



# SIGTARP

OFFICE OF THE SPECIAL INSPECTOR GENERAL  
FOR THE TROUBLED ASSET RELIEF PROGRAM

ADVANCING ECONOMIC STABILITY THROUGH TRANSPARENCY, COORDINATED OVERSIGHT AND ROBUST ENFORCEMENT

# **EMERGENCY CAPITAL INJECTIONS PROVIDED TO SUPPORT THE VIABILITY OF BANK OF AMERICA, OTHER MAJOR BANKS, AND THE U.S. FINANCIAL SYSTEM**

**SIGTARP-10-001  
OCTOBER 5, 2009**



# SIGTARP

Office of the Special Inspector General  
for the Troubled Asset Relief Program

## Summary of Report: SIGTARP-10-001

### Why SIGTARP Did This Study

From about July 2007 through August 2008, financial markets were hit with news of large losses at major institutions resulting from, among other things, issues related to subprime loans. However, September 2008 became a month of historic turmoil in the financial markets, creating fear of a collapse of these markets. The Troubled Asset Relief Program (“TARP”) was created by the Emergency Economic Stabilization Act (“EESA”) on October 3, 2008. EESA provided the Secretary of the Treasury with authorities to restore the liquidity and stability of the financial system. On October 13, 2008, Treasury made its first use of this authority by providing capital injections into nine financial institutions, including Bank of America Corporation (“Bank of America”), under the TARP’s Capital Purchase Program (“CPP”). Merrill Lynch & Co., Inc. (“Merrill Lynch”), which was facing severe financial problems and was in the process of being acquired by Bank of America, was included in the initial nine banks. Following the completion of the acquisition of Merrill Lynch in January 2009, Bank of America received additional assistance under TARP’s Targeted Investment Program (“TIP”) and announced loss protections under the Asset Guarantee Program (“AGP”).

Numerous questions have arisen over the initial CPP investment, Bank of America’s effort to terminate the merger in December 2008, efforts by federal officials to dissuade Bank of America from terminating, and the subsequent investment under TIP and loss protection under AGP.

This report examines the basis for the selection of Bank of America and eight other financial institutions for TARP funds. Specifically, this report addresses (1) the significant economic events in September 2008 that led Treasury to inject capital into the financial system; (2) the rationale and criteria used to select these institutions compared to those used to select subsequent institutions for CPP participation; and (3) the basis for the decision by Treasury and federal regulators to provide Bank of America with additional assistance following the acquisition of Merrill Lynch, and federal efforts to forestall Bank of America from terminating the planned acquisition.

### What SIGTARP Recommends

This report makes no recommendation, but it does identify an important lesson learned. As discussed in the report, federal officials should take more care in publicly characterizing the nature and objectives of their initiatives, since accuracy and transparency will enhance the credibility of Government programs like TARP.

October 5, 2009

## Emergency Capital Injections Provided To Support the Viability of Bank of America, Other Major Banks, and the U.S. Financial System

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### What SIGTARP Found

In September 2008, a rapid-fire set of destabilizing financial events occurred, including the federal bailout of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, the failure of Lehman Brothers, and the bailout of American International Group, among others. These events and other failures caused runs on some financial institutions and the freezing of interbank short-term lending that is critical to the liquidity of financial institutions. Because federal regulators concluded that numerous attempts over the previous year to minimize damages to the financial system had proved insufficient, the Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System determined that, without extraordinary measures, there was a significant risk of financial market collapse. Believing that time was of the essence, federal officials decided that a dramatic infusion of capital into major banks would demonstrate U.S. support for financial markets, hoping that this would help unfreeze the credit markets.

After deciding that some TARP funds would be used to inject capital directly into the financial system, the government selected nine financial institutions to receive the initial \$125 billion on an emergency basis as a dramatic show of U.S. government support to the financial system. The first nine institutions were selected because they represented a cross-section of the U.S. financial activities, but their systemic importance to the financial system and economy was a more significant consideration. Although announced as a program for healthy banks, senior Treasury and Federal Reserve officials had serious concerns about the health of some of the first nine institutions selected. Among these nine were Bank of America and Merrill Lynch, which together, received \$25 billion in CPP funding. By providing CPP funds to the nine institutions, Treasury, the Federal Reserve, and federal regulators sought to promote investor confidence. Financial institutions that later wanted to participate in the CPP, a program for “healthy” banks, were required to submit applications for CPP funding through their primary federal regulators. These applications were subjected to a more formal review process before funding approval by Treasury.

Citing substantial losses incurred by Merrill Lynch in the fourth quarter, Bank of America’s Chief Executive Officer, Kenneth Lewis, informed Treasury and Federal Reserve officials that he was considering terminating the planned acquisition of Merrill Lynch. Federal officials believed that this action was ill advised, would likely be unsuccessful, and could potentially destabilize Merrill Lynch, Bank of America, and the broader financial markets. Bank of America subsequently agreed with this view and completed the acquisition; Treasury then provided Bank of America with an additional \$20 billion TARP investment and announced asset guarantees related to \$118 billion of troubled assets.

Questions have emerged about the potential acquisition termination and whether federal officials had put pressure on Bank of America to complete the transaction without disclosing Merrill Lynch losses. This report addresses these issues from the perspective of the principals involved and ultimately concludes that federal officials acted based on their concerns for the financial markets as a whole and provided additional government assistance to ensure that Bank of America remained a viable financial institution after the acquisition.

Special Inspector General for the Troubled Asset Relief Program



## OFFICE OF THE SPECIAL INSPECTOR GENERAL

FOR THE TROUBLED ASSET RELIEF PROGRAM

1801 L STREET, NW

WASHINGTON, D.C. 20220

October 5, 2009

MEMORANDUM FOR: Timothy F. Geithner, Secretary of the Treasury  
John C. Dugan, Comptroller of the Currency  
John E. Bowman, Acting Director of the Office of Thrift  
Supervision  
Sheila C. Bair, Chairman of the Federal Deposit Insurance  
Corporation  
Ben S. Bernanke, Chairman of the Board of Governors of the  
Federal Reserve System

SUBJECT: Emergency Capital Injections Provided To Support the Viability of  
Bank of America, Other Major Banks, and the U.S. Financial  
System (SIGTARP-10-001)

We are providing this audit report for your information and use. It discusses the events that led to the EESA enactment and the rationale and criteria in which Treasury, the Federal Reserve, and other federal regulators selected Bank of America Corporation and eight other institutions to be the first CPP participants. It also examines the basis for the decision by Treasury and federal regulators to provide Bank of America with additional government assistance following the acquisition of Merrill Lynch & Co., Inc., and federal efforts to forestall Bank of America from terminating the planned acquisition. The Office of the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP") conducted this audit as Project 003, under the authority of Public Law 110-343, as amended, which also incorporates the duties and responsibilities of inspectors general of the Inspector General Act of 1978, as amended.

We considered written comments from Treasury's Office of Financial Stability and the Federal Reserve Board of Governors; the comments are addressed in the management and audit response section of the report. Their full responses are included in Appendices H and I.

We appreciate the courtesies extended to the SIGTARP staff. For additional information on this report, please contact Mr. Barry W. Holman at (202-622-4633/[barry.holman@do.treas.gov](mailto:barry.holman@do.treas.gov)).

Neil M. Barofsky  
Special Inspector General  
for the Troubled Asset Relief Program

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# Emergency Capital Injections Provided To Support Bank of America, Other Major Banks, and the U.S. Financial System

SIGTARP REPORT 10-001

October 5, 2009

## Introduction

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From about July 2007 through August 2008, financial markets were hit with news of large losses at major financial institutions resulting from subprime lending and the derivatives markets.<sup>1</sup> The situation worsened in September 2008 when multiple failures and deepening concerns about other institutions resulted in historic turmoil in financial markets. The Emergency Economic Stabilization Act of 2008 (“EESA”) provided the Secretary of the Treasury with the authority and facilities necessary to restore the liquidity and stability of the U.S. financial system. EESA authorized up to \$700 billion to stabilize the financial system under the Troubled Asset Relief Program (“TARP”).

- One of the first uses of TARP funds was providing capital to nine major financial institutions as part of the **Capital Purchase Program** (“CPP”), a program designed to infuse capital into “healthy” banks. The development of the program was based on the belief that the federal government needed to make a significant show of support to the troubled financial markets.
- These nine institutions, which held more than \$11 trillion in banking assets (approximately 75 percent of all assets held by U.S.-owned banks as of June 30, 2008), received \$125 billion, or about 61 percent of the total CPP funds that Treasury has provided to participating banks. Through September 11, 2009, over 670 banks have received a total of \$204.55 billion under the CPP.
- One of the first nine institutions to receive CPP funds was Bank of America Corporation (“Bank of America”), which prior to the CPP infusion, had agreed to purchase Merrill Lynch & Co., Inc. (“Merrill Lynch”), a company in serious financial difficulty.
- Three months later, after the banking industry experienced one of the most financially devastating earnings quarters in recent history, including dramatic losses to Merrill Lynch, which was being acquired by Bank of America. This precipitated an additional \$20 billion in assistance to Bank of America as part of the **Targeted Investment Program** (“TIP”). This program allows Treasury to make targeted additional investments in financial institutions beyond what was provided under the CPP if a loss of confidence would threaten other similar institutions, the broader financial markets, or the economy as a whole.

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<sup>1</sup> A derivative is a financial instrument whose value is based on (“derived from”) a different underlying asset, indicator, or financial instrument.

- At the same time that TIP funds were provided, Treasury, the Federal Deposit Insurance Corporation (“FDIC”), and the Federal Reserve had also agreed to share losses with Bank of America on a designated pool of assets valued at approximately \$118 billion through the **Asset Guarantee Program** (“AGP”). This program provides guarantees for assets held by systemically significant financial institutions that face a high risk of losing market confidence due in large part to a portfolio of distressed or illiquid assets.<sup>2</sup> (As discussed later in the report, Bank of America has withdrawn its request for AGP assistance.)

Together, this assistance to Bank of America totaled \$45 billion,<sup>3</sup> making Bank of America one of the largest recipients of TARP funds.

## Background

In recent years, the dramatic downturn in the U.S. housing market led to an abrupt decline in the price of financial assets associated with housing. The value of mortgage-backed securities, particularly those based on subprime loans,<sup>4</sup> declined precipitously as the financial crisis unfolded and the housing boom ended. As loan delinquencies increased and housing prices decreased, mortgage-backed securities (bundles of individual mortgages) began losing value, and the associated losses at financial institutions resulted in serious financial difficulties. Some financial institutions—ranging from government-sponsored enterprises, such as the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”), to the largest of the Wall Street firms—were left holding “toxic” mortgages and/or securities that were increasingly difficult to value, illiquid, and potentially had little worth. Some institutions found themselves so exposed that they were threatened with failure, and some failed, because they were unable to raise needed capital as the value of their portfolios declined.

The declining value of mortgage-backed securities undermined the confidence of investors; many sought to cut ties with struggling financial institutions holding these securities. As 2008 progressed, this led to an escalating crisis in the financial markets. By late summer 2008, the ramifications of the financial crisis included the failure of several significant financial institutions, increased losses of individual savings, diminished corporate investments, and further tightening of credit. All of this combined to exacerbate the emerging global economic slowdown.

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<sup>2</sup> Illiquid assets cannot be quickly converted to cash.

<sup>3</sup> This figure excludes the \$7.5 billion loan guarantee that would have been available from Treasury, if required, under the AGP.

<sup>4</sup> Subprime loans are designed for borrowers who do not qualify for prime mortgages, such as borrowers who have one or more of the following characteristics: weakened credit histories typically characterized by payment delinquencies, previous charge-offs, judgments, or bankruptcies; low credit scores; high debt-burden ratios; or high loan-to-value ratios. These loans were often not supported by full documentation and carried less favorable terms to the borrower, such as higher interest rates. Many of these loans were bundled into securities that were sold to investors, including banks, hedge funds, insurance companies, and retirement fund systems.

## Financial Failures from July 2007 to July 2008

One of the first major failures of a financial institution caused by the rapid deterioration in the performance of subprime mortgages was the large investment bank<sup>5</sup> Bear Stearns Companies (“Bear Stearns”). On July 31, 2007, Bear Stearns placed into bankruptcy two funds<sup>6</sup> that had heavily invested in mortgage-backed securities. The securities in these two funds were estimated to have lost 28 percent of their value since the beginning of that year.

Although the funds held only about \$600 million in investor capital around that time, their liquidation caused alarm for at least two reasons. First, the mortgage-backed securities had been originally rated as safe and low-risk by the rating agencies, and their substantial loss in value over a very short period raised doubts about the ratings of all similar securities. The liquidation suggested that other holders of similar subprime mortgage-backed securities might also experience similar losses. Thus, investors became less willing to invest with any fund or financial institution that held subprime mortgage-backed securities. Second, Bear Stearns funds had borrowed heavily to invest in these funds; this meant that losses in the funds posed problems for their investors, creditors, and counterparties.<sup>7</sup> Moreover, because these funds do not disclose their sources of funding, there was uncertainty about which institutions were exposed to credit risk from funds tied to subprime mortgages in the market. On August 9, 2007, soon after Bear Stearns liquidated its two funds, BNP Paribas (France’s largest bank) halted redemptions<sup>8</sup> on three of its funds that held mortgage-backed securities.

From mid-2007 to early 2008, the increased financial strains led to a liquidity crisis<sup>9</sup> at Bear Stearns: in the fourth quarter of 2007, Bear Stearns reported the first quarterly loss in its history. By March 2008, other large financial institutions had stopped doing business with Bear Stearns, and it became evident that absent some form of assistance, Bear Stearns would fail. In a deal brokered by the Federal Reserve Bank of New York (“FRBNY”), JPMorgan Chase & Co. (“JPMorgan Chase”) purchased Bear Stearns on March 16, 2008, for a fraction of what the bank was worth a year earlier.

