

- 1. According to Treasury's *Monthly Lending and Intermediation Snapshot*, which measures the lending levels of the top 22 Capital Purchase Program recipients, there have been mixed signals with regards to the lending habits of those institutions that benefitted the most from TARP assistance. There are certain areas of lending that have shown improvement, most notably the 32 percent increase in mortgage originations and the 75 percent increase in refinancing originations since the enactment of EESA. However, precipitous drops in other lending categories have offset these increases. For example, new commitments to commercial real estate loans by these 22 institutions have decreased by nearly 64 percent while commercial and industrial loans have decreased by 26 percent since October 2008. Total originations made by these 22 institutions have decreased by 9 percent since October 2008. Why has lending continued to shrink after these financial institutions took TARP money? What do these trends indicate about the success of the TARP? Do these trends concern you?**

The role of the financial sector is to provide credit to our economy. Americans rely on that credit for homes, education, and cars. Businesses rely on it to hire and pay their employees. While U.S. credit conditions and the outlook for economic growth have improved significantly over the past year, bank lending continues to contract. It is vital that banks lend to creditworthy American consumers and businesses.

A major cause of the reduction in lending is the fact that the U.S. banking system entered this crisis with insufficient capital. As credit losses mounted, first because of the correction in the U.S. housing market and subsequently because of the sharp contraction in the economy, banks have had to adjust. That adjustment has come through raising additional capital, reductions in total assets held by banks, and changes in the composition of those assets. The declines in loans held by banks are one part of this process of adjustment. But the economic contraction has also reduced the demand for credit as both consumers and businesses have pulled back. In addition the contraction has undermined the credit worthiness of many borrowers. In past recessions, particularly those driven by credit cycles, bank lending has tended to lag the recovery of the economy. The fact that bank lending continues to contract is an indication that the adjustment in the U.S. banking sector is incomplete. Without TARP, the contraction in lending would no doubt have been much more severe. But TARP was never intended to solve all the problems of the banking sector. Relative to this historical record, the performance of bank lending in this cycle is not unusual.

However, there has likely been some overcorrection in bank lending practices. And tight bank credit has a particularly severe impact on small businesses, which do not have the ability to raise funds in securities markets. To help mitigate this decline in bank credit, we are seeking legislation to transfer \$30 billion from TARP into a new Small Business Lending Fund that would provide smaller and community banks with capital structured to provide an incentive to increase small business lending. We are also expanding our community development lending program. Eligible banks will now be able to receive more capital from the government--up to 5% of risk-weighted assets and the Treasury will match private investments in firms in order to increase the number of firms that have

access to the program. Finally, we continue to encourage major U.S. banks to expand lending, and we created and publish a monthly snapshot of their lending activity.

As the President has repeatedly stated publicly and privately to these banks: “The taxpayers were there for you to clean up your mistakes. You now have a responsibility to be there for the community.”

2. **There were 149 bank failures between January 1, 2008 and November 30, 2009. The FDIC, forced to repay depositors at a growing number of banks, is in the red for the first time in 17 years. In the absence of a robust economic recovery, this problem may worsen. How do you explain this rate of failure? What are you doing now to redress that balance and protect the FDIC against further losses? What implications for financial stability do you see in the FDIC’s present level of assets?**

The current elevated pace of bank failures is a consequence of the excesses that built up in our financial system in recent years, resulting in large credit losses that many institutions were not equipped to absorb. Among the key lessons of the crisis is the need for more capital and more vigilant supervision of banks to make sure our system is safer and more resilient going forward.

Despite the elevated pace of bank failures, it is clear that the FDIC has the resources and necessary tools to protect insured depositors and resolve failed banks. Throughout the FDIC’s 75-year history, no depositor has ever lost a penny of insured deposits. Although the Deposit Insurance Fund (DIF) balance fell to negative \$21 billion as of December 31, the DIF balance should be distinguished from the FDIC’s liquid resources, which stood at \$66 billion of cash and marketable securities. To bolster the DIF’s cash position, the FDIC’s Board approved a measure on November 12 to require insured institutions to prepay 13 quarters worth of deposit insurance premiums at the end of 2009. These prepayments were collected on December 31 and totaled approximately \$45 billion. Additionally, the Helping Families Save Their Home Act, enacted on May 20, 2009, permanently increased the DIF’s statutory line of credit with the U.S. Treasury from \$30 billion to \$100 billion, and increased it to \$500 billion through the end of 2010 if certain conditions are met.

To redress the negative DIF balance going forward, on September 22, the FDIC took action to increase assessment rates on the banking industry. The FDIC’s Board decided that effective January 1, 2011, rates will uniformly increase by 3 basis points. The FDIC has projected that bank and thrift failures will peak in 2009 and 2010 and that industry earnings will have recovered sufficiently by 2011 to absorb a 3 basis point increase in deposit insurance assessments. . The Budget projects the DIF reserve ratio will return to 1.15 percent in 2018.

3. **Section 134 of the Emergency Economic Stabilization Act of 2008 (EESA) (P.L. 110-343) states that should TARP realize a net loss, “the President shall submit a legislative proposal that recoups from the financial industry an amount equal to the shortfall in order to ensure that the Troubled Asset Relief Program does not add to the deficit or national debt.” Please explain the plan Treasury is putting in place to recoup any losses.**

Due to improved market conditions and the effective performance in the management and use of TARP authority, the projected cost to the taxpayer is now significantly lower than earlier anticipated. In our FY 2011 budget, we estimated that the cost to taxpayers and the deficit will be about \$224 billion lower than the estimate of \$341 billion projected in the Midsession Review in August. However, as part of our commitment to ensuring that taxpayers do not face the costs of the extraordinary efforts taken to stabilize the financial system, the Administration proposed the Financial Crisis Responsibility Fee on January 14, 2010. This fee – which fulfills the President’s commitment to submit a plan to recoup TARP losses three years early – would be levied on the liabilities of financial institutions with over \$50 billion in assets, and is expected to raise \$117 billion over about 12 years, and \$90 billion over the next 10 years.

