



**SIGTARP**

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

ADVANCING ECONOMIC STABILITY THROUGH TRANSPARENCY, COORDINATED OVERSIGHT AND ROBUST ENFORCEMENT

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SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

**STATEMENT OF KEVIN R. PUVALOWSKI**

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

BEFORE THE  
HOUSE COMMITTEE ON FINANCIAL SERVICES  
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

May 11, 2010

Chairman Moore, Ranking Member Biggert, and Members of the Committee:

Thank you for this opportunity to apprise you of the Office of Special Inspector General for the Troubled Assets Relief Program's ("SIGTARP") audit assessing Treasury's process to sell warrants it received from Troubled Asset Relief Program ("TARP") recipients.

## **Background**

EESA mandated that financial institutions receiving TARP assistance provide warrants to Treasury as a way to generate additional returns for taxpayers. Under TARP's Capital Purchase Program ("CPP"), Treasury invested \$204.9 billion in 707 banks and other financial institutions in exchange for preferred stock and, in some instances, debt securities. In connection with these CPP transactions, Treasury received warrants from 282 publicly traded banks and 402 companies that are private, S-corporations, or mutual holding companies. For these 402 companies, Treasury received warrants of additional preferred shares or debt instruments, in an amount equal to five percent of the CPP investment, that were immediately exercised when the investments were made, thus effectively providing Treasury more preferred shares or debt than it purchased. For publicly traded institutions, Treasury received warrants of common stock with a 10-year expiration date that give Treasury the right to purchase common stock worth 15 percent of the total amount of Treasury's CPP investment in the institution.

Treasury also received warrants for common stock in companies in connection with investments made under other TARP programs. Specifically, Treasury has received warrants from American International Group under the Systemically Significant Failing Institutions program, from Citigroup and Bank of America under the Targeted Investment Program, from Citigroup under the Asset Guarantee Program, from General Motors and GMAC under the Automotive Industry Financing Program, and from each of the Public-Private Investment Funds under the Legacy Securities Public-Private Investment Program.

As recipient institutions repay their TARP investments, Treasury sells the warrants, either directly to the recipient institution at a negotiated price or via public auction. Because warrants of this duration are not typically traded on an open market, however, determining their value is not straightforward. Treasury determines a fair market value estimate for the warrants, called a "composite value," after referencing three different pricing methods: market quotes, financial modeling outputs and third-party estimates. Treasury uses the composite value as a reference when considering whether to accept recipients' bids for the warrants.

In light of this factual context, and consistent with the questions raised by Senator Jack Reed, Representative Maurice Hinchey, and others, SIGTARP's audit addressed (1) the process and procedures Treasury has established to ensure that the Government receives fair market value for the warrants; and (2) the extent to which Treasury follows a consistent and well-documented process in reaching its decision to sell warrants back to recipient institutions. Although SIGTARP's audit did not address Treasury's valuation methodologies, it is intended to complement a Congressional Oversight Panel report released on July 10, 2009, that examined the warrant valuation process.

## **Treasury's Warrant Repurchases**

To its credit, Treasury has generally succeeded in negotiating prices from recipients for the warrants at or above its estimated composite value. Of the 33 public company warrant repurchases completed through March 19, 2010, 20 of the final negotiated prices were at or above Treasury's composite value, and 9 of the final negotiated prices were just under the composite value (generally between 90-99 percent of composite value). Of the 4 remaining transactions, 2 were the first two transactions completed (during which time Treasury was operating under a governing statute that limited how long Treasury had to negotiate and before Treasury had its valuation methodology worked out), and the other 2 were for warrants in small institutions that received less than \$100 million in TARP funds (for which valuation is particularly difficult because of less liquidity in the bank's stock). Treasury has over time been more consistent in obtaining negotiated prices at or above its estimated composite value. Recent sales of warrants in larger, more widely traded firms have contributed to this trend, as has improved transparency in the market for long-term warrants overall. This is an important accomplishment that reflects a significant improvement in Treasury's ability to better realize returns for the taxpayer since the Congressional Oversight Panel's initial review of the warrant process in its July 2009 report. In total, for all warrant transactions (repurchases and auctions) through March 19, 2010, Treasury received \$5.63 billion in proceeds from warrant sales.