The liquidity crisis had also affected other financial institutions. Countrywide Mortgage (the nation’s largest mortgage lender at the end of 2006) had also experienced liquidity problems caused by the decline of the secondary market for mortgage-backed securities. The company was later acquired by Bank of America. Following the acquisition of Countrywide Mortgage, IndyMac Bank (the nation’s ninth-largest mortgage servicer at the time) failed as a result of tighter credit, decreasing home prices, and rising foreclosures. The bank had relied heavily on

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<sup>5</sup> An investment bank performs a variety of services, including underwriting (purchasing and distributing securities), acting as the intermediary between an issuer of securities and the investing public, facilitating mergers and other corporate reorganizations, and acting as brokers for institutional clients.

<sup>6</sup> These funds were subsequently liquidated. On July 18, 2007, Bear Stearns had circulated a letter to shareholders of these funds, which was promptly obtained and widely distributed by the press, indicating that the value of their shares in these funds had been essentially wiped out. Thus, the bankruptcy filing was widely expected.

<sup>7</sup> A counterparty is the other party that participates in a financial transaction. Every transaction must have a counterparty for the transaction to go through. More specifically, every buyer of an asset must be paired with a seller who is willing to sell and vice versa.

<sup>8</sup> A redemption is the act of an investor reclaiming his or her money.

<sup>9</sup> A liquidity crisis occurs when an institution lacks the cash required to pay for day-to-day operations, or meet its debt obligations when they are due, causing it to default.

risky loans made to home buyers with little or no evidence of income or assets. While home prices climbed, these loans posed few problems for IndyMac. However, when the housing bubble burst and prices began to fall, losses at IndyMac began to rise. When the FDIC seized the company on July 11, 2008, IndyMac had experienced a run on its deposits. IndyMac's failure was the fourth-largest bank failure in U.S. history and the largest since 1988.

## **Initial Steps Taken To Address the Financial Crisis Proved Insufficient**

As the financial market strains continued, the Federal Reserve, Treasury, and other government entities took significant steps to address the liquidity crisis and other underlying causes of the financial crisis. However, these actions proved insufficient to stem the economic deterioration. Some key measures taken prior to the EESA legislation are discussed below. For a more comprehensive list of measures taken by Treasury and federal regulators, see Appendix B.

In the period leading up to EESA, the Federal Reserve implemented several measures to increase the liquidity in the financial system, including:

1. **Lowering the target level of the federal funds rate**—the interest rate at which banks lend their balances held at the Federal Reserve, usually overnight, to other depository institutions—seven times from August 2007 to April 2008, including two cuts of 1.25 percentage points in January 2008. The federal funds target rate decreased from 5.25 percent in August 2007 to 2.0 percent in April 2008. More recently, as of July 31, 2009, the target rate was 0 to .25 percent.
2. **Lowering the primary credit rate**—the rate at which eligible institutions can borrow money from the Federal Reserve, usually on a short-term basis—from 6.25 percent in August 2007 to 2.25 percent in April 2008. It was at .50 percent as of August 20, 2009. In addition, the Federal Reserve increased the maximum maturity of such loans.
3. **Introducing the Term Auction Facility** on December 12, 2007, as a means of offering short-term liquidity to depository institutions. The Term Auction Facility permitted depository institutions to anonymously bid to receive funds secured by a wide variety of collateral for a term of 28 days. The maximum term of such funding was later extended to 84 days.
4. **Announcing the Term Securities Lending Facility** on March 11, 2008, under which the Federal Reserve lends Treasury securities to primary dealers<sup>10</sup> secured by a range of collateral, initially for a term of 28 days. The maximum term was later extended to 84 days.
5. **Facilitating the orderly acquisition of Bear Stearns** by providing financing to JPMorgan Chase to help buy the investment bank and limit the downside risks of a portfolio of Bear Stearns assets.

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<sup>10</sup> Primary dealers are a group of securities broker-dealers that trade in U.S. Government securities with the Federal Reserve Bank of New York for the purpose of carrying out open market operations. As of July 27, 2009, there were 18 primary dealers.



Along with Treasury and the Federal Reserve, other government agencies adopted measures designed to stabilize the financial markets prior to the enactment of EESA.<sup>11</sup> In October 2007, for example, Treasury and the Department of Housing and Urban Development announced the HOPE NOW initiative to stem the rising number of home foreclosures. HOPE NOW is an alliance between counselors, mortgage companies, investors, and other mortgage-market participants that works with at-risk homeowners to help prevent foreclosures.<sup>12</sup> In July 2008, the Securities and Exchange Commission (“SEC”) issued an emergency order limiting the short selling of the securities of Fannie Mae, Freddie Mac, and primary dealers at commercial and investment banks. The SEC temporarily extended for one month the ban to include the short sale of all stocks in the financial sector in September 2008.

In response to the continuing and growing economic crisis, the U.S. and other governments sought to implement even more aggressive plans to address the stresses on their financial institutions and the turmoil in the global financial markets. The governments of the United Kingdom, Germany, France, Canada, Ireland, and Sweden either provided liquidity and capital injections to their institutions or prohibited the short selling of financial stocks of several institutions.

On September 20, 2008, then-Secretary of the Treasury Henry Paulson submitted to Congress a three-page proposal, “Legislative Proposal for Treasury Authority To Purchase Mortgage-Related Assets.” The proposal would have authorized Treasury to purchase, manage, and sell certain mortgage-related assets. Although this initial proposal was not accepted by Congress, it prompted legislative action that resulted in EESA, which was enacted on October 3, 2008. However, as discussed further in this report, continued economic deterioration shortly after EESA was enacted led to a change in strategy over the use of TARP funds.

## Objectives

Overall, this report completed by SIGTARP’s Audit Division, examines the basis for selecting Bank of America and the other eight financial institutions to receive TARP capital investments. Specifically, it addresses:

- the significant economic events in September 2008 that led Treasury to inject capital into the financial system,
- the rationale and criteria used to select Bank of America and the other eight financial institutions to receive CPP funds as compared to those used to select subsequent banks for CPP participation, and
- the basis for the decision by Treasury and federal regulators to provide Bank of America with additional financial assistance following the acquisition of Merrill Lynch, and federal efforts to forestall Bank of America from terminating the planned Merrill Lynch acquisition.

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<sup>11</sup> Approximately 50 initiatives or programs have been created by various federal agencies since 2007.

<sup>12</sup> By November 2008, the alliance claimed that the mortgage industry had prevented nearly 2.7 million foreclosures since July 2007.

For a discussion of the audit scope and methodology, see Appendix A. For a list of key measures taken by the government to stabilize the financial markets before the EESA legislation, see Appendix B. For data on assets of the top U.S. financial institutions, see Appendix C. For a summary of the net gains and losses of major financial institutions from 2007 to 2009, see Appendix D. For a list of key events related to the merger of Bank of America and Merrill Lynch, see Appendix E. For definitions of the acronyms used in this report, see Appendix F. For a list of team members who contributed to the audit, see Appendix G. For copies of management comments, see Appendices H and I.

Numerous issues have arisen in the aftermath of the merger of Bank of America and Merrill Lynch. Some of these issues are the focus of ongoing investigations, including by SIGTARP's Investigations Division, and are, therefore, not discussed in this report.

# Rapidly Deteriorating Economic Conditions Led to the Capital Purchase Program

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This section addresses the significant destabilizing events that occurred in September 2008 that led federal officials to realize that their attempts to minimize damages to the financial system had not worked and that the system needed extraordinary government support. For example, in the first week of September, the mortgage firms Fannie Mae and Freddie Mac were put into conservatorship; by the second week of September, three major Wall Street financial institutions were bankrupt or near bankruptcy. These events and other September failures caused the freezing of interbank short-term lending that is critical to the liquidity of financial institutions. Believing that time was of the essence, the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System (“Federal Reserve”), and other federal officials decided that a dramatic infusion of capital into major banks, rather than the purchase of illiquid mortgage-related assets, would best demonstrate the U.S. government’s support for the financial markets and restore confidence to the system. They hoped this would free credit and improve the condition of national and international financial systems.

## Major U.S. Financial Strains in September 2008

In September 2008, a succession of major U.S. financial institutions either failed or experienced intense pressure that would require federal assistance to save them from collapse. These events are depicted in Figure 1 and include:

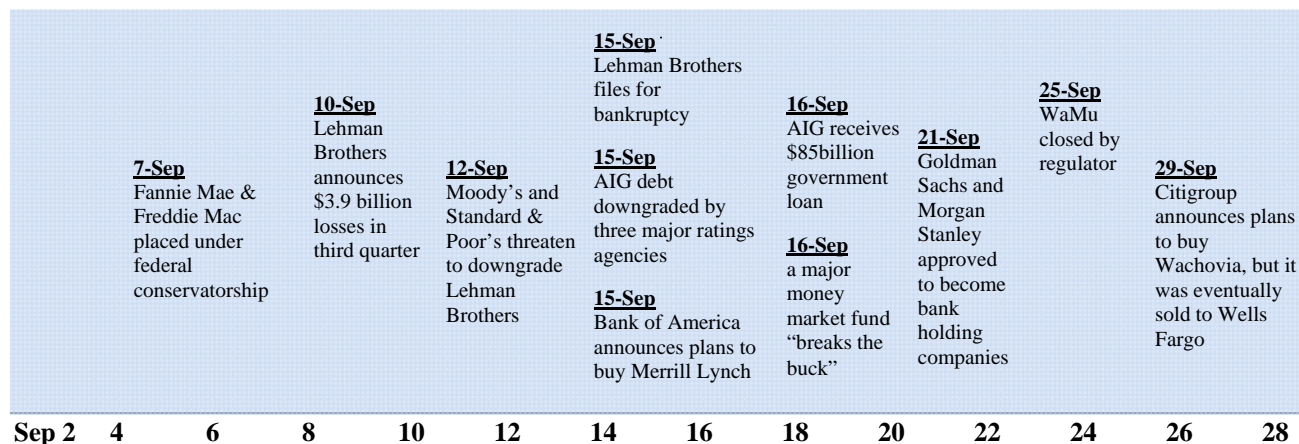
- The Federal Housing Finance Agency, which was created two months earlier, placed under conservatorship Fannie Mae and Freddie Mac, the two government-sponsored enterprises that are primary participants in the secondary mortgage market.<sup>13</sup>
- Lehman Brothers filed for bankruptcy.
- The FRBNY provided an \$85 billion credit facility to American International Group (“AIG”) to prevent its failure.

In that same month, Merrill Lynch, which also was experiencing large financial losses, agreed to merge with Bank of America; the FDIC took over Washington Mutual Inc. (“WaMu”) in what was to be the largest depository institution failure in U.S. history; and Citigroup announced its purchase of Wachovia Corp (“Wachovia”) although it was subsequently purchased by Wells Fargo & Company (“Wells Fargo”). Although they did not fail, the large investment firms of Goldman Sachs Group, Inc. (“Goldman Sachs”) and Morgan Stanley reportedly also came under pressure as a result of the credit crisis and converted to bank holding companies in September 2008. The conversions could allow them greater access to more stable sources of funding—namely, deposits from ordinary people and businesses, and made them eligible for certain government programs designed to address the liquidity crisis.

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<sup>13</sup> In the secondary mortgage market, mortgage loans and servicing rights are bought and sold between mortgage originators, mortgage aggregators (including the housing-related government-sponsored enterprises), and investors.

**Figure 1: Major Financial Events in September 2008**



Source: SIGTARP analysis of data from the FRBNY

Prior to being placed under federal conservatorship on September 7, 2008, Fannie Mae and Freddie Mac had lost a combined total of more than \$5.46 billion as a result of the turmoil in the housing and credit markets in the first six months of 2008. These two government-sponsored enterprises play a central role in mortgage finance: they purchased about 80 percent of all new home mortgages in the United States in 2008, and their combined investment portfolios held mortgage assets (loans and mortgage-backed securities) valued at \$1.5 trillion as of June 30, 2008. Amid worries that the capital of Fannie Mae and Freddie Mac would be insufficient to absorb mounting losses on their mortgage portfolios, their stock prices began to decline significantly in July 2008, and the possibility emerged that investors would not extend credit to the two entities. From the end of 2007 to August 1, 2008, Fannie Mae's stock lost 72 percent of its value, and the value of Freddie Mac's stock fell by 77 percent. In July 2008, the Federal Reserve authorized lending to Fannie Mae and Freddie Mac at the primary credit rate, and Treasury temporarily increased its lines of credit to both entities. Nevertheless, losses continued to mount over the summer, and the Federal Housing Finance Authority<sup>14</sup> subsequently placed them under conservatorship.

On September 10, 2008, Lehman Brothers announced that it had lost \$3.9 billion in the third quarter. Two days later, rating agencies Moody's Investors Service and Standard & Poor's threatened to downgrade the firm unless it could find a merger partner. At that time, Lehman Brothers executives were in talks with Bank of America and Barclays PLC regarding a possible sale of the company, but both banks eventually declined to purchase the firm. On Friday, September 12, 2008, then-FRBNY President Timothy Geithner and then-Secretary of the Treasury Henry Paulson summoned executives from major financial firms to the FRBNY to discuss a rescue plan for Lehman Brothers. One executive at the meeting told SIGTARP<sup>15</sup> that

<sup>14</sup> The Federal Housing Finance Agency is an independent federal agency created in July 2008 as the successor regulatory agency resulting from the statutory merger of the Federal Housing Finance Board and the Office of Federal Housing Enterprise Oversight. The new agency absorbed the powers and regulatory authority of both entities, with expanded legal and regulatory authority—including the ability to place Fannie Mae and Freddie Mac under conservatorship.

<sup>15</sup> For this report, federal officials and bank executives were interviewed by SIGTARP Audit Division.