Our proposed fee fulfills the requirement of Section 134 of EESA – ensuring that taxpayers are paid back in full – while also providing a deterrent against excessive leverage among the largest financial firms. In the coming weeks, we will be developing further details concerning the Financial Crisis Responsibility Fee, and we look forward to working with Congress and members of this Panel in designing it to most effectively recover the costs of TARP.

- 4. I understand that the regulators’ enforcement action with respect to certain very large banks are embodied in memoranda of understanding with these banks, but those memoranda have not been made public. In the past, the regulatory agencies have explained that all such material must be confidential to assure the cooperation of banks with the examination process. The events of the last several years have revealed critical flaws in that process, flaws that have led to a bailout using hundreds of billions of dollars of taxpayer money. In light of the failure of the examination process and its results, do you believe that supervisory enforcement memoranda should be disclosed to the public, which is ultimately responsible for paying the costs of such failure? If you do not believe that such memoranda should be made public, please explain why not in light of the rationale I have cited.**

Treasury agrees that the financial crisis revealed serious flaws in the supervisory process. Supervisors for several large financial institutions missed emerging weaknesses or failed to react forcefully when such weaknesses were known. Treasury has called for a fundamental reassessment of the supervision and regulation of financial institutions based on an analysis of the lessons learned in the years leading up to this crisis.

However, Treasury does not believe that memoranda of understanding that were confidential at the time of signing should be made public after the fact. Supervised entities rely on decisions taken by supervisors, including supervisor’s decisions to keep information confidential. Supervisors need to maintain their ability to ensure confidentiality in order to effectively carry out their authorities. In addition, the distinction between public and nonpublic enforcement actions is important to the conduct of supervision: the issuance of public enforcement actions represents a significant escalation in supervisory efforts to address weaknesses at financial institutions. It is important that supervisors retain the ability to address issues either confidentially or publicly, as warranted by specific circumstances.

- 1. Can you explain how it was in the public interest to allow Bank of America to repay TARP funds in such a manner that it had less Tier I capital than it did before the repayment? If you disagree with this characterization of the transaction, please explain why?**

While it would not be appropriate for Treasury to comment on any individual institution, it is important to note that Treasury is required under the American Recovery and Reinvestment Act of 2009 to accept repayment of TARP funds “without regard to whether the financial institution has replaced such funds from any other source,” subject to consultation with the appropriate federal banking agency. As a result, many of the elements of this question would be best directed to the regulatory bodies that oversee the safety and soundness of individual institutions.

We also note that one of our objectives has been to improve the quality of capital in the banking system. Although in some cases following the repayment of TARP, the total Tier 1 capital of an institution has been lower than that immediately preceding repayment, the quality of capital at institutions that have repaid TARP funds has generally improved. Tier 1 capital, the highest quality form of capital, has accounted for the vast preponderance of new capital raised by institutions since the Supervisory Capital Assessment Program (SCAP) stress test results were released. For example, the institutions subject to the stress test alone have raised more than \$110 billion from common equity issuance since the May release of the stress test results.

Further, the level of capital immediately before and immediately after TARP repayment is not the only relevant comparison. Post-repayment capital levels and ratios should also be compared to pre-TARP capital levels and ratio and, more generally, to supervisory capital requirements. Tier 1 capital has increased substantially at individual institutions and in the banking sector as a whole since the inception of TARP, demonstrating that TARP has successfully served as a bridge to private capital.

Lastly, we believe that, consistent with the stability of the financial system, it is in the public interest for taxpayers to get their money back from TARP recipients, with interest, at the earliest date consistent with continued financial stability. Our judgment has been and continues to be that by replacing the Treasury investments with private capital, institutions will be in a better position to expand lending as the economy expands.

- 2. Can you explain further why it was not possible in your view to negotiate concessions from the largest AIG counterparties as part of the rescue of AIG, in light of their limited number and those entities' substantial stake in government intervention to support AIG and their relative financial and political vulnerability? Note I am not asking whether the Treasury and the Federal Reserve Bank of New York should have allowed AIG to go bankrupt or whether the Treasury and the New York Fed should have allowed a general default on all AIG derivatives-related obligations.**

On January 27, 2010, the House Committee on Oversight and Government Reform held a hearing that addressed the government's role in negotiations with AIG's counterparties.¹ As part of that hearing, I, former Treasury Secretary Henry Paulson, Federal Reserve Bank of New York (FRBNY) General Counsel Thomas Baxter, and others provided extensive testimony on the subject. Although I provide an answer to your question below, I also refer you to the testimony from that hearing.

In the fall of 2008, a near-complete collapse of our financial system was a realistic possibility. Americans were starting to question the safety of their money in the nation's banks, and a growing sense of panic was producing the classic signs of a generalized run. Peoples' trust and confidence in the stability of major institutions, such as AIG, and the capacity of the government to contain the damage was vanishing. Lehman Brothers filed for bankruptcy just a few days after AIG alerted Federal authorities that its problems had become acute. In the wake of Lehman's failure major institutions such as Washington Mutual and Wachovia experienced debilitating deposit withdrawals, eventually collapsed, and were acquired by competitors. Money market funds also suffered a broad run, threatening what was considered one of the safest investments for Americans and severely disrupting the commercial paper market, a vital source of funding for many businesses.

