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CONGRESSIONAL OVERSIGHT PANEL

JULY OVERSIGHT REPORT *

SMALL BANKS IN THE CAPITAL PURCHASE PROGRAM

JULY 14, 2010.—Ordered to be printed

* Submitted under Section 125(b)(1) of Title 1 of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110–343

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EXECUTIVE SUMMARY *

In late 2008, as the financial markets neared collapse, Congress provided Treasury with the authority to spend up to $700 billion through the Troubled Asset Relief Program (TARP). Treasury's first and largest use of its new authority was to create the Capital Purchase Program (CPP), which would eventually pump nearly $205 billion into 707 banks across the country. Through this massive display of financial force, Treasury hoped to restore confidence in the markets, return stability to the financial system, and restart the flow of credit.

The Panel has focused past CPP oversight on the experience of the nation's largest banks, which received the lion's share of the program's funding. Of the 19 American banks with more than $100 billion in assets, 17 participated in the CPP, receiving 81 percent of the total CPP funds. Money was made available to these banks in only a matter of weeks, in some cases even before the banks applied for the funds. Most of these large CPP banks have already repaid taxpayers, and many are now reporting record profits. By contrast, of the 7,891 banks with assets of less than $100 billion, only 690 received funds from the CPP. Those banks experienced a much longer and more stringent evaluation, and many are now struggling to meet their obligations to the taxpayers.

The CPP had a different impact on large and small banks in part because these banks vary in a number of fundamental ways. Small banks, for example, do not benefit from any "too big to fail" guarantee; their regulators have been quite willing to close down failing institutions. Small banks are disproportionately exposed to commercial real estate, where future losses are likely. Small banks are

* The Panel adopted this report with a 5–0 vote on July 13, 2010.

often privately held or thinly traded and have limited access to capital markets. Despite these differences, Treasury provided CPP capital under only a single set of repayment terms. This "one-size-fits-all" approach appears to have suited large banks much better than their smaller counterparts.

Most significantly, Treasury's terms included very strong incentives for banks to repay taxpayers and to exit the CPP within a five-year period. In the current distressed financial market, however, smaller banks may find it difficult or impossible to raise the capital necessary for repayment. Some banks are already having difficulty making their dividend payments, and the circumstances facing these banks may grow more acute over time. Beginning in 2013 the dividend rate charged to CPP-recipient banks will rise from today's relatively modest 5 percent to a very expensive 9 percent. If they are unable to access new capital by the time the dividend rate increases, more small banks may become trapped, with no way either to escape the CPP or to pay their required dividends. A growing number could default on their obligations to taxpayers, be forced to consolidate, or collapse completely. Consolidation or failure may be appropriate for some weak and poorly managed banks, but it would be unfortunate if well-run institutions were forced onto this path solely due to the CPP.

In principle, Treasury established safeguards to ensure that CPP-recipient banks would not fall into this trap. Because the CPP was announced to stabilize the banking system, not to rescue troubled banks, there were a number of restrictions in place to ensure that the banks receiving CPP funding would not have difficulties repaying. CPP funding for small banks was capped at 5 percent of risk-adjusted capital, and funding was offered only to banks deemed "healthy" by their primary regulator. In practice, these safeguards appear to have been insufficient. CPP-recipient small banks appear to be no healthier than other small banks, and the broader small bank sector is struggling under the general strain of a poor economy and the more acute strain of commercial real estate liabilities. One in seven small banks in the CPP has already missed a dividend payment, and fewer than 10 percent of CPP-recipient small banks have repaid taxpayers. At the moment Treasury has $24.9 billion in CPP funds outstanding at small banks, and the prospects for full recovery are uncertain.

It is also unclear whether the participation of small banks in the CPP has advanced Treasury's broader aims for the program. Treasury's main stated goal was to restore stability to the financial system, but the participation of small banks likely did not advance this cause. Even in the aggregate, by themselves the smaller CPP banks comprise too small a share of the banking sector to be systemically significant. Treasury's other initial goal was to increase credit availability, but as the Panel explored in depth in its May 2010 report, there is very little evidence to suggest that the CPP led small banks to increase lending.