President Geithner and Secretary Paulson stated that any plan must be “an industry solution” and that the government would not use taxpayer funds to help Lehman Brothers. The executive told SIGTARP that the group determined that sufficient funds could not be raised to rescue Lehman Brothers. Absent the funding, the group determined that Lehman Brothers would have to file for bankruptcy. Lehman Brothers, which had operated for 158 years, filed for bankruptcy on September 15, 2008, because it was unable to find a merger partner or obtain government assistance. Secretary Paulson, Federal Reserve Chairman Bernanke and other senior federal officials informed SIGTARP that, because Lehman Brothers did not meet minimum collateral and equity criteria, the Federal Reserve was unable to assist the institution in the manner in which it facilitated the sale of Bear Stearns to JPMorgan Chase. To many market observers, the failure of Lehman Brothers was particularly detrimental to market confidence because it demonstrated that the government might not be willing to rescue large financial institutions.

Largely as a result of its exposure to Lehman Brothers, the Reserve Primary Fund dipped below \$1.00 per share, thereby “breaking the buck,”<sup>16</sup> which further aggravated the credit crisis. Money market funds are considered among the safest investments; it is a rare and significant event when their per share value drops below \$1.00. When Lehman Brothers filed for bankruptcy, the Reserve Primary Fund was forced to write off approximately \$785 million in Lehman Brothers debt that it held. The resulting market anxiety contributed to a run on the fund,<sup>17</sup> with many investors attempting to withdraw their money. In addition, large-scale redemptions caused other money market mutual fund companies to hoard cash so that they could be able to pay investors back, rather than investing in term funding markets, such as those for commercial paper<sup>18</sup> and certificates of deposit. Consequently, banks and corporations that sell these securities were cut off from a fundamental source of short-term funding and subsequently faced their own difficulties meeting operating expenses.

On September 16, 2008, one day after Lehman Brothers filed for bankruptcy, the Federal Reserve authorized FRBNY to establish an \$85 billion secured line of credit to ensure that AIG could meet its obligations. The FRBNY loan was secured by the stock of AIG-owned subsidiaries and required AIG to provide warrants that, if exercised, would give the government a 79.9 percent equity stake in the company, making it the largest government bailout of a private company in U.S. history.<sup>19</sup> The Federal Reserve was concerned that a bankruptcy of AIG would have significant consequences for the broader economy because it was a central player in the financial markets. Among other things, AIG sold credit protection, or “insurance,” in the form of credit default swaps,<sup>20</sup> to other financial institutions that held asset-backed securities (which include mortgage-backed securities). Absent government support, AIG did not have enough

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<sup>16</sup> The Reserve Primary Fund was the oldest money market fund in the United States. When the fund falls below \$1.00 per share, it is known as “breaking the buck.”

<sup>17</sup> Approximately 50 percent of all funds were withdrawn from the Primary Fund between September 15 and October 30, 2008, or about \$26 billion.

<sup>18</sup> Commercial paper is a type of note issued to cover short-term obligations, such as operating and payroll expenses.

<sup>19</sup> Fannie Mae and Freddie Mac are government-sponsored enterprises. They are privately owned, but publicly chartered.

<sup>20</sup> A credit default swap is a derivative contract between two counterparties. The buyer makes periodic payments to the seller and, in return, receives a payoff if the underlying financial instrument defaults.

resources to meet its obligations to other financial institutions under transactions in these instruments.<sup>21</sup>

## Cost of Interbank Borrowing Sharply Increases

The cumulative effects of the failures of these major financial institutions caused general uncertainty about the financial condition, the solvency of some financial entities, and the likely liquidity needs of other firms going forward. The result was that lending in the interbank markets<sup>22</sup> ceased to function effectively and the cost of term borrowing sharply increased in September 2008. Access to loans through the interbank market, usually on a short-term basis, is essential for financial institutions to fund their positions and manage their liquidity.

A key measure of financial stress and the availability of credit is the difference (or “spread”) between two short-term interest rates—the London Interbank Offered Rate (“LIBOR”) and the Overnight Index Swap (“OIS”) rate. The difference reflects what banks believe is the risk of default associated with lending to other banks and the uncertainties associated with the supply and demand for funding.<sup>23</sup> Prior to the start of the financial crisis, in April 2007, the one-month LIBOR-OIS spread was between six and seven basis points. According to the then-Acting Assistant Secretary of Financial Stability, Treasury was watching closely this measure. As shown in Figure 2, the spread increased in August 2007 after Bear Stearns liquidated and BNP Paribas froze funds that were tied to subprime mortgages. It increased again in response to the strains at Countrywide Mortgage and the failure of Bear Stearns. The spread spiked dramatically in the middle of September 2008 when the series of destabilizing economic events occurred; it increased from 54 to 142 basis points after Lehman Brothers filed for bankruptcy and AIG received \$85 billion from the FRBNY. The spread reached a historical high of 341 basis points on October 13, 2008, signaling a severe disruption to the interbank market. Since reaching this high in mid-October, the LIBOR-OIS spread has fallen sharply, indicating that the credit markets, although still not at normal levels, are now working better than before the government capital injections.

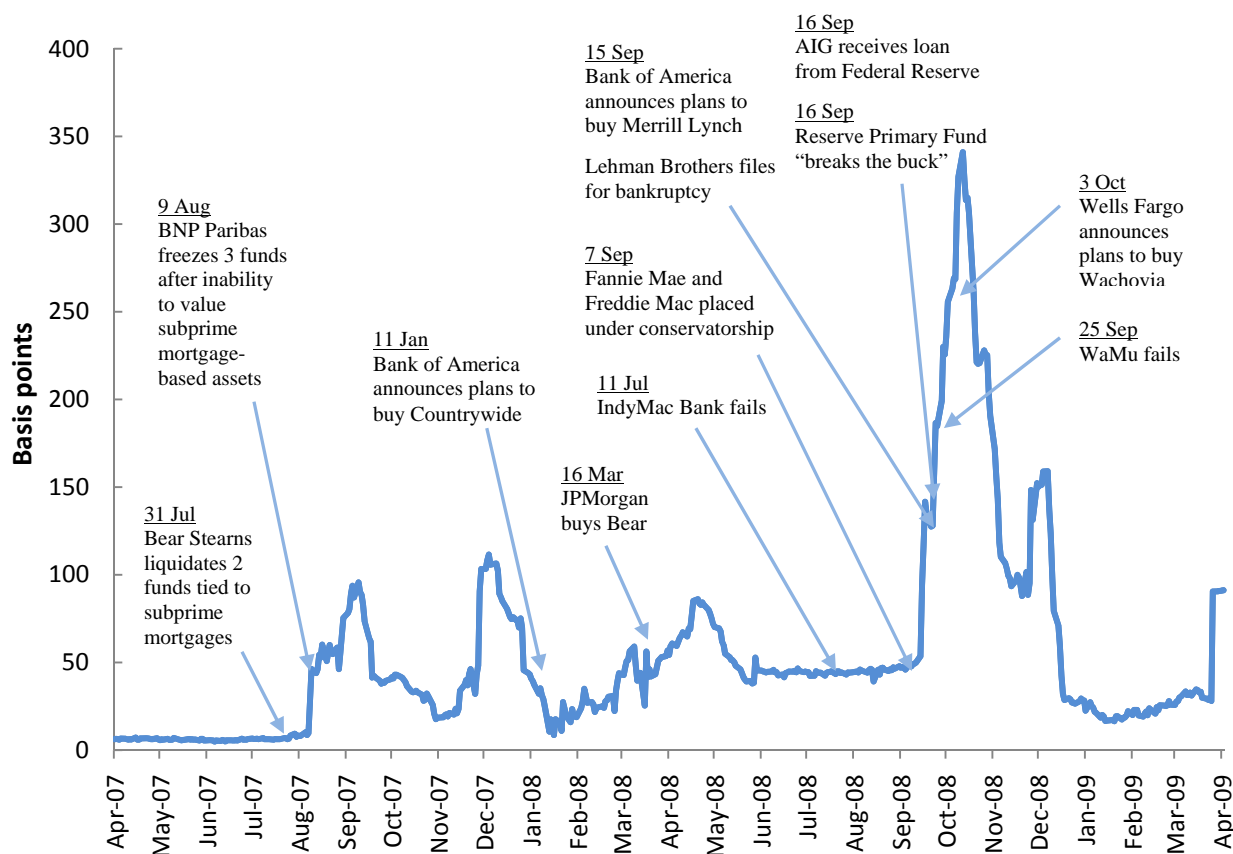
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<sup>21</sup> SIGTARP is completing a separate review that examines AIG’s payments to its counterparties. That report is expected to be released in within the next 30 days.

<sup>22</sup> Banks borrow and lend money in the interbank lending market to manage liquidity and to meet requirements placed on them. (Banks are required to hold specific amounts of reserve balance against some types of deposit accounts). A bank that wishes to augment its reserves can borrow money in the interbank market to do so. Banks that have a higher level of reserves than they desire can lend money in the interbank market, receiving interest on the loan. Without the ability to borrow funds readily, banks are more concerned about retaining cash, and so are more reluctant to lend.

<sup>23</sup> The difference between these two rates is an indicator of counterparty credit risk and liquidity pressures, with a lower spread suggesting diminished concerns about credit risk. The spread is measured in basis points—a unit equal to 1/100<sup>th</sup> of a percentage point.

**Figure 2: Significant Economic Events and Corresponding LIBOR-OIS Spread**

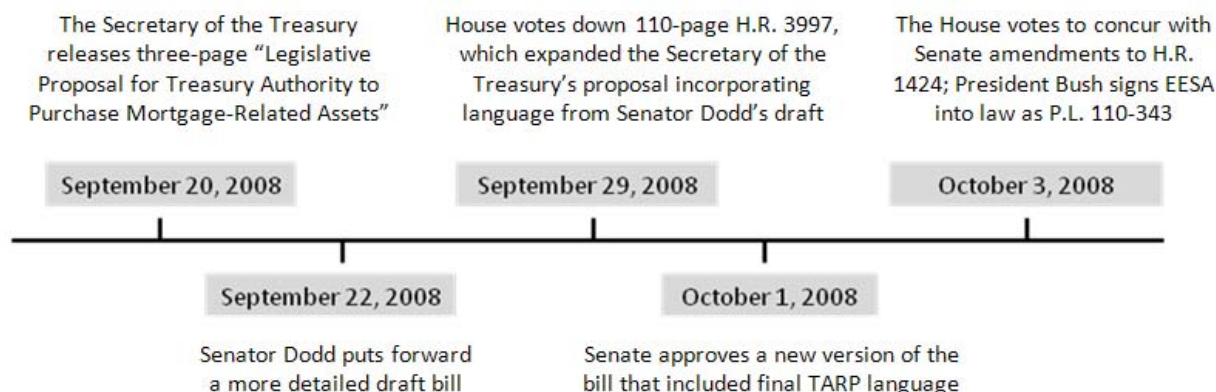


Source: SIGTARP analysis of data from the Federal Reserve System and SEC

## Initial Plan for the Use of TARP Changes in Response to Severe Stress in the Financial Markets

Following a week of severe stress in financial markets that saw the failure of Lehman Brothers, the government bailout of AIG, and the virtual freezing of the credit markets, Treasury and the Federal Reserve determined that a more significant, broadly based, and systemic approach was needed to promote stability, prevent additional disruption to the financial markets and banking system, and avoid the risk of a financial market collapse. On September 20, 2008, then-Secretary Paulson submitted to Congress a proposal that would have authorized Treasury to purchase up to \$700 billion in mortgage-related securities, among other things. Congress did not enact this initial proposal, but a series of counterproposals that evolved into EESA followed over the next two weeks, as noted in Figure 3. On October 3, 2008, EESA was signed into law as P.L. 110-343.

### Figure 3: Legislative Process Leading to the Passage of EESA



Source: SIGTARP

The original legislative proposal would have limited the Secretary's ability to use TARP funds to the purchase of mortgage-related assets, but EESA gave the Secretary of the Treasury broad latitude to determine both the type of financial instrument purchased and the institution from which it would be bought. As the financial and credit markets continued to rapidly deteriorate, Treasury's initial strategy evolved from purchasing toxic troubled assets to injecting capital directly into financial institutions to encourage them to build capital, increase the flow of financing to businesses and consumers, and support the economy. In explaining the change in strategy, which was implemented within two weeks of EESA's enactment, former Secretary Paulson said that, when market conditions had worsened considerably, it was clear that Treasury needed to act quickly and forcefully, and that purchasing troubled assets—the initial focus—would take time to implement and would not be sufficient given the severity of the problem. In consultation with the Federal Reserve, he believed that the most timely and effective step to improve credit market conditions was to strengthen bank balance sheets quickly through direct purchases of equity in banks. Two bank executives whom SIGTARP interviewed similarly concluded that Treasury may not have had time to value properly the troubled assets and that the \$700 billion provided by EESA was not, in any event, sufficient to buy the troubled assets on the financial institutions' balance sheets. Chairman Bernanke also stated to SIGTARP that a fire sale of these assets pursuant to such an asset purchase would have reduced their value.<sup>24</sup> Although he believed that the plan to buy troubled assets was appropriate, Chairman Bernanke noted that the time factor prevented the plan from being implemented, stating that it could be a months-long process, if not longer. As a result, Treasury announced the CPP on October 14, 2008, to infuse capital directly into banks.

In addition to Treasury's CPP, the FDIC and Federal Reserve also announced new programs on October 14, 2008 to strengthen market stability, improve the strength of financial institutions, and enhance market liquidity. The FDIC created the Temporary Liquidity Guarantee Program in which it guaranteed newly issued senior unsecured debt of all FDIC-insured institutions and their

<sup>24</sup> In a fire sale, an asset holder must sell the asset very quickly, potentially depressing the price of the asset significantly in the process.



holding companies, and provided full coverage of none-interest bearing deposit transaction accounts, regardless of the dollar amount. Under the plan, certain newly issued unsecured debt issued on or before June 30, 2009, would be fully protected in the event the issuing institution subsequently fails, or its holding company files for bankruptcy. Coverage would be limited to June 30, 2012, even if the maturity exceeds that date. The Federal Reserve announced further details on its Commercial Paper Funding Facility, created a week earlier, that would provide a liquidity backstop to U.S. issuers of commercial paper by purchasing commercial paper of three month maturity from high-quality issuers.