In this chaotic environment, the Federal Reserve and Treasury concluded that AIG's failure could be catastrophic. At the time, the failure of a large, global, highly-rated financial institution that had written hundreds of billion dollars of insurance on a range of financial instruments could have tipped an already weak and fragile financial system and economy into the abyss. The company's failure would directly threaten the savings of millions of Americans to whom it had provided financial protection through investment contracts and products that protect participants in 401(k) retirement plans. AIG was one of the largest life and property/casualty insurance providers in the United States. The withdrawal of such a major underwriter at the time risked creating a void for millions of households and businesses for basic insurance protection. And doubts about the value of AIG life insurance products could have generated doubts about similar products provided by other life insurance companies, feeding the panic that was crippling the economy.

Convinced that the failure of AIG could be catastrophic for a financial system already in free fall, the Federal Reserve and Treasury determined that it was in the best interests of the United States to support AIG in order to slow the panic and prevent further damage to our economy. From the beginning, it was clear that AIG needed a durable restructuring of its balance sheet and operations. Although the government faced escalating and unprecedented challenges on many fronts of the financial storm in September and October, it continued to work to address this need. Falling asset prices generated both substantial losses on the company's balance sheet and increases in required payments to AIG's counterparties under the terms of its credit protection contracts. This, along with other factors, undermined market confidence in AIG and put its investment-grade credit rating again at risk. Understanding the counterparty negotiations addressed by your question requires an understanding of the role of the rating agencies in AIG's businesses. Avoiding further

¹ House Committee on Oversight and Government, Hearing, "The Federal Bailout of AIG," Jan. 27, 2010, transcripts and webcast of hearing available at http://oversight.house.gov/index.php?option=com_content&task=view&id=4756&Itemid=2.

downgrades of AIG's credit rating was absolutely essential to sustaining the firm's viability and protecting the taxpayers' investment. Under credit protection contracts that AIG had written and the terms of various funding arrangements, AIG was required to make additional payments to its counterparties if its credit rating was downgraded. A downgrade (to below a certain level) also constituted an event of default or termination under many contracts. In addition, rating downgrades of the AIG parent holding company would have significantly undermined confidence in its insurance subsidiaries. People do not buy insurance products from firms they do not believe have the financial capacity to make good on those commitments over the long term – firms that they do not believe will pay out a life insurance policy or compensate a business if a factory burns down. Credit ratings are central to how people judge that viability.

The counterparty negotiations were conducted in connection with the formation and funding of Maiden Lane III LLC (ML III), a company formed to purchase troubled assets that AIG had insured and to help insulate the company from further liquidity drains, thereby preventing it from being downgraded and failing. Before the Federal Reserve became involved with AIG, the company had entered into credit default swap (CDS) contracts with various third parties to protect the value of certain risky securities, called multi-sector CDOs, in exchange for periodic premium payments. The value of these securities was tied to pools of other assets, mostly subprime mortgages. The contracts required AIG to provide its counterparties collateral as the market value of the underlying CDOs, the credit rating of the assets behind the CDO, or AIG's credit rating declined. As the financial crisis intensified, each of these events occurred. As of November 5, 2008, AIG had already posted approximately \$37 billion in collateral against these exposures in accordance with the terms of the contracts, and these collateral calls contributed significantly to the \$25 billion in losses that AIG reported for the third quarter of 2008. The box below provides a simplified example to help understand these contracts and negotiations with counterparties to them.

AIG's Credit Default Swap Exposure – Simplified Example

While the financial contracts involved were complex, AIG had basically agreed to insure the value of certain risky securities called multi-sector CDOs. The value of these securities was tied to pools of other assets, mostly subprime mortgages. As the financial crisis intensified, the value of the securities fell sharply. AIG incurred losses on these contracts and had to post collateral or make payments on the insurance.

To help understand this kind of contract, imagine AIG had provided insurance on the value of a tangible asset, such as a house, to the homeowner. If the price of the house fell, AIG would be required to post collateral, or essentially make a payment to the owner, equal to the decline in the value of the house. So, if the house was originally worth \$200,000 and fell to \$125,000, AIG had to give \$75,000 to the homeowner as collateral and would incur a loss of the same amount. In addition, AIG would have to post more collateral if the credit rating of the house fell, because it would signal that the home's value was in jeopardy. Finally, if AIG's credit rating fell, it would have to post even more collateral because the homeowner would be concerned about whether AIG could ultimately pay on the insurance.

The problem was AIG had written billions of dollars of such insurance without sufficient capital.

AIG was fine as long as the prices of the assets they were insuring -- housing prices, in the example -- didn't fall, the credit rating of the assets didn't fall, and AIG's own credit rating didn't fall. But if any of those events happened, it would be in trouble. In the fall of 2008, each of these events occurred. The value of the assets, their credit rating, and AIG's own credit rating all fell, bringing AIG to the brink of bankruptcy.

The counterparty/homeowner was fully protected and had all the leverage. If AIG failed to pay on the insurance, the counterparty could keep the collateral and the asset (house) and sue AIG for damages. Further, if AIG had failed to pay or threatened not to pay, it would have been downgraded and collapsed—threatening the economy. If the government had guaranteed the insurance, as some have suggested, and asset prices fell, the counterparty could demand more collateral and keep the asset (house). Therefore, the government funded ML III to buy the asset (house) at fair market value (\$125,000). The counterparty kept the collateral (\$75,000) in exchange for tearing up the insurance. As a result, the counterparty received par (\$200,000), but the taxpayer gained the opportunity to benefit from recovery in asset prices—as has occurred. The transaction supported AIG's viability and credit rating, removing a substantial threat to the economy at the crisis's peak.

To remove the persistent threat that these contracts posed to AIG's continuing viability, ML III purchased the underlying CDOs from the counterparties at their then fair market value. The counterparties received \$27 billion in payment from ML III, retained approximately \$35 billion in collateral previously provided by AIG, transferred the CDOs to ML III, and terminated the CDS contracts. Thus, the counterparties essentially received the "par" value of \$62 billion, consistent with the terms of their insurance contracts with AIG. ML III's purchase was funded by a \$24 billion loan from the FRBNY and \$5 billion equity contribution by AIG.