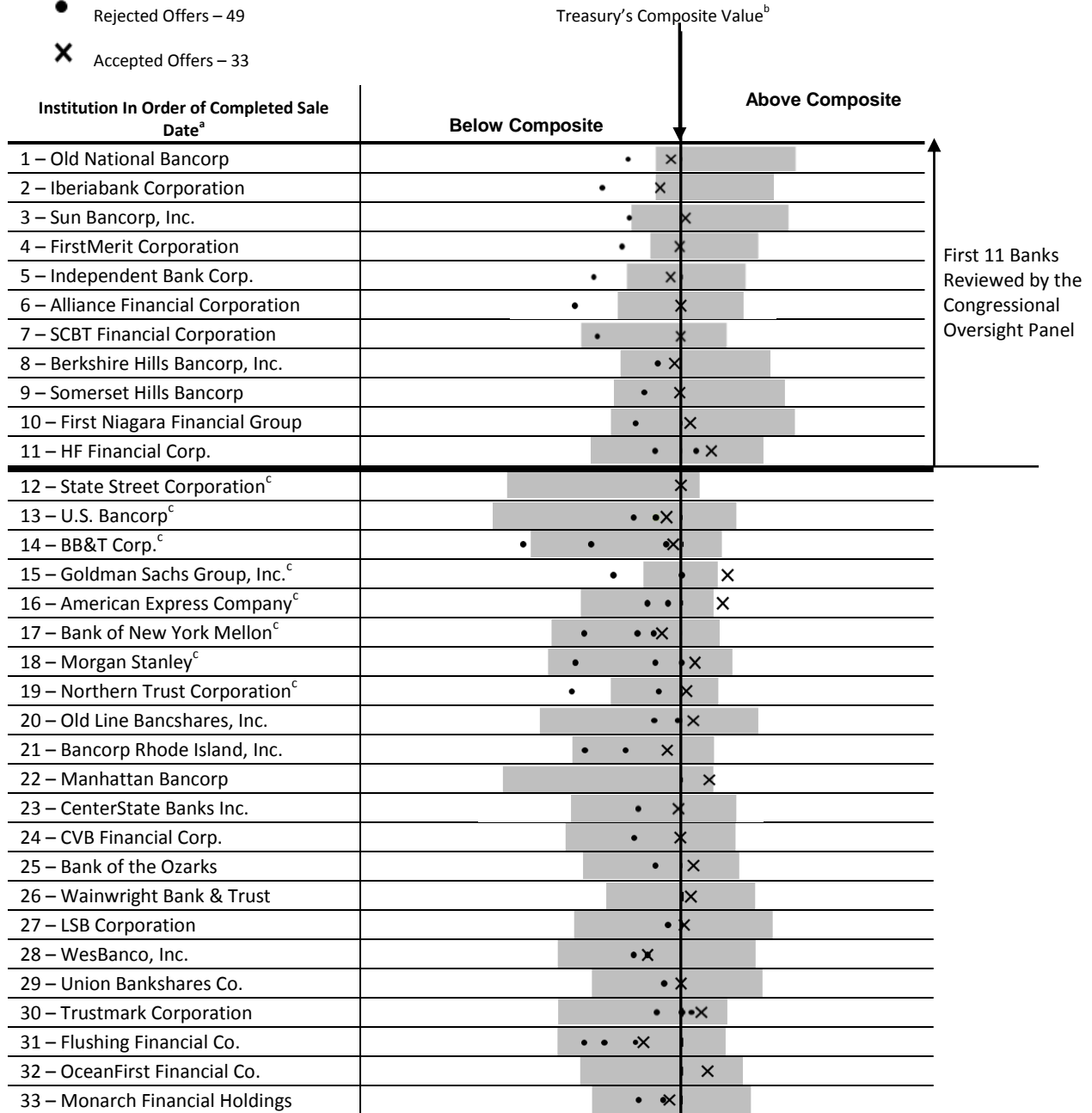
The following chart illustrates the final negotiated price in comparison to Treasury analysts' estimate of value captured in the composite value. Treasury's decisions tend to center around its analyst's determination of composite value.