# Initial CPP Funds Provided as an Emergency Measure To Stabilize the Markets

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This section discusses the rationale and criteria used to select the initial nine institutions compared to those used to select subsequent institutions. Because of their perceived importance to the market and financial system, the U.S. government provided \$125 billion to Bank of America and eight other financial institutions—half of the TARP funds available at that time—in hopes of expanding the flow of credit and promoting economic growth. Government officials strongly urged the nine institutions to accept these monies as a group, irrespective of whether individual institutions felt that they required assistance, in the belief that it was crucial to restore public confidence in the banking system. The amount of funding each financial institution received was largely formula-driven and based on risk-weighted assets. Treasury required later CPP applicants to apply through a review and approval process for the remaining funds that placed an emphasis on the strength and viability of each applicant and not on its potential use of funds. Although CPP is designed to invest capital in “healthy” viable institutions, the strength of the initial nine participants varied: two of them later required additional government assistance, and one was in the process of being acquired by another.

## Initial Institutions Selected Based on Their Market Activities and Collective Importance to the Financial System

To demonstrate federal government support to the financial system and promote consumer and investor confidence, Bank of America, Citigroup, Wells Fargo, JPMorgan Chase, Goldman Sachs, Morgan Stanley, Merrill Lynch, State Street Corporation (“State Street”), and the Bank of New York Mellon were selected to receive the first government capital injections based on the types of services they provide to the consumers and businesses and their collective importance to the financial system, according to Treasury officials and federal regulators. FRBNY staff-developed briefing documents obtained by SIGTARP indicate that FRBNY officials played a key role in developing the capital injections program and selecting the nine initial institutions to receive CPP funds. These briefings laid out the rationale for the need to inject quickly a large amount of capital into the U.S. banking system, the different components of the plan, and the selection of the participating banks including the initial nine. Former Secretary Paulson told SIGTARP that he relied on then-FRBNY President Geithner to help develop the plan because he was viewed as the most skilled person to provide options and develop processes to help stabilize the financial markets. Other federal regulators agreed that the institutional selections were logical and viewed them as “systemically important”<sup>25</sup> because of the types of services they provide, their size, and their interdependence with each other and the broader economy. As

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<sup>25</sup> The term “systemically significant institutions,” as used by Treasury and federal regulators, generally refers to those institutions whose failure would impose significant losses on creditors and counterparties, call into question the financial strength of other similarly situated financial institutions, disrupt financial markets, raise borrowing costs for households and businesses, reduce household wealth, and have an adverse effect on the economy as a whole.

such, their participation in the CPP was considered central to the government’s solution to stabilize the financial markets.

According to Treasury officials and federal regulators, the nine institutions represented the nation’s leaders in the commercial and investment banking sector, as well as the U.S. custodial and securities processing system. These institutions include four large commercial banks, three investment banks, and two custodial and processing institutions:

- The four large commercial banks—Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo—are “traditional” banks. They accept deposits, make commercial and industrial loans, and perform other banking services for the public.
- The three investment banks—Goldman Sachs, Morgan Stanley, and Merrill Lynch—are largely financial intermediaries. They perform a variety of services, including underwriting (purchasing and distributing securities), acting as the intermediary between an issuer of securities and the investing public, facilitating mergers and other corporate reorganizations, and acting as brokers for institutional clients.
- State Street and the Bank of New York Mellon are also central to the financial system because they provide custodial services, such as securities processing and settlement services for financial transactions.

Together, these nine institutions provide broad financial services and engage in key activities of the U.S. financial system.

Another criterion considered in the selection was the size of the institutions. The nine selected institutions together held more than \$11 trillion dollars in banking assets—approximately 75 percent of all assets held by U.S.-owned banks as of June 30, 2008. By September 30, 2008, Bank of America was the third-largest bank holding company in the country, with nearly \$1.84 trillion in consolidated assets (see Table 1). The nation’s first- and second-largest bank holding companies by asset value as of September 30, 2008, were JPMorgan Chase (\$2.25 trillion) and Citigroup (\$2.05 trillion). Although behind Goldman Sachs and Morgan Stanley in total assets, Merrill Lynch was the nation’s sixth-largest financial institution at that time, with reported assets of nearly \$876 billion. Wachovia Corporation, which would be acquired by Wells Fargo, reported about \$761 billion in assets. With the acquisition of Merrill Lynch, Bank of America became the nation’s largest bank holding company, with about \$2.32 trillion in assets as of March 31, 2009 (see Appendix D).

**Table 1: Consolidated Assets of Top U.S. Financial Institutions for Quarter Ending September 30, 2008 (in \$ billion)**

<b>Rank</b>	<b>Name</b>	<b>Asset Value Ending in 9/30/08<sup>b</sup></b>
1	JPMorgan Chase & Co	\$2,251.47
2	Citigroup Inc.	2,050.13
3	Bank of America Corporation	1,836.45
4	Goldman Sachs Group, Inc. <sup>a</sup>	1,081.77
5	Morgan Stanley*	987.40
6	Merrill Lynch & Company*	875.78
7	Wachovia Corporation	760.56
8	Wells Fargo & Company	622.36
9	State Street Corporation	286.71
10	The Bank of New York Mellon Corporation	267.64
	<b>Total</b>	<b>\$11,020.27</b>

Source: The Federal Reserve and the SEC

Note: <sup>a</sup>Data for Goldman Sachs is for the quarter ending August 29, 2008; data for Morgan Stanley is for the quarter ending August 31, 2008; data for Merrill Lynch & Company is for the quarter ending September 29, 2008.

<sup>b</sup>Numbers are affected by rounding

Various federal officials and bank executives noted that these nine systemically important institutions are also highly interdependent and interconnected with each other. Some of the institutions are counterparties to each other, such that a risk of one institution failing to live up to its contractual obligations would cause financial problems, if not failure, for another. Bank of America and Merrill Lynch had counterparty exposures with many financial institutions, including several of the nine banks in the initial group that received CPP funds. In addition, two bank executives SIGTARP interviewed explained that State Street and the Bank of New York Mellon were included in the initial group of nine institutions because they were ‘infrastructure’ institutions that provided securities processing and settlement services for other financial transactions. According to the executive, when the operations of then-Bank of New York were temporarily disrupted as a result of the terrorist attacks on September 11, 2001, it had significant effects on the functioning of other financial institutions.

According to government officials interviewed by SIGTARP, the relative health of the first nine institutions selected to receive CPP funds was not a primary factor in the institutions selection, though then-Secretary Paulson and Chairman Bernanke made several references to the health of the nine institutions at the time. In an October 14, 2008, statement, for example, Secretary Paulson stated that the nine “are healthy institutions, and they have taken this step for the good of the U.S. economy. As these healthy institutions increase their capital base, they will be able to increase their funding to U.S. consumers and businesses.” A joint statement released by Secretary Paulson, Chairman Bernanke and Chairman Bair that same day similarly stated that “these healthy institutions are taking these steps to strengthen their own positions and to enhance the overall performance of the U.S. economy.”

Notwithstanding these statements that the nine institutions were healthy, contemporaneous reports and officials' statements to SIGTARP during this audit indicate that there were concerns about the health of several of the nine institutions at that time and, as detailed in this report, that their overall selection was far more a result of the officials' belief in their importance to a system that was viewed as being vulnerable to collapse than concerns about their individual health and viability. Leading up to the October 13, 2008, meeting, for example, Merrill Lynch had suffered several consecutive quarters of large losses and had agreed, in September 2008 (over the same weekend during which Lehman collapsed), to be acquired by Bank of America. On October 9, 2008, just three days before the meeting, Moody's Investors Services put the long term debt of both Morgan Stanley and Goldman Sachs on watch for possible downgrade. During the course of this audit, Chairman Bernanke told SIGTARP that there were differences in the nine banks in terms of strengths and weakness, but that the selection was generalized in order to avoid stigmatizing any one bank as being a weak bank and creating a panic. He stated that the differences among the firms with regard to their health were less important than the fact that all the banks were systemically important and interconnected. He recounted, for example, that a few of the banks were under stress, but that they were included because they were key players in the financial markets. Indeed, Chairman Bernanke said that the Federal Reserve believed that each of the banks in the original nine faced certain risks given the economic environment that preceded the announcement of the CPP and was concerned that the failure of a systemically significant institution could rapidly cause the failure of others due to the high degree of interconnectedness of the systemically significant institutions. For his part, although former Secretary Paulson stated that each of the nine financial institutions was viewed as viable and healthy, he also acknowledged that he was aware of no independent assessment of the conditions of the nine institutions at the time. He further acknowledged that he was concerned during the lead up to the CPP announcement that one of the nine institutions (which has since paid back its CPP investment) was in danger of failing, and that, in retrospect, it was clear some of the nine were healthier than others. Secretary Geithner, who was then President of the FRBNY told SIGTARP that, in selecting the first nine institutions, size and importance were the key characteristics that guided the process, and that no judgments were made as to their strength or weakness.

Of course, two of the nine institutions—Citigroup and Bank of America—just months later needed further support. Citigroup's fourth quarter 2008 losses totaled \$17.26 billion. After taking \$25 billion in capital injections under the CPP, Citigroup later accepted an additional \$20 billion of government funds under TARP's Targeted Investment Program ("TIP"). Citigroup also required support from the Asset Guarantee Program ("AGP"), in which Treasury, the Federal Reserve, and the FDIC agreed to provide guarantees on a pool of \$301 billion of troubled assets. Large fourth quarter losses at Merrill Lynch (\$15.31 billion) would also later necessitate additional government assistance to its acquirer, Bank of America, as further discussed later in this report.

## **Accepting CPP Funds for the “Good of the Country” and Restoring Confidence in the Financial System**

After the list of the nine institutions was established, Secretary Paulson made phone calls to the bank executives on October 12, 2008, and requested that they come to Washington, D.C., for a meeting the next day. At the meeting on October 13, 2008, senior government leaders led by

Secretary Paulson, Chairman Bernanke, FRBNY President Geithner, FDIC Chairman Sheila Bair, and Comptroller of the Currency John Dugan, told them that providing capital to their institutions as a group was designed to demonstrate clearly the government's support for, and to rebuild public confidence in, the U.S. financial sector, and that they needed to accept the capital injections for the "good of the country."<sup>26</sup> In an analysis prepared by the FRBNY, staffers noted that it was crucial to inject large amounts of capital into these nine institutions (and subsequently to other participating banks) as quickly and as nearly simultaneously as possible "in order to give the maximum amount of certainty to market participants that the banking system can withstand any near term credit loss."

Officials at Treasury, the Federal Reserve, and other federal regulators felt strongly that the nine institutions should not be permitted to reject the government's capital infusions. Documentation obtained from Treasury suggests that if the banks had not accepted, their regulators would have required them to accept the funds. For example, a draft "CEO talking points" prepared for Secretary Paulson state that "if a capital infusion is not appealing, you should be aware that your regulator will require it anyway." Furthermore, former Secretary Paulson told SIGTARP that if necessary, the government would make clear to the nine executives that they had no choice but to take the money. Indeed, one bank executive told SIGTARP that the impression he received from Secretary Paulson and other regulators was that the executives did not have a choice in the matter. However, in describing the meeting, one federal regulator told SIGTARP that, although the government strongly encouraged the bank executives to take the funds, it did not "force" them to do so. Knowing that the nine executives needed approval from their board of directors to participate in the capital injection program, but confident that the agreements would ultimately be signed, Treasury staff pre-arranged for nine private offices in the Treasury building to allow the executives to call their boards and senior personnel.

According to the bank executives interviewed by SIGTARP, there was limited debate among the participants as to the government's rationale for adopting the capital injection plan. These executives told SIGTARP that all participants understood the severity of the situation, the government's strong belief that things were going to get worse, and that immediate action was needed to address the rapidly deteriorating economic conditions. One of the executives expressed concern about the amount of capital he was asked to take, but agreed with the government's rationale that swift and decisive actions were required to stem the crisis. This executive recalled others in the group remarking that the CPP was a good idea, and that they took the government's funds because of the reasonable terms. Another executive also recalled that some executives commented that the government's funds were "cheap money."

These six executives also told SIGTARP that government officials strongly urged them to accept the capital injections as a group, irrespective of whether they believed that their institutions required such substantial assistance. Federal Reserve officials later explained that acting as a group would help avoid any stigma that might have been associated with accepting capital from

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<sup>26</sup> The nine executives were Vikram Pandit (Citigroup), Jamie Dimon (JPMorgan Chase), Richard Kovacevich (Wells Fargo), John Thain (Merrill Lynch), John Mack (Morgan Stanley), Lloyd Blankfein (Goldman Sachs), Robert Kelly (Bank of New York Mellon), and Ronald Logue (State Street), and Kenneth Lewis (Bank of America). Key Federal officials included Secretary Paulson (Treasury), Chairman Bernanke (Federal Reserve), President Geithner (FRBNY), Chairman Bair (FDIC), Comptroller Dugan (Comptroller of the Currency), and other senior federal officials.

the government. If some of the institutions had accepted capital and others had not, the markets may have viewed the decision to accept capital as a sign that the institution was experiencing financial problems. Such an assessment by investors could have led to a further destabilization of financial institutions and markets. By requiring that the institutions accept government capital at the same time, the participating institutions would be less likely to suffer adverse market consequences. Further, it was argued that those who opted out would be left vulnerable and exposed if the economy further deteriorated.