In designing and implementing this transaction the FRBNY's objective was, as it always is, to protect the taxpayer. The FRBNY made judgments about these transactions carefully with the advice of outside counsel and financial experts. As they had done when establishing the lending facility in September, the FRBNY and its advisors reviewed a range of materials, including details regarding AIG's exposure to each counterparty under the CDS contracts. However, the FRBNY faced significant constraints. The CDS contracts entitled the counterparties to full or par value. The FRBNY could not credibly threaten not to pay without being willing to follow through on that threat and put AIG into bankruptcy. At the time, the government was working desperately to rebuild confidence in the financial system. Any suggestion that it might let AIG fail would have worked against that vital aim. The FRBNY could not risk a protracted negotiation. AIG's financial position was deteriorating rapidly, and the prospect of a further ratings downgrade was imminent. AIG was scheduled to report a \$25 billion loss for the third quarter on November 10, and the ratings agencies had informed AIG that, absent a parallel announcement of solutions to its liquidity and capital problems, they would downgrade the company yet again. Such a downgrade would have led

to AIG's failure and triggered the same catastrophic consequences the government had been trying to avoid since September 2008. Moreover, a bankruptcy would have entitled the counterparties to terminate the CDS contracts and keep the collateral that AIG had previously posted, as well as the underlying CDOs that AIG had insured.

The Special Inspector General for the Troubled Asset Relief Program (SIGTARP) has suggested that the FRBNY should have used its regulatory authority, or some other means, to coerce AIG's counterparties to accept concessions.² This was not a viable option for several reasons. First, if the FRBNY had tried to force counterparties to accept less than they were legally entitled to, market participants would have lost confidence in AIG leading to the company's failure. Once a company refuses to meet its full obligations to a customer, other customers will quickly find other places to do business. Second, the counterparties could have said refused to grant such concessions, kept the collateral they had already received, kept the CDO securities that AIG had insured, and sued AIG for breach of contract. This would have increased the taxpayer's potential exposure and precluded them from benefiting from any recovery in the value of the CDOs, which has in fact happened.

Third, if the FRBNY had attempted to use its regulatory authority to coerce or extract concessions from AIG's counterparties, that attempt would likely have led to a further downgrade of AIG's ratings, precisely the result that all of the government's actions were intended to avoid. An "investment grade" credit rating is the rating agencies' judgment that creditors will likely be repaid in accordance with the terms of their contracts, not according to a hypothetical government-coerced discount. If the FRBNY had attempted to force counterparties to accept less than they were legally entitled to, then AIG would not have met the ratings agencies' standards for "investment grade" status, and it would likely have lost its "investment grade" rating. Such a downgrade could have led to the company's collapse, threatened government efforts to rebuild confidence in the financial system, and meant a deeper recession, more financial turmoil, and a much higher cost for American taxpayers. In addition, the SIGTARP has stated that Treasury and the Federal Reserve "were fully prepared to use their leverage as regulators to compel the nine largest financial institutions (including some of AIG's counterparties) to accept TARP funding." The SIGTARP suggests that the government should have similarly compelled concessions from AIG's counterparties. First, I disagree with the SIGTARP's characterization of the government's discussions with the initial recipients of TARP funds. Second, the circumstances and authority in that situation were fundamentally different from what existed in the ML III transaction. Congress granted the Federal Reserve and, through EESA, Treasury with the responsibility to ensure the safety and soundness of the financial system. In the Federal Reserve's case, that authority was limited to providing liquidity and regulating bank holding companies. In Treasury's case, it was limited to purchasing or guaranteeing assets. Consistent with that responsibility and authority, in the midst of the financial crisis the government encouraged nine banks to accept additional capital. They were not forced to forfeit contractual rights for the benefit of another financial institution. The latter would have been an abuse of the authority granted by Congress, violated private parties' contractual rights, and undermined confidence in the government's strategy to stabilize the U.S. financial system.

² Factors Affecting Efforts to Limit Payments to AIG Counterparties, Nov. 17, 2009, available at http://www.sigtar.gov/reports/audit/2009/Factors_Affecting_Efforts_to_Limit_Payments_to_AIG_Counterparties.pdf.

Operating with these constraints, the FRBNY and AIG initiated discussions with the major counterparties about whether they would be prepared to accept concessions on the prices of the securities. The FRBNY knew that the likelihood of success of such a negotiation was modest, especially given the imminent deadline and the bargaining constraints under which it was operating. Not unexpectedly, the FRBNY discovered that most firms would not, under any condition, provide such a concession. One counterparty (UBS) said that it was willing, but only if every other counterparty would agree to equal concessions on their prices. In the end, the prices paid for the securities were their fair market value, and because the counterparties retained the collateral they had previously received from AIG, they all received an aggregate amount equal to par value of their securities. In return, the insurance contracts were terminated, and ML III kept the securities.

I strongly believe that the strategy that the Federal Reserve pursued in establishing ML III will generate a better outcome than any alternative. In particular, attempting to coerce concessions risked making the U.S. taxpayer significantly worse off.

Since ML III purchased the CDOs, they have generated significant cash flows that have been used to pay down the FRBNY's loan by more than 25 percent. The Federal Reserve and Treasury expect ML III to pay the FRBNY back in full and to generate substantial returns for U.S. taxpayers. The FRBNY is not only the senior creditor to ML III. It also has a right to two-thirds of any profits from the portfolio, once its loan has been repaid. Moreover, because ML III can hold the CDOs to maturity, it is largely immune from trading prices and liquidity needs, and is therefore in a better position to maximize the value of the portfolio.

