The report highlighted the benefits and problems of several basic approaches to dealing with failing banks- liquidation, reorganization, or subsidization- based on these historic examples. The review highlighted that each successful resolution of a financial crisis involved four key elements: transparency, assertiveness, accountability, and clarity.

In May the Panel considered the state of small business and consumer lending and provided an assessment of the Term Asset-Backed Securities Loan Facility (TALF). (http://cop.senate.gov/reports/library/report-050709-cop.cfm) The TALF is intended to support more lending by financing credit through asset-backed securities. These are securities that represent interests in pools of loans made to small businesses and households. Our primary question was whether the TALF program is well-designed to attract new capital. The program allows the investors to reap a substantial portion of the potential profits, but leaves taxpayers to absorb a large portion of potential losses. Even with this asymmetry, there was a slow initial uptake to the program. More recent subscriptions have shown greater participation. Unfortunately, other factors may mean that even a well-designed program could have difficulties helping market participants meet the credit needs of small businesses and households. Families are awash in debt and in the process of deleveraging. Stagnant wages and rising unemployment further constrain the ability of households to manage ever-larger debt loads, suggesting that strategies to increase consumer lending may be counterproductive for American families—and ultimately for the economy. TALF is unlikely to have a meaningful impact on small businesses, as asset-backed securities have never been a significant source of small business funding. The report raises questions about whether taxpayer support for small business lending should be concentrated elsewhere, such as increased availability of SBA loans.

In June the Panel examined the stress tests conducted on the 19 largest bank holding companies to ensure their continued ability to lend to creditworthy borrowers in the event of a weaker-than-expected economic environment and larger-than-estimated losses. (http://cop.senate.gov/reports/library/report-060909-cop.cfm) The stress tests were conducted using two scenarios: one test based on a consensus set of economic projections and one based on more adverse economic conditions. Under the announced results, nine of the nineteen banks were found to already hold sufficient capital to operate under the adverse scenario through 2010; however, ten of the nineteen banks were found to need additional capital totaling nearly $75 billion. Only the results from the adverse scenario have been released, leaving many unanswered questions about the test methodology. While the Federal Reserve is to be commended for releasing an unprecedented amount of bank supervisory information, they should release additional information that would allow the tests to be replicated by others. Moving forward, the Panel recommended that the stress tests should be repeated should the economy exceed the assumptions built into the models, the stress tests should be repeated so long as banks continue to hold large amounts of toxic assets on their books, banks should be required to run internal stress tests and share the results with regulators, and regulators should have the ability to use stress tests when they believe it necessary.

Just yesterday, the Panel released a special report on farm credit and farm loan restructuring, as mandated by the Helping Families Save Their Homes Act of 2009. (http://cop.senate.gov/reports/library/report-072109-cop.cfm) Farmers entered the recession in a historically strong position, and for many, balance sheets are in fairly good shape. But prosperity is not evenly spread across America. Today, more farmers are struggling. Net farm income is expected to fall 20 percent this year, and some sectors – especially dairy – are doing worse. Congress asked the Panel to consider whether three existing loan restructuring models – the USDA's Farm Service Agency, the Farm Credit System, and the Making Home Affordable program for residential mortgages – could be used as a model for a farm loan restructuring mandate for TARP recipient banks. The Panel found that a foreclosure plan that only works through a mandate on TARP recipient banks, no matter which model it followed, would have limited effect. Right now TARP recipient banks only hold about ten percent of farm real estate debt. Treasury and Congress could consider other alternatives, such as setting aside a portion of remaining TARP funding for a farm mortgage foreclosure mitigation program, patterned on the incentive based program developed to protect homes, but focusing on bank participation beyond current TARP recipients. Another option would be to create within TARP a loan guarantee program for restructured farm loans. Both commercial banks and other lenders, like the Farm Credit System, report using government guaranteed loans to restructure trouble loans, but the availability of such loan guarantees is insufficient to meet the need. Finally, Congress has options outside of TARP to assist struggling farmers, such as commodity and price support programs. Such programs could allow assistance to be targeted to the specific sectors in need, like the dairy industry.

For August the Panel will turn to the topic of toxic assets. The precipitous drop in value of classes of assets linked (primarily) to residential real estate loans, produced the most serious financial crisis of the last 75 years. But government policy has not focused on those assets. Instead it has aimed to stabilize the financial institutions that hold them. What are the consequences, and more important, the risks of this approach to putting the financial sector into a position where the crisis cannot reignite?

The Panel will hold a field hearing next week in Detroit to look into the questions surrounding the automotive transactions. We also continue a number of oversight initiatives on residential mortgage foreclosure.

What have we learned thus far? In a crisis, transparency, accountability and a coherent plan with clearly delineated goals are necessary to maintain public confidence and the confidence of the capital markets. Sophisticated metrics to measure the success and failure of program initiatives are also critical. Assuring that the TARP reflects these elements underlies all of our oversight efforts.

Thank you again for the opportunity to explain the work of the Congressional Oversight Panel. I look forward to answering your questions.