The meeting began at 3:00 p.m. After remarks by Secretary Paulson, program details were provided by FRBNY President Geithner and other federal officials, along with discussion among the participants. The nine executives had limited time to discuss the capital injection plan with their respective boards of directors before returning with signed agreements. One bank executive stated that some executives immediately signed the term sheets placed before them and left within an hour after the meeting. Another executive told his board of directors that they could take all the time they needed, but it was not going to change the government's expectation of a signed agreement by the end of the day. By 6:25 p.m., all nine executives had signed the agreements and agreed to accept the CPP funds.

## **Basis for Funding Amounts**

In determining the amount of capital provided to Bank of America and the eight other financial institutions, Treasury decided to use \$125 billion—half of the \$250 billion that was available to Treasury at the time under Section 115 of EESA.<sup>27</sup> The other half of the available funds were to be injected into subsequent banks applying for funds under a formalized CPP approval process. More specifically, Treasury determined that institutions receiving CPP funds should receive between one percent and three percent of their risk-weighted assets,<sup>28</sup> with a maximum of \$25 billion. Based on their risk-weighted assets, six of the nine financial institutions in the initial group—JPMorgan Chase, Citigroup, Goldman Sachs, Morgan Stanley, Bank of New York Mellon Corp, and State Street Corporation—followed roughly the established formula and received either close to the three percent or the maximum amount of capital allowed under the program (see Table 2). However, the determination of capital injections for three other financial institutions—Wells Fargo, Bank of America, and Merrill Lynch—was complicated by merger agreements.

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<sup>27</sup> The \$700 billion made available to Treasury came in three authorizations. The first authorization was for \$250 billion; the second was for \$100 billion; and the third was for \$350 billion.

<sup>28</sup> Risk-weighted assets are the amount of a bank's total assets after applying an appropriate risk factor to each asset and to selected off-balance sheet positions.

**Table 2: Top U.S. Financial Institutions' Risk-weighted Assets and CPP Funds Received (in \$ billion)**

<b>Financial Institution</b>	<b>Risk-weighted Assets as of 9/30/08</b>	<b>3 percent of Risk-weighted Assets</b>	<b>CPP Funds Received</b>
JPMorgan Chase & Co.	\$1,377.06	\$41.31	\$25.00
Citigroup Inc.	1,175.71	35.27	25.00
Bank of America Corporation	1,328.01	39.84	15.00
Wells Fargo & Company	525.69	15.77	25.00
Wachovia Corporation	585.06	17.55	N/A
Goldman Sachs <sup>a</sup>	379.17	11.38	10.00
Morgan Stanley <sup>a</sup>	296.59	8.90	10.00
Merrill Lynch & Co., Inc. <sup>a</sup>	304.02	9.12	10.00
Bank of New York Mellon Corp	125.12	3.75	3.00
State Street Corporation	75.03	2.25	2.00
<b>Total</b>			<b>\$125.00<sup>b</sup></b>

Source: Federal Reserve, Securities and Exchange Commission, and Treasury

Note: <sup>a</sup>Data for Goldman Sachs is from August 29, 2008; data for Morgan Stanley is from August 31, 2008; data for Merrill Lynch is from September 26, 2008.

<sup>b</sup>All but Bank of America, Wells Fargo, and Citigroup have paid back their CPP funds, leaving \$75 billion of the \$125 billion outstanding.

Table 2 shows that Wells Fargo was approved for \$25 billion even though its risk-weighted assets did not qualify it to receive the allowable maximum amount of CPP funds. At that time, Wells Fargo was in the process of acquiring Wachovia, which was in danger of default. It had received regulatory approval for the acquisition on October 12, 2008, and was cleared for immediate consummation (which occurred on December 31, 2008). Thus, Treasury and federal regulators viewed Wells Fargo and Wachovia as one entity at the October 13, 2008, meeting. When Wachovia's assets were considered, the combined institution was qualified to receive \$25 billion in CPP funds. With the acquisition of Wachovia, Wells Fargo became the fourth-largest bank holding company in the nation, as of March 2009 (see Appendix D).

Although Wells Fargo and Wachovia were considered one institution, Bank of America and Merrill Lynch were not, even though they too were in the process of merging. In contrast to the Wells Fargo and Wachovia merger, Bank of America had not received regulatory approval for the merger at the time of the October 13, 2008, meeting. Therefore, based on interviews SIGTARP held with Mr. Lewis and federal officials, Merrill Lynch was considered an independent entity with its own Board of Directors separate from Bank of America. Consequently, \$10 billion was pledged to Merrill Lynch and \$15 billion to Bank of America, with the agreement that Bank of America would receive the full amount of both pledges on consummation of the merger. However, as Table 2 also shows, the amount of Bank of America's risk-weighted assets would have qualified it to receive \$25 billion on its own and



without consideration for the Merrill Lynch merger.<sup>29</sup> According to Federal Reserve officials, Bank of America was required to wait until the merger was completed to receive the additional funds because the \$10 billion was intended for Merrill Lynch—not Bank of America. Once the merger was completed, Bank of America’s total amount received under the CPP would equal \$25 billion, on par with the other large commercial banks. The merger received regulatory approval on November 26, 2008, and was completed on January 1, 2009.

## **Subsequent CPP Approval Process Was Put in Place for Viable Banks To Receive Government Capital**

In contrast to the process for selecting the first nine financial institutions, Treasury required later financial institutions to submit an application to be considered for capital investments under the CPP. Each application was submitted through the institution’s primary federal regulator and then sent through a tiered review and approval process. The primary federal regulator provides an initial screening and prepares a case decision memorandum detailing quantitative and qualitative aspects of the institution’s viability. It then determines whether to forward the application for Treasury’s review based on its initial assessment. Prior to forwarding the application to Treasury, however, the regulator may send the application to an interagency CPP Council where a representative from each of the four primary federal regulators evaluates the merit of the application and decides whether to forward the application to Treasury. At Treasury, each application is considered by an Investment Committee comprising of three to five senior Treasury officials. A majority of the Investment Committee members must recommend approval of the application before the Assistant Secretary for Financial Stability officially approves the investment of funds. Eligibility for CPP funds for the institutions that go through this process is based on an assessment of the strength and viability of each applicant, as measured primarily by examination ratings and performance ratios, without taking into account the potential application of TARP funds. Final approval for CPP funding comes from the Assistant Secretary for Financial Stability.<sup>30</sup>

Although the first nine financial institutions did not go through the formal CPP process, Treasury officials retroactively applied part of the new CPP procedures to some of these institutions. Specifically, primary federal regulators subsequently submitted the case decision memoranda, and the Investment Committee ratified the prior approval of funding for JPMorgan Chase, Citigroup, Bank of America, Wells Fargo, Morgan Stanley, Goldman Sachs, State Street, and the Bank of New York Mellon during its first meeting on October 23, 2008. Also approved for funding at the meeting were 24 other banks.<sup>31</sup> The next day, the Investment Committee

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<sup>29</sup> The Bank of America Chief Executive Officer, Kenneth Lewis, speculated to SIGTARP that his institution had recently raised \$10 billion in capital that could have influenced Treasury’s decision to initially allocate only \$15 billion to Bank of America.

<sup>30</sup> SIGTARP conducted a separate review that examined the external influences on the CPP funding approval process. See SIGTARP-09-002, “*Opportunities To Strengthen Controls To Avoid Undue External Influence over Capital Purchase Program Decision-Making*,” August 6, 2009.

<sup>31</sup> Other institutions and their subsidiaries included: Wachovia, Valley National Bancorp, Saigon National Bank, the PNC Financial Services Group, Inc., Old National Bancorp, KeyCorp, Huntington Bancshares Inc., First Horizon National Corporation, First Community Bancshares, Inc., City National Corporation, Centerstate Banks of Florida, Inc., Capital One Financial Corporation, Regions Financial Corporation and Regions Bank, HF Financial Corporation, Washington Federal Savings & Loan Association, First Niagara Financial Group, Inc, Crossroads

approved funding for Merrill Lynch and several other institutions. Treasury provided CPP funds to all institutions, except for Merrill Lynch, on October 28, 2008. Once the acquisition was completed, Bank of America received Merrill Lynch's CPP investments on January 9, 2009.

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Bank, SunTrust Banks, Inc. Broadway Federal Bank, Western Illinois Bancshares, Northern Trust Corporation, UCBH Holdings, Inc. /United Commercial Bank, Mountain 1<sup>st</sup> Bank & Trust Company, and Bank of Commerce Holdings.

# Officials Believed that Terminating the Merger with Merrill Lynch Could Undermine the Viability of Bank of America and Destabilize the Financial System

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This section addresses the basis for the decision by Treasury and federal regulators to provide Bank of America with additional assistance following the acquisition of Merrill Lynch, and federal efforts to forestall Bank of America from terminating the planned acquisition. Citing substantial and growing losses, the Bank of America Chief Executive Officer informed Treasury and Federal Reserve officials that the Bank was considering terminating the planned acquisition of Merrill Lynch. Because Treasury and Federal Reserve officials believed that the termination of this acquisition could potentially weaken Bank of America and destabilize financial markets, they pressured Bank of America to complete the acquisition and provided Bank of America, at its request, \$20 billion in additional TARP funds and asset guarantees worth up to \$118 billion against possible future losses. Since it was completed, however, numerous questions have emerged about the acquisition and the extent to which government officials pressured Bank of America to complete the merger without making public Bank of America and Merrill Lynch's losses. SIGTARP reviewed available documentation and interviewed key principals involved in the discussions to address this issue.

## Treasury and the Federal Reserve React Strongly to the Possibility of a Failed Merger

On December 17, 2008, Bank of America's Chief Executive Officer, Kenneth Lewis, called Secretary Paulson and Chairman Bernanke and informed them that substantial losses at Merrill Lynch could justify Bank of America's invoking the merger agreement's material adverse change (or MAC) clause,<sup>32</sup> which would allow the bank to either renegotiate with Merrill Lynch on more favorable terms or completely back out of the acquisition agreement. During a meeting held later that evening, Secretary Paulson, Chairman Bernanke, and other Treasury and Federal Reserve officials discussed a number of issues with Mr. Lewis and two other Bank of America senior executives, including:

- the nature of Merrill Lynch's losses
- the risks of invoking the MAC to the financial system, Bank of America, and Merrill Lynch
- the availability of TARP funds

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<sup>32</sup> The MAC clause (also sometimes referred to as the material adverse event clause) is a legal provision often found in mergers and acquisition contracts. MAC clauses typically allow the buyer to get out of an agreement if certain conditions, such as the seller's financial condition, have materially changed.

The meeting concluded with Secretary Paulson's request that Bank of America executives take no action relative to the MAC and give the government time to consider its options. A few days later, on December 21, 2008, Mr. Lewis again contacted the Secretary of the Treasury, stating that he still intended to invoke the MAC clause because of increasing losses at Merrill Lynch.

According to Chairman Bernanke and former Secretary Paulson, the view of Federal Reserve lawyers was that it was highly unlikely that Bank of America would be successful in terminating the contract by invoking the MAC clause. Furthermore, an attempt to invoke the MAC clause would likely involve extended and costly litigation with Merrill Lynch that, with significant probability, would result in Bank of America being required to pay substantial damages. The merger agreement between Bank of America and Merrill Lynch states that when determining whether a material adverse effect [MAC] has occurred, both parties will disregard the effects resulting from, among other things, "changes in global, national or regional political conditions including changes generally in prevailing interest rates, currency exchange rates, credit markets and price levels or trading volumes in the United States [...] generally affecting the industries in which the relevant party or its subsidiaries operate and including changes to any previously correctly applied asset marks resulting therefrom." As such, Federal Reserve lawyers concluded that exercising the MAC clause was not a legally reasonable option. Mr. Lewis also told SIGTARP that it was unclear whether Bank of America could win a MAC clause case and that if invoked, there would be hefty lawsuits against the company.

Federal Reserve and Treasury officials also feared that Bank of America's invocation of the MAC clause could lead to a destabilization of Bank of America, Merrill Lynch, and the broader financial system. A failed acquisition could lead investors to speculate that Bank of America was not strong enough to acquire Merrill Lynch. This could result in a loss of confidence in the judgment of the bank's management and additional downgrades by the credit-rating agencies, which could make it more difficult to obtain funding. Both former Secretary Paulson and Chairman Bernanke told SIGTARP that invoking the MAC would show poor judgment on the part of Bank of America's management and that the decision was 'ill-advised.' For Merrill Lynch, federal officials and industry executives believed that the institution would likely not survive if the merger failed. According to Federal Reserve officials, a failed merger would:

- limit Merrill Lynch's ability to access the interbank funding markets as investors perceived the firm being at risk
- severely limit its ability to fund and transact with counterparties as other institutions lost confidence in the firm
- cause it to have difficulty in raising new capital and/or receive government support because of the uncertainty about its prospects and possible future losses

For the broader financial system, federal officials believed that the spillover effects of a failed merger would threaten the viability of otherwise financially sound institutions and cause collateral damage to the economy because Bank of America and Merrill Lynch participate in several critical financial markets and are interconnected with and exposed to other systemically important financial institutions.

There has been much public discussion regarding how strongly the Federal Reserve and Treasury officials pressured Bank of America executives to go forward with the acquisition of Merrill Lynch. Email communications show that the issue of removing Bank of America's management and Board of Directors was discussed among some Federal Reserve officials. For example, in an email written on December 20, 2008, a Federal Reserve Bank Richmond official summarized a conversation he had with Chairman Bernanke, stating, "just had a long talk with [Chairman Bernanke]. Says they think the MAC threat is irrelevant because it's not credible. Also intends to make it even more clear that if they play that card and then need assistance, management is gone." However, the email communications obtained by SIGTARP does not provide indication that such views were voiced by Chairman Bernanke to Mr. Lewis. In fact, Chairman Bernanke testified to the House Committee on Oversight and Government Reform on June 25, 2009, that he did not make such threats to Mr. Lewis.