However, the government's return on ML III should be considered in the context of the overall return on its support for AIG. On the one hand, the Federal Reserve will likely generate returns on its financial support of AIG, including the FRBNY Credit Facility, its loans to Maiden Lane II and Maiden Lane III, and its preferred interests in AIA Aurora LLC and ALICO Holdings LLC. On the other hand, it is unlikely that Treasury will fully recover the direct costs of its capital investments in AIG. . In June 2009, the Congressional Budget Office estimated that Treasury would lose \$35 billion of its \$70 billion total commitment to AIG, including undrawn funds in the equity facility.³ And the 2011 Budget reflected an expected loss of \$48 billion on that commitment.

Today, on the basis of a range of measures, Treasury believes that losses on its investments in AIG are likely to be lower. If market conditions continue to improve and AIG's businesses perform well, the actual recovery on Treasury's preferred stock could be significantly higher. The Congressional Budget Office recently estimated that losses on all Treasury investments in AIG would be \$9 billion.⁴

³ Congressional Budget Office, *The Troubled Asset Relief Program: Report on Transactions Through June 17, 2009*, Jun. 2009, 2, available at <http://www.cbo.gov/ftpdocs/100xx/doc10056/06-29-TARP.pdf>.

⁴ Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2010-2020*, Jan. 2010, at 13, available at <http://www.cbo.gov/ftpdocs/108xx/doc10871/01-26-Outlook.pdf>.

The President has put forward a concrete plan to recover every penny that Treasury committed to stabilize our financial system, including Treasury investments in AIG. The President's proposed Financial Crisis Responsibility Fee would be imposed on large financial institutions to recoup all losses from TARP investments.

- 1. With respect to Treasury's position that its authorization under EESA to extend \$700 billion for the acquisition of troubled assets operates in the nature of a revolving line of credit, how does that treatment of repayments as restoring the ability to make further payments out of TARP up to the overall statutory limit not render nugatory the provisions of EESA that the public debt be reduced through repayments?**

Section 106(d) of the Emergency Economic Stabilization Act of 2008 (EESA) requires that revenues and the proceeds from the sale of troubled assets purchased under that law must be paid into the general fund of the Treasury for reduction of the public debt. However, other applicable provisions under EESA govern the use of TARP funds. Section 115(a) authorizes Treasury to purchase troubled assets having aggregate purchases up to \$700 billion "outstanding at any one time," and section 106(e) authorizes Treasury to continue to purchase troubled assets under commitments entered into by Treasury prior to EESA's sunset date. Finally, section 118 makes new funding available for new purchases of troubled assets.

Taken together, these provisions operate as follows: When a purchased troubled asset is sold or when a TARP investment is repaid, the proceeds are deposited into the Treasury general fund for reduction of the public debt. Upon such a sale or repayment, the total amount of troubled assets that are held by the Treasury and count against the \$700 billion cap is reduced. This reduction in the total amount of assets "outstanding" frees up headroom under the cap. To be clear, the funds used to pay for any new purchases under the freed-up headroom under the cap are not the same as the funds received from the sale or repayment of troubled assets. Instead, new funding is made available under section 118 for any new purchases and is recorded as a new, current-year cost.

That the words "outstanding at any one time" mean that the statutory cap is a "revolving" cap on purchasing authority is without question. These words are always used by Congress to confer revolving budget authority (whether revolving borrowing authority, revolving lending authority or, as in this case, revolving purchase authority) as opposed to "once-used-gone" authority.

EESA provides the U.S. government with a powerful tool for stabilizing the financial system. The Congress wisely provided Treasury with the flexibility to apply EESA's purchasing power over the lifetime of the statute.

- 2. How are the equity and other securities that Treasury has acquired under the CPP and other programs "troubled assets" under EESA, particularly since Treasury and the various institutions participating in those programs over the course of the past approximately 14 months have averred that the institutions into which Treasury's capital injections have been made were "healthy"?**

EESA defines "troubled asset" to mean "(A) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability; and (B)

any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.” Each purchase of a troubled asset has been made in accordance with this language. Since the enactment of EESA, I have made such determinations, in consultation with the Chairman of the Board of Governors of the Federal Reserve System, which have been transmitted to the appropriate committees of Congress. In the case of the Capital Purchase Program, participation was reserved for viable institutions that were recommended by their federal banking regulator to receive a TARP investment. The Secretary of the Treasury under the prior Administration determined that injecting capital into viable institutions by purchasing preferred shares in those institutions was an effective way of increasing the capital base and strength of those institutions, thereby promoting financial market stability.

- 3. At our hearing on 10 December, you discussed Treasury’s plans to extend more TARP funds to smaller banks, ostensibly to increase their lending. If Treasury acquires equity or other securities from these banks, does that mean that these instruments are perforce “troubled assets” under EESA? Or, if Treasury acquires the underlying loans, are they perforce “troubled assets,” even if the loan is performing? By extension, does that mean that any such bank receiving such a capital injection is a troubled bank?**

Under the terms of the Small Business Lending Fund that the President announced earlier this month, capital investments would be made under new legislative authority, not through EESA. We are currently in the process of developing legislation with Congress that would define the exact parameters for purchases under that program, although – as Treasury has announced – our proposal would provide for capital investments in banks with less than \$10 billion in assets that receive approval from their primary federal regulator.

- 4. Do you believe that the acquisition of stock and warrants under the CPP has been more – or less – effective than the original intent of TARP, which was to purchase "residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008”?**

Capital injections and purchases of illiquid assets serve somewhat different functions. The purchase of illiquid assets is a targeted response to problems involving specific assets. Capital injections have the advantage of providing insurance against the full range of challenges facing financial institutions. As the financial crisis intensified following the failure of Lehman Brothers, the broadening panic moved beyond mortgage-backed, and related, securities. In addition, the deteriorating economic outlook posed new challenges for banks. In this context, capital injections through the CPP were a more effective means of containing the financial panic than purchases of illiquid mortgage-related assets.

5. Would you describe the current process in which Treasury determines which institutions should receive TARP assistance, how much, and under what terms? How was this determination made with respect to GMAC?