## Comparison of Treasury’s Acceptance of Offers and Composite Value for Completed Warrant Transactions through March 19, 2010

■ Aggregate Price Range – 33

● Rejected Offers – 49

✕ Accepted Offers – 33



Notes: a. Bars are positioned on the axis in the order that the bank completed the warrant transaction.  
 b. Bars are not drawn to scale. The bars in this figure show the total range of all estimates provided by Treasury’s three independent pricing mechanisms. Morgan Stanley submitted the same dollar amount as its second offer; hence, the graphic above appears to present only one offer because the offers overlap.  
 c. These are larger institutions that received at \$1 billion or more in TARP funds.

Source: SIGTARP analysis of Treasury data.

SIGTARP's audit, however, identified two broad areas in which Treasury's process for selling warrants directly to financial institutions is lacking in ways that impair transparency and have led to a lack of consistency in the process.

The first area of concern is that Treasury does not sufficiently document important parts of the process, impairing transparency and making a comprehensive review of the integrity of the decision-making process impossible. This documentation issue manifests itself in two important contexts. One, Treasury lacks detailed documentation supporting the decisions of the Warrant Committee, the internal Treasury committee that reviews TARP recipients' offers to repurchase their warrants and makes recommendations to the Assistant Secretary on whether to accept or reject them. Most of the meeting minutes from Warrant Committee sessions were extremely limited and included only the name of the institution, the institution's offer amount, the name of the analyst who presented Treasury's analysis of fair market value, the analyst's recommendation on whether to accept or reject the offer, whether the offer was at or close to the analyst's composite value, and the final vote of the Warrant Committee members. Significantly, the minutes generally do not reflect the qualitative factors considered by the Warrant Committee members when making determinations whether to accept or reject a bank's offer, or their justifications or explanations for their decisions.

This lack of documentation contrasts significantly to that of Treasury's Investment Committee (part of the decision-making process for making TARP investments), even though both processes are designed to support a financial decision about a particular firm and both committees discuss analysts' assessments of potential transactions. Investment Committee minutes, for example, capture details regarding the qualitative factors that the Investment Committee members consider in support of each decision. SIGTARP found far less documentation supporting the warrants sale decision-making process than was standardized and required for the comparable TARP investment process.

This deficiency significantly limits the ability to test the consistency of Treasury's decisions. Treasury's decision making with respect to two institutions, HF Financial and Somerset Hills, for example, appeared inconsistent when viewed in light of the meager information provided in the Warrant Committee minutes. Although Treasury officials were able to provide justifications for the different treatment of the two institutions in interviews in connection with this audit, this is not an adequate alternative to proper documentation in the first instance. Memories fade over time (as demonstrated in the case of Somerset Hills, in which a member of the Warrant Committee could not recall the precise liquidity discount percentage that he identified as being key to his decision), Treasury officials leave office, and although SIGTARP does not question the explanations provided by Treasury during the audit process, it is also impossible to know, without adequate documentation, if the explanations accurately and fully reflect the factors the members of the Warrant Committee actually considered at the time they made their decisions. The development of a full record on decisions that can mean the difference of tens of millions of dollars to taxpayers should not depend on whether an oversight body happens to examine a particular transaction (particularly, when, as here, hundreds of transactions will be occurring over a period of years), if the particular decision maker happens to still be available, or if that decision maker has a detailed recollection of the transaction. Even assuming that Treasury is making decisions in every case based upon reasonable and fair rationales, in the absence of documentation Treasury leaves itself vulnerable to criticism that its decisions are unwise, arbitrary or unfair.

Even more troubling, Treasury similarly does not document the substance of its conversations and negotiations with the recipient institutions. Treasury officials can interact directly with the recipient institution on several occasions during the warrant repurchase process. As discussed below, the transactions examined in detail in this audit suggest that the amount of information provided to recipient institutions concerning the price that Treasury is likely to accept, information that is only shared with some institutions, can have a significant impact on the return realized by taxpayers. Because Treasury does not make note of these conversations (or even keep a list of the institutions with which it shares such information), however, SIGTARP was only able to partially reconstruct, for the sample of eight institutions interviewed for this audit, the substance of the conversations and their import based on interviews conducted at times long after the fact. Again, memories fade and with the passage of time and the occurrence of intervening negotiations, different parties to a conversation may have different recollections of what occurred. When a brief telephone call can mean the difference of tens of millions of dollars, it is a basic and essential element of transparency and accountability that the substance of that call be documented contemporaneously.