On the other hand, former Secretary Paulson testified to the same committee that he told Mr. Lewis that the Federal Reserve could remove Bank of America's management and the Board of Directors if the MAC clause was invoked and the merger agreement was abandoned. He explained to SIGTARP that such a position was justified because of the risk to the financial system and that investors would perceive invoking the MAC as poor judgment. Mr. Lewis also stated in his deposition taken at the New York Office of the Attorney General on February 26, 2009, that Secretary Paulson made statements about removing Bank of America's Board and management. He subsequently relayed Secretary Paulson's statements to his Board of Directors in a special meeting held on December 22, 2008. Although confirming the threat of possible removal, Mr. Lewis told SIGTARP that he also independently came to the same conclusion that the potential failure of the merger would be harmful to his bank. Consequently, he concluded that it was in the best long-term interest of the shareholders to go forward and complete the merger.

## **No Indication of Federal Direction to Bank of America Regarding the Disclosure of Fourth Quarter Losses**

Since the acquisition of Merrill Lynch was completed in January 2009, numerous questions have emerged about the acquisition and the extent to which federal officials put pressure on Bank of America to complete the merger without making public Merrill Lynch's losses. Specifically, questions have arisen over whether the federal government directed Mr. Lewis not to disclose Merrill Lynch's losses to Bank of America's shareholders. Although it was the government's intention to ensure that the acquisition was "kept on track," both Chairman Bernanke and former Secretary Paulson stated that they did not advise Mr. Lewis to withhold Merrill Lynch's losses from Bank of America's shareholders. In an interview with SIGTARP, Mr. Lewis confirmed no such instruction was given to him by Secretary Paulson or Chairman Bernanke. Chairman Bernanke told SIGTARP that if Mr. Lewis "wanted to inform his shareholders of Merrill Lynch's losses, we [the Federal Reserve] would have worked" with him to develop a government support plan. Chairman Bernanke also reiterated that the announcement of losses has been, and will always be, the responsibility of the institution. In addition, Bank of America's legal counsel informed SIGTARP that he believed that the bank was under a legal obligation to announce those losses at the end of each quarter, not mid-stream. Based on the information it received and discussions with key principals, SIGTARP found nothing to indicate Treasury and Federal Reserve officials instructed Bank of America executives to withhold the public

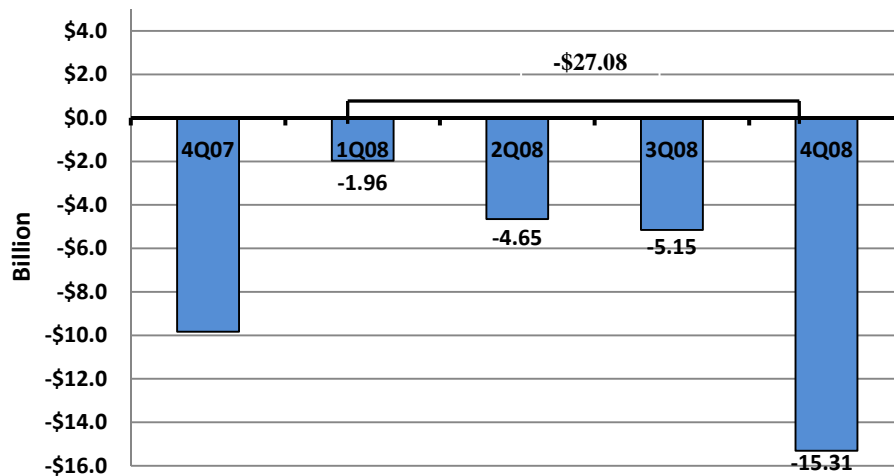
disclosure of losses, but that they agreed to provide financial assistance to ensure that Bank of America remained a viable financial institution after the acquisition out of concern for the financial markets as a whole.

Former Secretary Paulson and Mr. Lewis told SIGTARP that, after agreeing to go forward with the merger on December 21, 2008, Bank of America executives asked for a letter committing the government to future financial support. According to Mr. Lewis, he wanted a formal commitment from the government to assure his Board of Directors that future financial support was forthcoming. However, Secretary Paulson refused to provide bank executives with written assurance of the government's additional assistance, stating that the decision-making process for additional support had not yet occurred. Moreover, once any written assurance was provided, it would become a "disclosable event." Secretary Paulson told SIGTARP that he and Chairman Bernanke assured Mr. Lewis that the government would provide assistance to his bank and that they were not going to let a systemically significant institution fail. However, they could not issue a statement of such support until their staff had the opportunity to review the type of assistance required and the assets that might be included in the support package. As a result, an announcement of additional government support could not be made until an agreement was reached.

## **Losses that Could Destabilize Bank of America and the Broader Financial System Resulted in Additional Support**

While Federal Reserve officials believed that a failure of Bank of America to complete the merger agreement with Merrill Lynch could prove destabilizing to the financial markets, they also believed that losses at both companies, but particularly at Merrill Lynch, were likely to have an adverse effect on Bank of America. During the meeting with former Secretary Paulson and Chairman Bernanke on December 17, 2008, Mr. Lewis and other Bank of America senior executives stated that Merrill Lynch's losses had been projected to be flat for the fourth quarter when the merger plan was initially agreed upon in September 2008. However, Mr. Lewis stated that estimated losses for the fourth quarter had accelerated by mid-December. In the fourth quarter of 2008, Merrill Lynch eventually lost \$15.31 billion after tax (approximately \$21.53 billion pretax). This was almost three times worse than its performance in the third quarter when it posted losses of more than \$5.15 billion. Largely reflecting a significant decline in revenues, Merrill Lynch posted losses of more than \$27 billion for the year (see Figure 4).

**Figure 4: Merrill Lynch After-Tax (Net) Losses from End of 2007 through 2008 (\$ in billions)**

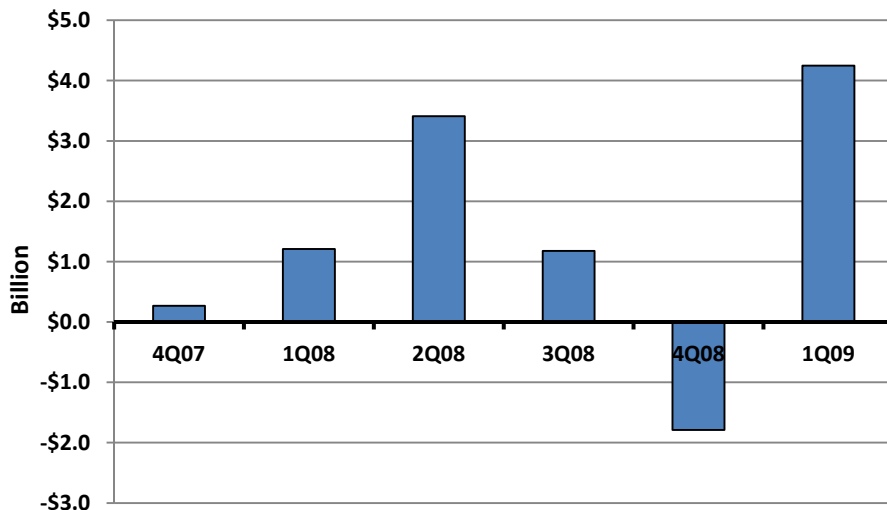


Source: Merrill Lynch and the SEC

In addition to Merrill Lynch’s losses, Mr. Lewis told SIGTARP that the unexpected and sharp market deterioration in the fourth quarter of 2008 resulted in losses for Bank of America and several other major financial institutions. Figure 5 shows that Bank of America lost \$1.79 billion in the fourth quarter, the first time it had posted a quarterly loss in more than 17 years. Its year-end financial data shows that the losses were due, in part, to escalating credit costs linked to the economic downturn and continued capital markets disruptions. It reported write-downs in its capital markets business, including losses on collateralized debt obligations<sup>33</sup> of \$1.7 billion and write-downs on commercial mortgage-backed securities of \$853 million. Bank of America was considered a well-capitalized company, but documentation obtained from the Federal Reserve shows that federal regulators were concerned that, once Bank of America merged with Merrill Lynch, the amount of tangible common equity at the combined entity would be among the lowest of the large bank holding companies. This would make Bank of America vulnerable if the financial system experienced further deterioration.

<sup>33</sup> A collateralized debt obligation is a financial instrument that entitles the purchaser to some portion of the cash flows from a portfolio of assets, which may include bonds, loans, or mortgage-backed securities.

**Figure 5: Bank of America Net Income Gain/Loss from 2007-2009 (\$ in billions)**



Source: Bank of America

In response to Mr. Lewis' request for additional government assistance, Treasury, the Federal Reserve, and FDIC subsequently agreed to provide additional assistance to shore up the combined company's financial position and reduce the risk of market disruption once the merger was complete.

## **\$20 Billion in Additional Capital under the Targeted Investment Program**

On January 16, 2009, Treasury made an additional investment in Bank of America by acquiring \$20 billion in newly issued senior preferred stock under the TIP. Combined with the \$25 billion received under the CPP, Treasury's total capital injection into Bank of America now totals \$45 billion. Because the ceiling on the amount of capital that Treasury could provide under the CPP was capped at \$25 billion, the TIP was used as a vehicle to infuse additional assistance to Bank of America. The preferred stock acquired under the TIP carries an 8 percent dividend payable to Treasury. As required by EESA, Treasury also received warrants to purchase common stock of Bank of America at a strike price<sup>34</sup> of \$13.30 per share and with an aggregate value of \$2 billion. Bank of America will be prohibited from paying dividends on common stock in excess of \$.01 per share per quarter for three years without the consent of Treasury.

## **\$118 Billion in Loss-sharing Agreement under the Asset Guarantee Program**

To further help restore confidence in Bank of America, Treasury, FDIC, and the Federal Reserve also agreed to share losses with the bank on a designated pool of up to \$118 billion of loans, securities backed by residential and commercial real estate loans and corporate debt, derivative

<sup>34</sup> A strike price is the stated price per share for which underlying stock may be purchased by the option holder upon exercise of the option contract.



transactions that reference such securities, and other financial assets. The pool would contain both Merrill Lynch (about 75 percent) and Bank of America (about 25 percent) assets. Based on the preliminary terms of the arrangement, Bank of America would absorb the first \$10 billion of losses in the asset pool. If the losses on these assets exceeded this amount, then Bank of America would absorb 10 percent of the additional losses of the pool of assets, and Treasury and FDIC would absorb 90 percent of the losses, up to \$10 billion. The terms would be in effect for ten years for residential mortgage-related assets and five years for other assets. As compensation for these guarantees, Treasury would receive \$3 billion, and FDIC would receive \$1 billion in preferred stock with an 8 percent annual dividend rate, and accompanying warrants. The Federal Reserve would provide Bank of America non-recourse loans backed by these assets with the same 90 percent and 10 percent loss-sharing provision if the coverage from Treasury and FDIC were to be exhausted.

Although the AGP term sheet was negotiated in January 2009, the final agreement was not completed. On May 6, 2009, Bank of America requested termination of its participation in the program because executives believed that the cost of the guarantees outweighed the potential benefits. Mr. Lewis and other senior executives told SIGTARP that future losses would not exceed the initial \$10 billion that the bank would need to cover under the terms of the AGP. The Federal Reserve, Treasury, and FDIC reviewed the effects of Bank of America's withdrawal from the program and negotiated with Bank of America regarding a fee to be paid that recognized both the costs incurred by the government and the benefits received by Bank of America once its participation in the AGP was announced. The termination agreement was reached on September 21, 2009 and Bank of America agreed to pay \$276 million to Treasury, \$57 million to the Federal Reserve, and \$92 million to the FDIC.

# Conclusions and Lesson Learned

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Faced with the threat of an unparalleled economic crisis, Treasury, the Federal Reserve and FDIC implemented programs designed to help prevent a further deterioration of the economy and a significant risk of financial market collapse. It may be difficult in the near term to assess fully the impact of Treasury's initial injections of capital to the first nine institutions on preventing an economic collapse. What is clear, however, is that key federal officials and senior industry leaders believed that the risks to the financial stability and economic growth of the United States and the rest of the world were too great for inaction.

In addition, former Secretary Paulson and Chairman Bernanke believed that the already fragile financial system could further destabilize if the acquisition of Merrill Lynch failed. This contributed to their decision to press Bank of America to consummate the transaction and then to provide it with additional financial support to help ensure that the bank remained a viable financial institution after the merger and to avert what they thought could be another market-destabilizing event.

At the same time, Treasury's description of how the investments in the first nine institutions were made in October 2008 highlights what should be an important lesson for how Treasury should describe its actions and rationales in future programs. In an October 14, 2008, statement announcing the investment in the original nine institutions, Secretary Paulson stated: "These are healthy institutions, and they have taken this step for the good of the U.S. economy. As these healthy institutions increase their capital base, they will be able to increase their funding to U.S. consumers and businesses." The nine institutions were similarly described as healthy in a joint statement released that same day by Treasury, the Federal Reserve and FDIC, and in a separate statement released by Treasury.

It is apparent, however, that senior Government officials had affirmative concerns, at the time the nine institutions were selected, about the health of at least some of those institutions: the Federal Reserve had concerns over the financial condition of several of these institutions individually and for all of them collectively absent some governmental action; and former Secretary Paulson noted concerns about the potential of an outright failure of one of the institutions. In addition to the basic transparency concern that this inconsistency raises, by stating expressly that the "healthy" institutions would be able to increase overall lending, Treasury may have created unrealistic expectations about the institutions' condition and their ability to increase lending. Treasury and the TARP program lost credibility when lending at those institutions did not in fact increase and when subsequent events — the further assistance needed by Citigroup and Bank of America being the most significant examples — demonstrated that at least some of those institutions were not in fact healthy.