Each institution receiving Troubled Asset Relief Program (TARP) assistance followed a different determination process depending on the individual program within TARP through which the institution applied for funding.

Treasury's assistance to GMAC was provided under the Automotive Industry Financing Program (AIFP) consistent with the goals of that program. Treasury's determination to make additional investments in GMAC in 2009 was driven by the need to maintain automotive financing for dealers and consumers during the critical restructuring periods for GM and Chrysler and Treasury's commitment under the Supervisory Capital Assessment Program (SCAP).

Treasury's investments in GMAC have helped to provide a reliable source of financing to both auto dealers and customers seeking to buy cars following the severe contraction of credit in the auto finance markets starting in 2008. Alongside Treasury's efforts through the TALF program, a recapitalized GMAC has offered strong credit opportunities, helped stabilize our auto financing market, and contributed to the overall economic recovery.

As to the SCAP, U.S. federal banking supervisors believe it to be important for the largest U.S. bank holding companies (BHCs) to have a capital buffer sufficient to withstand losses and sustain lending even in a significantly more adverse economic environment than is currently anticipated. In keeping with this aim, the Federal Reserve and other federal bank supervisors engaged in the SCAP, or the stress tests, with each of the 19 largest U.S. BHCs, including GMAC. As part of the SCAP, Treasury committed to contribute capital to these institutions in the event that any of them could not meet their SCAP buffer requirement via third party sources.

In line with its commitment to support the SCAP institutions, Treasury made a \$7.5 billion investment in GMAC in the form of mandatorily convertible preferred stock (MCP) in May 2009. This investment was the result of two distinct capital needs: (i) \$3.5 billion of the investment was an initial contribution towards the \$9.1 billion SCAP buffer requirement, and (ii) \$4.0 billion of the investment was to support the origination of Chrysler dealer and retail loans which had been previously funded by Chrysler Financial.

Treasury did not fund the additional \$5.6 billion for the SCAP buffer requirement at that time. Waiting for certain events underlying the assumptions that formed the basis for the SCAP buffer to play out, resulted in a smaller Treasury funding requirement for the second installment. Due to a variety of factors, including that the establishment of the new General Motors and new Chrysler was accomplished with less disruption to GMAC than banking supervisors initially projected, the amount of funding to meet the SCAP was determined by the Federal Reserve to be \$3.8 billion (\$1.8 billion less than the \$5.6 billion previously announced).

On December 30, 2009, Treasury funded the second installment of an additional \$3.8 billion in GMAC. In structuring the investment, Treasury ensured that its capital

contribution was in a form the Federal Reserve deemed satisfactory to establish the SCAP buffer and was made on terms most beneficial to the U.S. taxpayer. As such, \$2.54 billion of the investment was made in the form of trust preferred stock, which are senior to all other capital securities of GMAC.

6. Does a potential failure of GMAC itself pose a systemic risk to our financial system?

The investment in GMAC was consistent with the purposes of EESA, which is to restore liquidity and stability to the US financial system. The Secretary of the Treasury was given broad discretion under EESA to establish programs to purchase “troubled assets.” One such program was the Automotive Industry Financing Program (AIFP), which was established by my predecessor, in the Bush Administration, to prevent a significant disruption of the American automotive industry. It was determined that such a disruption would pose a systemic risk to financial market stability and have a negative effect on the economy.

Treasury's investments in GMAC were made pursuant to the AIFP and a “troubled asset” determination made by Secretary Paulson in December 2008. These investments have helped to provide a reliable source of financing to both auto dealers and customers seeking to buy cars. A recapitalized GMAC has enabled GMAC to restore liquidity to its finance business and helped to restore stability to the US domestic automobile industry. This has in turn contributed to the overall economic recovery and to financial stability.

As noted above, the current investment in GMAC also represents the completion of funding provided to GMAC as part of the SCAP process. Ensuring SCAP compliance enables GMAC to maintain adequate capital under stressed conditions and continue to fulfill its role as a leading provider of financing within the US automotive industry. Completing the SCAP exercise should help assuage investor concerns and assist GMAC in its private capital raising efforts. Capital market access will provide GMAC with necessary liquidity and should allow Treasury ultimately to exit its investment in a manner that protects taxpayers.

7. Has Treasury performed a legal analysis of its authority under EESA with respect to foreclosure mitigation, including section 109 of EESA? Has Treasury performed such a legal basis for HAMP, HARP, etc.? Please provide any such legal memoranda or opinions to the Panel.

Treasury has separately provided Mr. Paul Atkins with a response to the request for a legal analysis of Treasury's authority under EESA with respect to foreclosure mitigation, including section 109 of EESA, and Treasury's legal basis for its Home Affordable Modification Program (HAMP). Delivery of that response did not waive the attorney-client privilege and is subject to the Panel's confidentiality protocol entered into on May 21, 2009 and updated on December 11, 2009.

The Home Affordable Refinancing Program (HARP) is a refinancing program developed by Fannie Mae and Freddie Mac (Government-sponsored enterprises, or GSEs) under the supervision of the federal regulator of the GSEs (the Federal Housing Finance Agency), and is available for eligible GSE-owned or GSE-guaranteed mortgages. Treasury does not administer the HARP, and the HARP is not based on Treasury legal authorities.

8. **According to Treasury's guidelines with respect to the Home Affordable Modification Program (HAMP), "new borrowers will be accepted until December 31, 2012" and "program payments will be made for up to five years after the date of entry into a Home Affordable Modification." How does Treasury intend to make HAMP payments using TARP funds beyond EESA's expiration date of October 3, 2010? Please cite the specific legal authority that allows Treasury to do this.**

EESA section 106(e) specifically authorizes Treasury to continue to fund the purchase of assets after the EESA purchase-authority sunset date (now October 3, 2010) under purchase commitments entered into before that purchase-authority sunset date. All HAMP payments made to servicers after October 3, 2010, will be funded under purchase commitments with servicers that will have been entered into before October 3, 2010.