More recently, Treasury has articulated a different reason for opening the CPP to small institutions: fairness. In this view, Treasury had an obligation to provide smaller banks with the same access to capital as larger banks so as to avoid tilting the playing field in favor of larger institutions. Yet the ideal of fairness will be poorly served if the CPP has the effect of stabilizing large institu-

tions while smaller institutions continue to struggle with growing losses and no capacity to repay their obligations to the taxpayers. Indeed, one of the most lasting and troubling effects of the CPP may be to increase concentration in the banking sector. In its earliest days the CPP provided a capital cushion that helped large banks weather the financial crisis and, in some cases, purchase smaller banks. Now small banks continue to struggle and the TARP provides little relief.

Although the majority of CPP small banks have so far managed to pay their dividends on time, evidence is mounting that many banks will fall behind in the future. Treasury should take immediate steps to ensure that as many banks as possible repay taxpayers and to prepare to deal accordingly with the banks that cannot. In particular, Treasury should work to support CPP banks' efforts to raise new capital, and it should articulate processes for finding and appointing board members for banks that fall too far behind on their dividend payments.

In the end, there is little evidence that the CPP has strengthened the small bank sector. As the small banking sector continues to struggle, the number of small banks that were once deemed healthy but that cannot make their dividend payments and repay their TARP obligations may grow. So long as small banks remain weak, their lending to customers—especially to small businesses—will remain constricted and will have a dampening effect on any economic recovery.

SECTION ONE

A. Introduction

Treasury announced the Troubled Asset Relief Program's (TARP) Capital Purchase Program—the CPP—in October 2008 as one of the programs authorized by the Emergency Economic Stabilization Act (EESA).[1] Under the CPP, Treasury provided capital to financial institutions in order to promote systemic stability and promote the flow of credit. In exchange, Treasury received senior preferred stock or subordinated debentures and, in most cases, warrants. The CPP was the largest of three capital injection programs under the TARP, providing 707 banks with capital injections totaling nearly $205 billion.[2] Funding under the program ended in December 2009.

The first CPP recipients were among the largest banks in the country. Subsequently, early in 2009, and as described in greater detail in the Panel's June 2009 report, the nation's 19 largest bank holding companies (BHCs) were "stress-tested" by the Federal Reserve Board of Governors (Federal Reserve) to determine whether their capital reserves were adequate. These BHCs, which had assets above $100 billion, were estimated at the time to hold approximately two-thirds of domestic BHC assets and over one-half of domestic loans, and Treasury and the Federal Reserve deemed their health to be critical to the stability of the banking system as a whole. After the stress tests concluded, the Federal Reserve and Treasury required some of the stress-tested banks to raise more capital.

Although more than 700 banks received CPP funds, the small number of very large banks above the stress-test limit received the lion's share of that money. In total, the stress-tested banks received 81 percent of the CPP funds, while the other 690 CPP recipient banks received 19 percent of the total CPP funds disbursed, approximately $40 billion, of which $24.9 billion is outstanding. These banks are regionally diverse banks that range in size from very small—less than $1 billion in assets—to very large, but just below $100 billion in assets. Since taking CPP funds, these banks have generally continued operations in a banking sector that remains weak. Some have merged, some have failed, some have expanded, and some, but by no means all, have repaid their TARP funds, while others—nearly one in seven—have missed dividend payments on their CPP preferred shares to Treasury. Treasury's portfolio of preferred shares and warrants therefore represents investments in a struggling sector and in a variety of disparate banks whose most obvious common trait is that they took CPP funds.

In this report, the Panel evaluates CPP's investments in small banks and attempts to judge the program's success by Treasury's own stated goals. In the early days of the CPP, when Treasury described its goals for the program, Treasury said that its primary goal was to stabilize the financial system, while its secondary goal

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[1] Emergency Economic Stabilization Act of 2008 (EESA), 110th Congress (12 U.S.C. § 5201, *et seq.*).

[2] U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for the Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transactionreports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf) (hereinafter "Treasury Transactions Report for the Period Ending June 30, 2010").

was to increase credit.[3] Treasury further explained that it included banks of all sizes in order to increase credit availability to the communities served by those disparate banks. But the links between these broad goals and including smaller banks in the program may be tenuous.