It is not our intent to suggest that Government officials should make public their concerns over the financial health of individual institutions, but rather that government officials should be particularly careful, even in a time of crisis, of describing their actions (and the rationales for such actions) in an accurate manner. Ultimately, the lesson is straightforward: accuracy and transparency will enhance the credibility of Government programs like TARP and restore

taxpayer confidence in the policy makers who manage them; inaccurate statements, on the other hand, could have unintended long-term consequences that could damage the trust that the American people have in their Government.

# Management Comments and Audit Response

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SIGTARP received official written responses to this report from both Treasury's Office of Financial Stability and the Board of Governors of the Federal Reserve Board (the "Federal Reserve").

In a letter from its General Counsel, the Federal Reserve concurred with the report's findings and expressly agreed "that an important lesson illustrated by the events that shocked the financial systems over the past two years is that transparency and effective communication are important to restoring and maintaining public confidence, *especially during a financial crisis.*" (Emphasis added.) For the Federal Reserve's full response see Appendix H.

Treasury, in contrast, did not express as positive a position on SIGTARP's findings. Although Treasury characterized the report as "a useful contribution," it did not expressly state whether it concurred with the lesson learned that SIGTARP identified in the report. Indeed, Treasury's response appears to take issue with SIGTARP's call for the need for careful consideration of public statements in a time of crisis, stating that "[w]hile people may differ today on how the contemporaneous announcements about the reasons for selecting the initial nine recipients should have been phrased, any review of such announcement must be considered in light of the unprecedented circumstances in which they were made."

Although SIGTARP certainly acknowledges the unprecedented circumstances that Treasury was operating under last fall, we believe that the lesson to be learned here is that it is precisely during such extraordinary times, as the Federal Reserve correctly noted, that the Government must exercise increased vigilance about accuracy and transparency in its statements to the public. It is axiomatic that the Government's capacity to address financial crises depends in no small measure on its credibility, both with market participants whose confidence is essential to stabilize the financial system and with the American public whose confidence is essential to underpin the political support necessary to take the difficult (and often expensive) steps that are needed. Accuracy and transparency can enhance the public's understanding of and support for government programs, whereas statements that are less than careful or forthright—like those made in this case—may ultimately undermine the public's understanding and support for these same programs. This loss of public support could damage the government's credibility and have long-term unintended consequences that actually hamper the Government's ability to respond to crises. For Treasury's full response, see Appendix I.

SIGTARP also received informal and technical comments from the Federal Reserve, Treasury, FDIC, and the Office of the Comptroller of the Currency. These were incorporated into the draft where appropriate.

# Appendix A—Scope and Methodology

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We performed the audit under authority of Public Law 110-343, as amended, which also incorporates the duties and responsibilities of inspectors general under the Inspector General Act of 1978, as amended. Work was completed from February to September 2009 as Project Number 003.

To determine the events that influenced the decision of Treasury officials and primary federal regulators to select the first nine institutions—including Bank of America—to receive CPP funds, SIGTARP’s Audit Division performed general research using academic studies, business and economic periodicals, and other available publications. We corroborated the importance of these events and their effect on the government’s decision-making process by interviewing key principals and policy-makers, including former and current Secretaries of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Federal Deposit Insurance Corporation, the Comptroller of the Currency, as well as other senior officials and staff members from Treasury, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

To determine the rationale and criteria for selecting the first nine financial institutions to receive CPP funds, we interviewed the above key principals and further supported their testimonials with data obtained from their offices, including email communications, internal legal opinions, and financial analysis. We also spoke with the chief executives of Bank of America, Merrill Lynch, Wells Fargo, Goldman Sachs, State Street, and Bank of New York Mellon to obtain their views on the selection process, their understanding of the government’s rationale, and their reasons for accepting the funds. We also reviewed these institutions’ financial regulatory filings and obtained data on total asset values, risk-weighted assets, and gains and losses for the last several reporting quarters.

To determine the basis for the decision of Treasury and federal regulators to provide Bank of America with additional government assistance, we focused on statements provided by officials at the Federal Reserve Board, Treasury, and other primary federal regulators. We reviewed written and oral testimonies made by former Secretary Paulson, Chairman Bernanke, and Mr. Lewis to the House Committee on Government Oversight and Reform. We also obtained analyses from the Federal Reserve Board, some of which originated from the Federal Reserve Banks of Richmond and New York. Officials from the Office of Financial Stability also provided additional information.

Numerous issues have arisen in the aftermath of the Bank of America and Merrill Lynch merger. Some of these issues are the focus of ongoing investigations, including by SIGTARP’s Investigations Division, and are, therefore, not discussed in this report.

This performance audit was performed in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## **Limitations on Data**

Federal Reserve Board officials provided institution-specific data and an analysis of the state of the U.S. economy that was deemed sensitive, confidential, and, restricted. As a result, we could only generalize from the data obtained. In addition, we relied on the judgment of the staff from these offices to provide us with complete information for us to perform our review. Other data may exist that we did not have the opportunity to review.

## **Use of Computer-processed Data**

We relied on the financial institutions' quarterly and annual filings with the SEC. Because financial institutions are required by law to submit these financial statements, we view the information contained in them as the best representation of the institutions' financial standings.

## **Internal Controls**

As part of our review of the selection of the initial nine institutions to receive CPP funds and the decision to provide Bank of America with additional government support, we examined the government's criteria and rationale behind these one-time decisions. In this regard, we evaluated the internal controls over the decisions of Treasury and the Federal Reserve to validate the magnitude of the losses of Merrill Lynch and Bank of America.

## Appendix B—Measures To Stabilize Financial Markets before EESA Passage

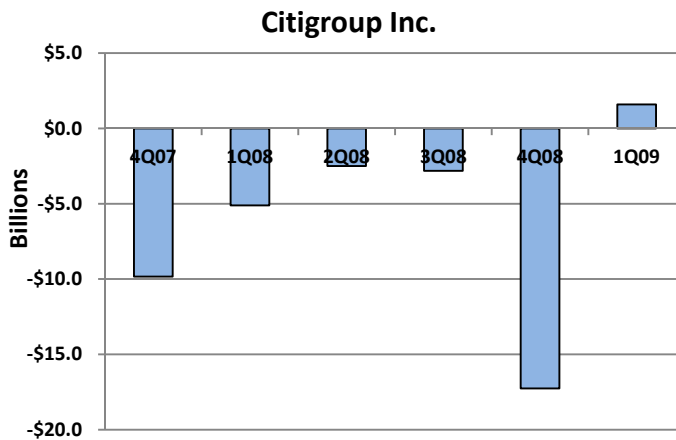
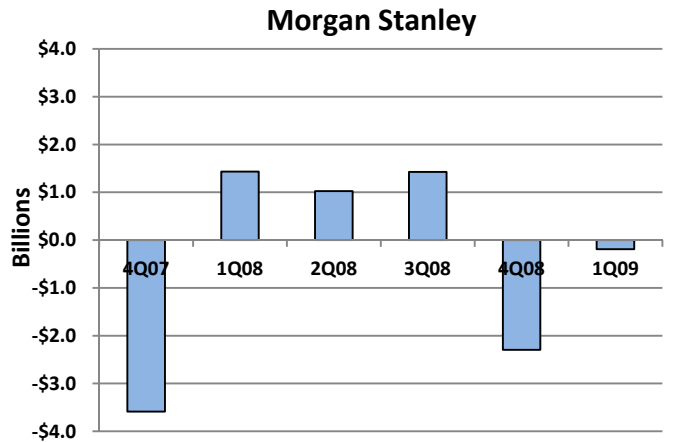
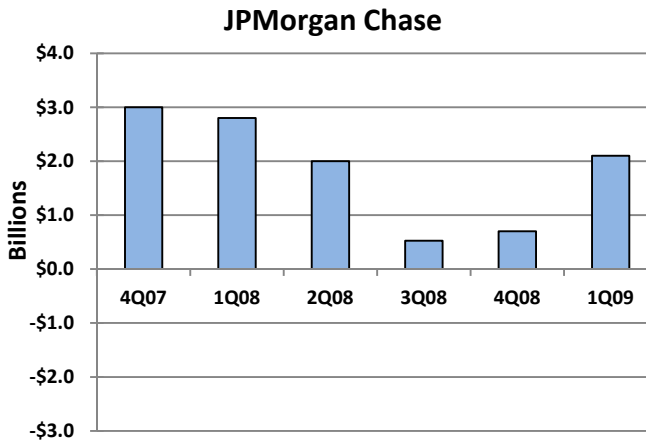
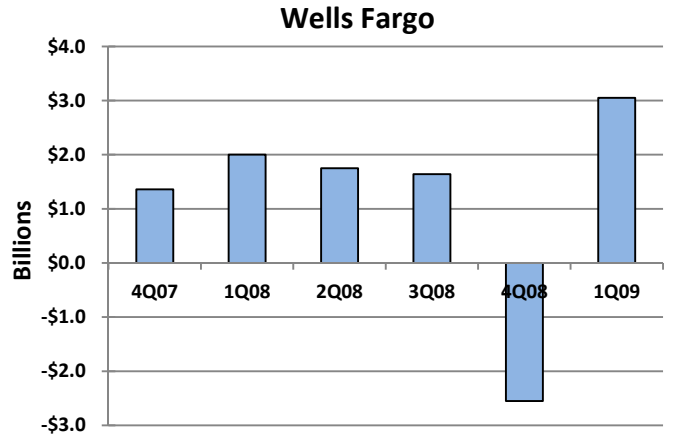
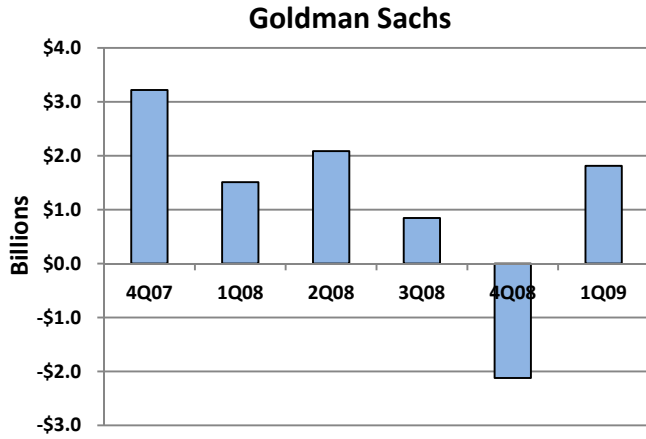
<b>Initiatives</b>	<b>Date</b>	<b>Agency</b>	<b>Description</b>
Reduce Primary Credit Rate	August 2007 to April 2008	<b>Federal Reserve</b>	Primary Credit Rate reduced from 5.75 percent to 2.25 percent. Maximum Primary Credit Borrowing Term increased to 30 days. The maximum term later increased to 90 days.
Reduce Federal Funds Rate			Federal Funds Rate reduced from 5.25 percent to 2 percent.
HOPE NOW	October 2007	<b>Treasury</b>	An alliance of investors, servicers, mortgage market participants, and credit and homeowners' counselors that works with at-risk homeowners to help prevent foreclosures.
Term Auction Facility	December 2007	<b>Federal Reserve</b>	Fixed amounts of term funds will be auctioned on a regular basis to depository institutions against a wide variety of collateral for terms of 28 days. Terms later extended up to 84 days.
Economic Stimulus Act of 2008	February 2008	<b>President of the United States</b>	Recovery Rebates, up to \$600, and Incentives for Business Investment
Term Securities Lending Facility	March 2008	<b>Federal Reserve</b>	Lending of Treasury securities for 28-day terms against a range of collateral. Terms later extended to up to 84 days.
Primary Dealer Credit Facility	March 2008	<b>Federal Reserve</b>	Extending credit to primary dealers at the primary credit rate against a broad range of investment-grade securities.
Limited liability company formed (Maiden Lane) to facilitate acquisition of Bear Stearns by JPMorgan Chase	March 2008	<b>Federal Reserve</b>	The FRBNY forms Maiden Lane to control \$30 billion of Bear Stearns assets that are pledged as security for \$29 billion in term financing at primary credit rate. JPMorgan Chase assumes first \$1 billion of any losses.
Increase of credit lines to Fannie Mae and Freddie Mac	July 2008	<b>Treasury</b>	A temporary increase in the credit lines to Fannie Mae and Freddie Mac, and a temporary authorization for Treasury to purchase equity in either enterprise if needed.
Temporary prohibition of short sales	July 2008	<b>Securities and Exchange Commission</b>	The Securities and Exchange Commission issues emergency order to limit short selling in the securities of Fannie Mae, Freddie Mac, and primary dealers at commercial and investment banks.
Housing and Economic	July 2008	<b>President of the</b>	Among other provisions, authorizes the