9. **Has Treasury performed an analysis or developed a metric to determine how effective TARP has been in encouraging various categories of lending, including interbank, commercial, residential mortgage, consumer revolving credit, etc.? Can banks and similar institutions in the current economic environment increase their lending, while simultaneously increasing their capital and writing off non-performing assets?**

The U.S. banking system entered this crisis with insufficient capital. As credit losses mounted, first because of the deterioration in the U.S. housing market and subsequently because of the sharp contraction in the economy, banks have had to adjust. That adjustment has come through raising additional capital, reductions in total assets held by banks, and changes in the composition of those assets. The fact that bank lending continues to contract is an indication that the adjustment in the U.S. banking sector is ongoing.

But the recession has also reduced the demand for credit as both consumers and businesses have pulled back. In addition it has undermined the creditworthiness of many borrowers. The reduction in lending by banks reflects all three of the factors: the need for banks to adjust their balance sheets; reduced demand for credit; and the decline in the creditworthiness of many borrowers.

The primary objective of TARP was to first contain the financial panic that followed the failure of Lehman Brothers and then to ensure the stability of the financial system by encouraging private capital raising by major financial firms. TARP has made an important contribution to achieving those objectives. Without TARP the contraction in lending would no doubt have been much more severe. But developing a specific estimate of TARP's impact on lending is problematic because it requires making a judgment about what would have happened had TARP not been put in place.

- 1. Foreclosure Prevention:** As we discussed at our December hearing, January 1st is expected to be a critical day for the roughly 375,000 homeowners whose trial modification period expires. Most of these homeowners have made at least 3 months of timely payments as required by the HAMP program. However, less than half of these homeowners have submitted all required documentation, and by some estimates half of these borrowers that have submitted their documentation have yet to have their documentation validated by the servicer. Thus, it looks as if possibly over 75% of homeowners who have demonstrated a willingness and ability to make timely payments on their trial modifications may be eliminated from the program and once again facing foreclosure.

- (a) Do you see the documentation problem as one of homeowners failing to get their materials in, servicers failing to validate, or perhaps a problem inherent in the documentation requirement itself?**

Converting trial modifications to permanent modifications is the shared responsibility of borrowers and servicers. Treasury has taken a number of steps to simplify the process for both borrowers and servicers. On October 8, Treasury published streamlined and simplified documentation requirements for HAMP. In November, Treasury launched a conversion campaign, including posting the HAMP application documents and a number of new tools for borrowers on our consumer website, www.makinghomeaffordable.gov. As part of the conversion campaign, Treasury and Fannie Mae (as our agent) are requiring servicers to report conversion progress on a daily basis.

As of the end of January, over 1 million Americans had begun trial modifications, saving an average of \$500 per month. However, only about 31,000 of those trials had become permanent modifications. Although both borrowers and servicers share responsibility for increasing the number of permanent modifications, it is clear that servicers need to do a better job of increasing capacity, reaching out to borrowers and processing documents quickly. The current number of permanent modifications suggests a lack of mobilization by major servicers to convert borrowers to permanent modifications.

For this reason, on December 23, Treasury released Supplemental Directive 09-10 (SD 09-10), enclosed here and posted at www.hmpadmin.com. Per SD-10, effective on December 23 and lasting through January 31, 2010, Treasury implemented a temporary review period for all active HAMP trial modifications scheduled to expire on or before January 31, 2010, with the exception of modifications failing property eligibility requirements, such as those that are investor owned.

During this review period, servicers were required to confirm the status of borrowers in active HAMP trial modifications scheduled to expire on or before January 31, 2010 as either current or not current. Servicers also must

have confirmed which, if any, documents are due from borrowers. Servicers must send written notification to borrowers to inform them that they are at risk of losing eligibility for a permanent HAMP modification because the borrower has (i) failed to make all required trial period payments, (ii) failed to submit all required documentation, or (iii) failed both to make all required trial period payments and to submit all required documentation. The notice must have provided the borrower with the opportunity to correct any error in the servicer's records or submit any missing documents or payments within 30 days of the notice or through January 31, 2010, whichever was later. If a borrower provided evidence of the servicer's error or corrects the deficiency within the timeframe provided, the servicer must have considered the new information and determine if the borrower is eligible to continue in the HAMP modification process.

On January 28, 2010, Treasury took an additional step to streamline the documentation process, releasing Supplemental Directive 10-01 which introduces a requirement for full verification of borrower eligibility prior to offering a trial period plan. Effective for all HAMP trial period plans with effective dates on or after June 1, 2010, a servicer may only offer a borrower a trial period plan based on verified income documentation in accordance with program guidelines. This Supplemental Directive also provides guidance to assist servicers in making HAMP eligibility determinations for borrowers currently in active trial period plans, including those borrowers subject to the temporary review period required by Supplemental Directive 09-10.

(b) What documentation flexibility, if any, could perhaps be provided that would not impact program integrity but would help people meet their documentation requirements and stay in their homes? For example, could alternative documents such as bank statements be accepted in lieu of a profit and loss statement? What particular documents does your office find to be consistently missing or deemed inadequate?

Treasury has taken a number of steps to simplify documentation requirements. On October 8, Treasury published streamlined documentation requirements for borrowers, simplifying the documentation required for borrowers to get permanent modifications. As outlined above, on December 23, Treasury published new guidance for servicers requiring trial modifications to be placed in a temporary review period while servicers review document receipt and processing to ensure that all borrowers are being treated fairly and in accordance with program guidelines.