The second significant deficiency is that Treasury does not have established guidelines or internal controls over how the negotiations proceed, and in particular as to how much information is shared with recipient institutions about Treasury's estimated fair market value and the price it will likely accept for the repurchase of the warrants. Descriptions provided to SIGTARP by several of the banks that engaged in negotiations with Treasury confirmed that Treasury was willing to provide detailed information about its estimates, including clear indications as to what prices it was prepared to sell the warrants back to certain banks, but was unwilling to share similar details with others. Moreover, although Treasury indicated that it generally would not provide an indication of its valuation until the institution's bid was close and the Assistant Secretary stated that Treasury generally engaged in a strategy not to provide specific valuation numbers because it would give away key negotiating leverage, the cases examined in detail in the audit simply do not bear this out. Indeed, in the negotiation reviewed by SIGTARP, the amount of information provided, the circumstances of when information would be provided, and the results of the negotiation were all over the lot:

- Old National Bancorp received information about Treasury's valuation range even though its bid was less than half of Treasury's composite value; it came back with a bid just under the composite, which was accepted.
- Sun Bancorp's initial bid was only about half of Treasury's composite value. Treasury responded with a specific number that was substantially higher than its composite value. Sun's next bid was just over the composite value and was accepted.
- SCBT Financial was told expressly that its initial bid used too large a liquidity discount; SCBT's subsequent bid, which utilized Treasury's suggested discount, was essentially at Treasury's composite value and was accepted.
- Following conversations with Treasury, Somerset Hills was clear what Treasury's valuation range was; their subsequent bid was right at Treasury's composite value and was accepted.
- Treasury gave essentially no information to American Express about its valuation even though the bank's second offer, \$260 million, was just \$20 million (7.1 percent) less than Treasury's composite value of \$280 million and thus within the percentage range where

other offers had been accepted. American Express's next bid, which was accepted, was \$340 million, far in excess of Treasury's composite value.

- Treasury suggested a specific figure that it would accept from Sterling Bank, but Sterling found that figure to be too high, even after Treasury then offered an even lower figure. Its warrants will be auctioned.
- Treasury provided essentially no valuation guidance to JP Morgan Chase and suggested that it would not do so even if the bank submitted a further bid. As a result, JP Morgan declined to submit a subsequent bid and went to auction, at which Treasury received approximately \$950 million, \$50 million less than its composite value.

These differing approaches and results raise important questions: what rationale is there for such disparate treatment, and, if Treasury officials believe that not providing specific valuation figures generally leads to a better negotiating position, what was the contemporaneous justification each time that Treasury elected not to follow that strategy? There are potentially good reasons for treating institutions differently—owing to differences in the size of institutions and thus the liquidity of their stock and to the costs of an auction if negotiations fail, for example—but because Treasury does not document the negotiations with financial institutions and because there are no established guidelines or criteria for what information is shared or when it will be shared, it is impossible to determine with certainty after the fact whether the difference in the quantity and timing of the sharing of information is justified or consistently applied, or if those decisions resulted in a benefit or a detriment to the taxpayer.

The case of the negotiations with Morgan Stanley is illustrative of these deficiencies in Treasury's warrant disposition process.

- The Warrant Committee minutes do not describe what Treasury's reasoning was with regard to its consideration of Morgan Stanley's bid, or even what in fact occurred. The minutes reflect, without substantial explanation, that the Warrant Committee had approved Morgan Stanley's bid of \$900 million; however, later documentation reflects, again without explanation, that the \$900 million bid was not approved.
- Notwithstanding the fact that SIGTARP was told by the Assistant Secretary that he had not overruled any decisions of the Warrant Committee, in an interview, the Assistant Secretary explained that, after receiving a recommendation to accept Morgan Stanley's \$900 million offer, rather than following that recommendation, he instead suggested that the Warrant Committee re-run its analysis with respect to Morgan Stanley because of an intervening increase in Morgan Stanley's stock price; that reason, however, was not documented.
- The critical telephone negotiation between the Assistant Secretary and Morgan Stanley officials during which Morgan Stanley's \$900 million offer was rejected was not documented by Treasury, and the parties have significantly different recollections about that call. The Assistant Secretary initially said that Morgan Stanley called him, but the Morgan Stanley official told SIGTARP that it was the other way around. A contemporaneous document indicates that the Assistant Secretary initiated the call, and the Assistant Secretary later said that it is possible that he called Morgan Stanley, but that he just could not remember. The Assistant Secretary told SIGTARP that he does not negotiate on such calls but just listens to the recipients' pitch and/or conveys Treasury's