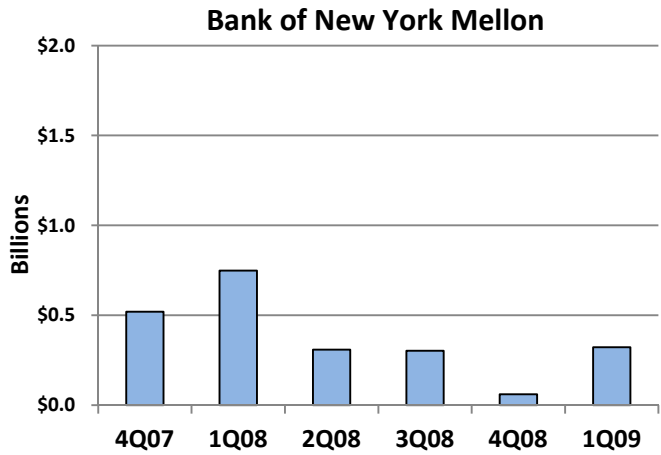
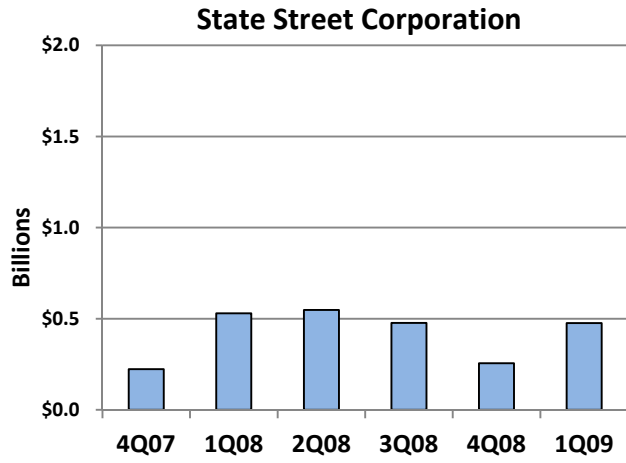
Recovery Act of 2008		<b>United States</b>	Treasury to purchase Fannie Mae's and Freddie Mac's obligations and reforms the regulatory supervision of these entities under a new Federal Housing Finance Agency.
Government conservatorship of Fannie Mae and Freddie Mac	September 2008	<b>Federal Housing Finance Agency and Treasury</b>	The Federal Housing Finance Agency places Fannie Mae and Freddie Mac in conservatorship. Treasury announces three additional measures to complement the decision: 1) preferred stock purchase agreements between Treasury/Federal Housing Finance Agency and Fannie Mae and Freddie Mac to ensure these entities positive net worth 2) a new secured lending facility that will be available to Fannie Mae, Freddie Mac, and the Federal Home Loan Bank 3) a temporary program to purchase Fannie Mae's and Freddie Mac's mortgage-backed securities
Lending Facility for AIG	September 2008	<b>Federal Reserve</b>	The Federal Reserve Board authorizes the FRBNY to lend up to \$85 billion to AIG under Section 13(3) of the Federal Reserve Act. Terms of Federal Reserve lending later amended in coordination with Treasury.
Temporary ban on short sales	September 2008	<b>Securities and Exchange Commission</b>	The Securities and Exchange Commission announces a temporary emergency ban on short selling in the stocks of all companies in the financial sector.
Creation of the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility	September 2008	<b>Federal Reserve</b>	Created to extend non-recourse loans at the primary credit rate to U.S. depository institutions and bank holding companies to finance their purchase of high-quality asset-backed commercial paper from money market mutual funds.
Temporary Guaranty Program for Money Market Mutual Funds	September 2008	<b>Treasury</b>	Treasury will insure the holdings of any publicly offered eligible money market mutual fund that pays a fee to participate in the program. The program will make \$50 billion available from the Exchange Stabilization Fund to guarantee investments in participating money market mutual funds.

Source: The Federal Reserve Bank of St. Louis, Treasury, and Public Law 110-185



# Appendix C—Net Income Gains and Losses from 2007 to 2009 of Seven U.S. Financial Institutions Receiving CPP Funds





Source: Morgan Stanley, Citigroup, State Street, and the SEC

## Appendix D—Selected U.S. Incorporated Bank Holding Companies by Total Assets (in \$ billions)

Name	Asset Value as of 6/30/08	Asset Value as of 9/30/08	Asset Value as of 12/31/08	Asset Value as of 3/31/09
Bank of America Corp	1,723.27	1,836.45	1,822.07	2,323.42
JPMorgan Chase & Co	1,775.67	2,251.47	2,175.05	2,079.19
Citigroup Inc.	2,100.39	2,050.13	1,938.47	1,822.58
Wells Fargo & Company	609.074	622.36	1,309.64	1,285.89
Goldman Sachs	N/A <sup>a</sup>	N/A <sup>a</sup>	1,125.23	925.29
Morgan Stanley	N/A <sup>a</sup>	N/A <sup>a</sup>	658.81 <sup>b</sup>	626.02
Wachovia Corporation	812.43	760.56	N/A	N/A
PNC Financial Service Group	142.79	145.64	291.09	286.47
U.S. Bancorp	246.54	247.06	267.03	263.62
Bank of New York Mellon Corp	201.34	267.64	237.65	203.88
SunTrust Banks	177.23	174.78	189.14	179.22
State Street Corp	146.52	286.71	176.63	144.86
Citizens Financial Group, Inc.	161.97	163.77	160.44	167.54
Capital One Financial Corp	151.11	154.80	165.91	177.39
Regions Financial Corp	144.44	144.29	146.25	141.95
BB&T Corporation	136.47	137.04	152.02	143.42
Fifth Third Bancorp	114.97	116.29	119.76	119.31
Key Corp	101.96	101.49	105.23	98.37

Source: Federal Reserve and the SEC

Notes: <sup>a</sup> Goldman Sachs and Morgan Stanley became bank holding companies in September 2008.

<sup>b</sup> As of November 30, 2008

## Appendix E—Key Events in the Bank of America and Merrill Lynch Merger

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When Merrill Lynch Chief Executive Officer concluded that Treasury and Federal Reserve officials were unlikely to provide assistance to Lehman Brothers, he realized that his institution could be next to fail and initiated plans for a merger. He reached out to Bank of America executives on September 13, 2008, seeking a deal in which Bank of America would acquire part of the firm. Uninterested in a partial investment, however, Bank of America pushed for a complete acquisition. Both institutions worked through that weekend and announced plans for the merger on Monday, September 15, 2008. After the merger announcement, both institutions began developing plans for integration. Shareholders of both institutions ratified the merger agreement on December 5, 2008, and the merger was completed on January 1, 2009.

Date	Events
13 September	Merrill Lynch contacts Bank of America to discuss a possible merger.
14 September	Bank of America and Merrill Lynch agree to merge.
15 September	Bank of America publicly announces plans to merge Merrill Lynch; at that time, Merrill Lynch's gains/losses estimated to be even for the fourth quarter of 2008.
26 November	Federal Reserve approves Bank of America's acquisition of Merrill Lynch.
5 December	Bank of America shareholders approve the acquisition of Merrill Lynch; Merrill Lynch's fourth quarter loss estimated to be about \$9 billion, after tax.
14 December	Bank of America updates Merrill Lynch's estimated fourth quarter losses to be about \$12.5 billion after tax (about \$18 billion pre-tax).
17 December	Bank of America informs Treasury and the Federal Reserve of its concerns over Merrill Lynch's fourth quarter losses and its possible withdrawal from merger, citing a MAC clause; Treasury requests a meeting with bank executives for that evening; Treasury request Bank of America not act while they consider the implications to the financial system of invoking the MAC.
19 December	Bank of America informs the Federal Reserve of additional losses discovered at Merrill Lynch. Losses at Merrill Lynch for the fourth quarter of 2008 eventually total \$15.31 billion (after tax).
21 December	Bank of America informs Treasury that it is still considering invoking the MAC clause; Treasury stated that management and Board of Directors could be removed if Bank of America invoked the MAC clause; Bank of America requested a de-escalation on the issue; Bank of America calls its Board to discuss Treasury's position; Treasury assures Bank of America that the government will stand behind the company.
22 December	Bank America informs its Board of conversations with Treasury and the Federal Reserve. The Board is also informed that Bank of America will not invoke the MAC clause and that Treasury and the Federal Reserve agreed to provide additional assistance. At that time, Treasury and the Federal Reserve had not provided written assurance of such assistance.
30 December	Bank of America executive convenes a special meeting with the Board of Directors to update members on the progress he is making with Treasury and the Federal Reserve regarding additional government assistance.
1 January 2009	Bank of America and Merrill Lynch merger closes.
16 January 2009	Bank of America announces additional TARP assistance through the TIP and AGP and fourth quarter 2008 and end-of-year earnings.

Source: The State of New York Office of the Attorney General and SIGTARP's analysis of statements from Mr. Lewis, Chairman Bernanke, former Secretary Paulson

## Appendix F—Definitions of Acronyms

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<b>Acronym</b>	<b>Definition</b>
AGP	Asset Guarantee Program
AIG	American International Group
Bank of America	Bank of America Corporation
Bear Stearns	Bear Stearns Companies
Citigroup	Citigroup Inc.
CPP	Capital Purchase Program
EESA	Emergency Economic Stabilization Act
Fannie Mae	Federal National Mortgage Association
FDIC	Federal Deposit Insurance Corporation
FRBNY	Federal Reserve Bank of New York
Freddie Mac	Federal Home Loan Mortgage Corporation
Goldman Sachs	Goldman Sachs Group, Inc.
JPMorgan Chase	JPMorgan Chase & Co.
LIBOR	London Interbank Offered Rate
MAC clause	Material Adverse Change clause
Merrill Lynch	Merrill Lynch & Co., Inc.
OCC	Office of the Comptroller of the Currency
OIS	Overnight Indexed Swap
SEC	Securities and Exchange Commission
SIGTARP	Special Inspector General for the Troubled Asset Relief Program
State Street	State Street Corporation
TARP	Troubled Asset Relief Program
TIP	Targeted Investment Program
Wachovia	Wachovia Corporation
WaMu	Washington Mutual Inc.
Wells Fargo	Wells Fargo & Company

## **Appendix G—Audit Team Members**

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This report was prepared and the review was conducted under the direction of Barry W. Holman, Director of Audits, Office of the Special Inspector General for the Troubled Asset Relief Program.

The staff members who conducted the audit and contributed to the report include:

Scott Harmon

Tinh T. Nguyen

James Shafer

# Appendix H—Management Comments from the Federal Reserve Board

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BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551

September 29, 2009

SCOTT G. ALVAREZ  
GENERAL COUNSEL

Mr. Neil Barofsky  
Special Inspector General  
For the Troubled Asset Relief Program  
1801 L Street, NW  
Washington, DC 20220

Dear Mr. Barofsky:

Thank you for the opportunity to comment on your draft audit report dated September 18 and titled *Emergency Capital Injections Provided to Support the Viability of Bank of America, Other Major Banks, and the U.S. Financial System*.

The draft report describes the increasingly dire circumstances that the financial industry faced in the fall of 2008 and, with increasing intensity, throughout the fourth quarter. We concur with the report's conclusions that rapidly deteriorating economic conditions led to the creation of the Capital Purchase Program ("CPP"); the initial CPP funds were provided to stabilize the markets; and officials believed that termination of the merger with Merrill Lynch could undermine the viability of Bank of America and destabilize the financial system.

The report supports the view that Bank of America's Chief Executive Officer Ken Lewis chose to go forward with the Merrill Lynch merger because it was in the best interests of Bank of America's shareholders; that communications between regulators and Mr. Lewis were proper; and that the additional assistance provided to Bank of America in January was based on Bank of America's financial situation in light of the Merrill Lynch merger.

We also agree that an important lesson illustrated by the events that shocked the financial systems over the past two years is that transparency and effective communication are important to restoring and maintaining public confidence, especially during a financial crisis. The Federal Reserve's commitment to transparency and effective communication is illustrated in numerous detailed announcements of its actions to address the financial crisis and in volumes of supporting information it has made available to the public detailing its actions and programs. Together the Federal Reserve's numerous actions and unprecedented transparency have played a critical role, along with the actions of the Department of the Treasury, other federal agencies and the

2.

Congress, in helping to abate the financial crisis. We remain committed to restoring and maintaining financial stability and a high level of transparency, and will continue to work with you as you concomitantly review these efforts.

Sincerely,

A handwritten signature in blue ink, reading "Scott G. Olsen". The signature is written in a cursive style with a large, prominent loop at the end of the last name.



# Appendix I—Management Comments from Treasury

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ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

October 1, 2009

Neil M. Barofsky  
Special Inspector General  
Office of the Special Inspector General for the Troubled Asset Relief Program  
1500 Pennsylvania Ave., NW, Suite 1064  
Washington, D.C. 20220

RE: SIGTARP Official Draft Report

Dear Mr. Barofsky:

Thank you for providing us the opportunity to review and comment on your audit report on the selection process for the first nine financial institutions that received funds under the Capital Purchase Program (CPP). This letter provides the Department of the Treasury's (Treasury) official comment on the official draft report.

The history of the events that led to the passage of EESA and the first injections under the CPP will be the subject of much study for years to come. While that history may be told differently by different persons, so that no report is likely to be the definitive work on the subject, this report is a useful contribution to that body of knowledge. As you have described in the report, the nation faced the risk of an imminent, potentially catastrophic, collapse of our financial system. Immediate direct injections of capital into key financial institutions—in addition to other measures--were needed to stabilize the system and prevent further disruption of the U.S. economy.

We believe the most important lesson from this history is that quick, forceful action prevented a catastrophic meltdown of the system. While people may differ today on how the contemporaneous announcements about the reasons for selecting the initial nine recipients should have been phrased, any review of such announcements must be considered in light of the unprecedented circumstances in which they were made.

We share your commitment to transparency and accountability in all of TARP's programs and policies, and we look forward to working with you and your team as we continue our efforts to stabilize our financial system.

Sincerely,

A handwritten signature in blue ink that reads "Herbert M. Allison, Jr." with a stylized flourish at the end.

Herbert M. Allison, Jr.  
Assistant Secretary for Financial Stability

## SIGTARP Hotline

If you are aware of fraud, waste, abuse, mismanagement, or misrepresentations associated with the Troubled Asset Relief Program, please contact the SIGTARP Hotline.

*By Online Form:* [www.SIGTARP.gov](http://www.SIGTARP.gov)

*By Phone:* Call toll free: (877) SIG-2009

*By Fax:* (202) 622-4559

*By Mail:*

**Hotline: Office of the Special Inspector General  
for the Troubled Asset Relief Program**

1801 L Street, NW, 4<sup>th</sup> Floor  
Washington, D.C. 20220

## Press Inquiries

If you have any inquiries, please contact our Press Office:

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202-927-8940

## Legislative Affairs

For Hill inquiries, please contact our Legislative Affairs Office:

Lori Hayman  
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202-927-8941

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