Treasury has also launched a conversion campaign, requiring servicers to provide detailed data describing the status of all borrowers in trial modifications and cataloguing which documents are missing. As part of the conversion campaign, Treasury and Fannie Mae have sent staff to servicer locations to better understand alternative documentation processes that could facilitate conversions while maintaining program standards. These specific documentation issues are being discussed and resolved by Treasury and Fannie Mae on a daily basis, with new FAQs posted on the administrative

website, www.hmpadmin.com, to explain program flexibilities on a regular basis. We will continue to examine ways to further streamline documentation and to make program adjustments to improve execution.

The program guidelines released on January 28, 2010 also included a number of additional steps to streamline specific documentation requirements, so as to increase the number of permanent modifications.

- (c) Do you expect that upcoming program improvements such as document standardization and the implementation of a web portal for online document tracking will alleviate the problem? Can any of these program improvements be implemented before the current March start date, so they can help people now at risk of losing their trial modifications?**

Streamlined documentation requirements announced on October 8 have had a significant positive impact in simplifying the HAMP modification process for servicers and borrowers. The streamlined documentation requirements were effective as of October 8, 2009. The temporary review period will also help require servicers to re-evaluate the status of trial modifications and document handling procedures. In addition, the temporary review period will require servicers to let borrowers know where they stand – by providing a letter outlining any missing documents, and an opportunity to correct errors or complete the application. The temporary review period process was effective as of December 23. The new additional streamlined processes for conversions of modifications announced on January 28, 2010 also became effective upon announcement – and we are seeing the impact of these changes in improved pull-through rates. As of the end of January there were over 116,000 permanent modifications and over 67,000 permanent modifications pending final approval. This group of approximately 180,000 permanent and pending permanent modifications represents about a third of the population of trial modifications who have completed the trial modification and are at a point in the process where they are able to convert to permanent. We recognize that there is much additional work to be done in converting borrowers to permanent modifications but view the changes outlined above as significant progress.

We expect that the web portal will further enhance the ability of borrowers to submit documents and servicers to receive and process HAMP applications. We are working to implement the web portal as quickly as possible.

- (d) What is the process for notifying borrowers if their trial modification fails to convert to a permanent modification? Will the reasons be provided, and what process is in place for borrowers to appeal?**

As described in Supplemental Directive 09-08 (SD-09-08), enclosed here and posted at www.hmpadmin.com, every borrower that is not approved for a trial modification must be sent a written explanation for the denial, indicating one of the specific denial reasons outlined in SD 09-08. In the letter required by SD 09-08, the borrower must also be provided with information about other

foreclosure alternatives, contact information for the servicer, contact information for the HOPE Now hotline, and instructions on how to contact MHA Help.

In addition, on December 23, Treasury released Supplemental Directive 09-10 as outlined above, requiring most trial modifications to be placed into a temporary review period. During this review period, servicers must have provided borrowers with a notice indicating application deficiencies. The notice must have provided the borrower with the opportunity to correct any error in the servicer's records or submit any missing documents or payments within 30 days of the notice or through January 31, 2010, whichever was later. If a borrower provides evidence of the servicer's error or corrects the deficiency within the timeframe provided, the servicer must consider the new information and determine if the borrower is eligible to continue in the HAMP modification process.

- 2. Small Business Lending: What additional clarity can you provide regarding Treasury's capital assistance program for small banks announced in October? As you stated, banks may be reluctant to participate due to potential stigma. What steps are you taking to address these concerns and to implement the program? What is the date for release of additional program details? Assistant Secretary Allison responded to questioning at our October hearing that he expected between \$10 and \$50 billion allocated to the program; is this still the estimated amount?**

On Tuesday February 2, the President announced details of his new proposal to create a Small Business Lending Fund. Under this proposal, \$30 billion in TARP funds would be transferred, through legislation, to a new program outside of TARP to support small business lending. The program would be separate and distinct from TARP. Participation would be limited to community and other smaller banks with less than \$10 billion in assets. A core function of the new fund would be to offer banks capital with built-in incentives to increase small business lending—as banks increase lending, the dividend rate on the new capital they had received would fall. The administration will work closely with the Congress to design this program and discuss other ways that the Small Business Lending Fund could be fully deployed.

As referenced, concerns about TARP stigma have been a significant concern throughout the policy process. These concerns in large part motivated the decision to call for TARP funds to be formally transferred through legislation to a new, separate entity. We believe that creating a distinct fund will encourage broader participation.

- 3. Limitations on Banks' Risky Activity: Large financial institutions are a large part of our free market system, but they are also supported by a federal safety net. Their deposits are insured by the FDIC, they have access to funding through the Federal Reserve, and of course have recently received significant taxpayer assistance through TARP. Are there certain activities that bank holding companies currently engage in that might be too risky given their access to government and taxpayer support?**

Under the legislation proposed by the Administration and passed by the House in December, the largest financial firms operating in the U.S. would be subject to higher capital, liquidity, and supervisory standards. For instance, the largest, most interconnected institutions will be subject to additional concentration limits and regulators may establish short-term debt limits as well. These new limits will help ensure that our largest, most interconnected financial firms have sufficient capital, liquidity, and other buffers to bear the risks they take. The Administration recognizes that the engagement by one or more of the largest, most interconnected firms in high volumes of certain high-risk activities could increase risk to the financial system. Accordingly, the Administration supports provisions in the House bill that give regulators the authority to force institutions to limit or terminate any activity that could threaten financial stability.

While many of the largest, most interconnected firms are currently organized as bank holding companies (BHCs), these are not the only firms that will be subject to activity limitations and higher prudential standards. The Administration's proposed legislation would also require any firm that owns an insured depository institution to become a bank holding company and, therefore, to be subject to the activity limits and higher safety and soundness standards of the Bank Holding Company Act. In addition, the Administration's proposal would identify other firms that are so large and interconnected that their failure could threaten financial stability and bring those firms under BHC Act activity limits and tough, consolidated supervision at the holding company – subject to the higher capital, liquidity, and supervisory standards mentioned above.