position; but Morgan Stanley stated that the Assistant Secretary made it clear that Treasury would not accept \$900 million and that Morgan Stanley would have to bid substantially higher. Indeed, internal Morgan Stanley e-mail unambiguously states that the Morgan Stanley official understood from that call that Morgan Stanley would have to bid \$950 million or face a public auction. The Assistant Secretary, however, told SIGTARP that he would not have told Morgan Stanley that they would have to bid at least \$950 million because it would give away key leverage. He stated that, by not revealing Treasury's target price to the bidder, Treasury is more likely to receive a bid exceeding its valuation.

- Morgan Stanley ultimately bid \$950 million, \$50 million over Treasury's composite value and \$50 million more than the Warrant Committee had initially approved.

Although the Assistant Secretary should be commended for exercising the initiative to intercede by overruling the Warrant Committee's initial recommendation and thus obtaining \$50 million more for taxpayers from Morgan Stanley, this example shows how Treasury's lack of documentation at critical points in the process and the lack of overarching guidelines can lead to difficult questions. What were the specific factors that were contemporaneously considered by the Warrant Committee that led to its initial approval of Morgan Stanley's \$900 million bid, and without documentation of those factors, how can Treasury determine what changes, if any, are needed in that deliberative process? What actually occurred on the critical call between the Assistant Secretary and Morgan Stanley? Could similar tactics by Treasury have resulted in similarly favorable prices for taxpayers from other large institutions? Why was Morgan Stanley apparently provided a price at which Morgan Stanley believed that the warrant transaction would close, while others, including American Express and JP Morgan Chase, were not? These difficult questions simply cannot be answered definitively after the fact because Treasury has not done an adequate job thus far in documenting its decision making and its negotiations, or in developing guidelines as to how much information is shared with banks during the negotiation process.

Unless Treasury addresses these deficiencies, it risks subjecting itself once again, fairly or unfairly, to criticism from third parties that through TARP it is favoring some institutions over others—picking winners and losers—irrespective of whether in fact it had legitimate reasons to take the negotiating positions that it did. Although SIGTARP acknowledges that every case is different and that Treasury needs to have some flexibility to address each particular situation, without some objective guidelines and, importantly, internal controls to ensure that such guidelines are followed, the risks and costs of arbitrary results and unjustifiable disparate treatment are just too great. The absence of documentation and uniform guidelines for negotiation may make it difficult for Treasury to defend itself convincingly against charges of arbitrariness or favoritism. Only through adoption of the recommendations below can Treasury minimize this reputational risk.

### **Audit Recommendations and Treasury's Response**

To address the deficiencies that were identified, SIGTARP's audit recommends that:

1. Treasury should ensure that more detail is captured by the Warrant Committee meeting minutes. At a minimum, the minutes should include the members' qualitative considerations regarding the reasons bids were accepted or rejected within fair market value ranges.



2. Treasury should document in detail the substance of all communications with recipients concerning warrant repurchases.
3. Treasury should develop and follow guidelines and internal controls concerning how negotiations will be pursued, including the degree and nature of information to be shared with repurchasing institutions concerning Treasury's valuation of the warrants.

SIGTARP received an official written response to the audit report from Treasury. In that response, although Treasury stated that it did not agree with all of the report's findings, Treasury noted its view that the audit report should be helpful in explaining this complicated subject to the public. With respect to the audit report's recommendations, Treasury agreed to review their procedures to ensure that there is sufficient consistency in their process, but did not specifically respond to our recommendations; instead, Treasury indicated that it would respond more fully to the report's findings and provide a detailed description of the actions it intends to take with regard to the concerns raised in the report within 30 days. SIGTARP will provide an update on Treasury's follow-up response in its next Quarterly Report to Congress.

Chairman Moore, Ranking Member Biggert, and Members of the Committee:

I want to thank you again for this opportunity to appear before you, and I would be pleased to respond to any questions that you may have.

If you are aware of fraud, waste, abuse, mismanagement or misrepresentations affiliated with the troubled asset relief program, please contact the SIGTARP Hotline.

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