The first goal—systemic stability—would not seem to have required the participation of smaller banks, although smaller CPP recipients were able to shore up their capital positions. The CPP, like the other TARP programs, was created in response to shocks to the financial system and the credit freeze caused by faltering, large, interconnected financial institutions. But by December 2008, when Treasury said that increasing capital in banks had already stabilized the system, for the most part only the larger banks had entered the program.[4] It would be a year before the smaller banks completed their entry. When they did, they represented less than a tenth of the number of banks in the United States and held less than 16 percent of the assets in the banking industry,[5] and they received only a small fraction of the CPP funds. Furthermore, it is clear that the missteps of a single smaller bank could not have frozen the credit markets and drained investor confidence, and there are few indications that even in the aggregate, by themselves the smaller CPP recipients have that sort of systemic significance.

The second goal—increasing credit availability—has had indifferent success, as the Panel explored in depth in its May 2010 report on the small business credit crunch.[6] While some CPP recipients increased lending, some did not, and it is very difficult to attribute shifts in lending levels to the receipt of CPP funds.[7]

Treasury has also stated that opening the CPP to banks of all sizes fulfilled a goal of fairness: to ensure that smaller banks had the same access to capital as larger banks so as to avoid tilting the playing field in favor of larger institutions. This was consistent with Treasury's mandate in EESA: Treasury's statutory considerations include equal access to EESA programs for financial institutions.[8] In this view, Treasury had an obligation to provide smaller banks with the same access to capital as larger banks. Small banks, however, are fundamentally different from large banks, and so their access to CPP capital has produced very different results. Smaller banks do not benefit from an implicit "too big to fail" guarantee; they are disproportionately exposed to commercial real estate, where future losses loom; they are often private or thinly traded; and these factors restrict their access to capital. If the banking sector remains weak and capital constricted, some of the

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[3] U.S. Department of the Treasury, *Interim Assistant Secretary for Financial Stability Neel Kashkari Remarks on Financial Markets and TARP Update* (Dec. 5, 2008) (online at www.ustreas.gov/press/releases/hp1314.htm) (hereinafter "Kashkari Remarks on Financial Markets and TARP Update").

[4] By December 1, 2008, of the 52 banks that had received CPP funds, 22 of them had less than $10 billion in assets. By that time, however, 73.9 percent of the CCP funds had already been disbursed. SNL Financial; Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2.

[5] SNL Financial.

[6] *See generally* Congressional Oversight Panel, *May Oversight Report: The Small Business Credit Crunch and the Impact of the TARP* (May 13, 2010) (online at cop.senate.gov/documents/cop-051310-report.pdf) (hereinafter "May Oversight Report").

[7] See Section E.1, *infra*.

[8] EESA, § 103(5) (12 U.S.C. § 5213(5)) (". . . all financial institutions are eligible to participate in the program, without discrimination based on size, geography, form of organization, or the size, type, and number of assets eligible for purchase under this Act").

smaller CPP recipients may not be able to either raise capital to repay Treasury or make their dividend payments.

Thus, it is possible that the effect of permitting smaller banks to participate in the CPP will be to increase consolidation among some of those banks. Without a clear means of raising equity capital that can substitute for the CPP Preferred on their balance sheets, not only will these banks remain subject to the stigma associated with participation (described in the Panel's May 2010 report), but they may also have to shrink or sell themselves in order to pay back Treasury. Thus, although Treasury did not consider concentration to be a factor in its goals for the CPP, the program could have the effect of increasing concentration in or weakening the smaller bank sector, with potentially harmful effects for communities, competition, and, to the extent that any merger or failure of CPP-recipient banks contributes to a larger trend of bank industry concentration, perhaps systemic stability.

Whether these problems were foreseeable in October 2008, they are readily identifiable now. Where, then, does this leave Treasury, the smaller CPP recipients, and the taxpayers' money? This report approaches this question by examining the current state of the smaller CPP recipients, comparing them to the banking sector as a whole in an effort to determine correlations, if any, among CPP recipients, and examining Treasury's approach to monitoring, managing, and divesting its holdings. Four primary questions remain: (1) how much taxpayer money is at risk in these smaller banks; (2) how stressed—or healthy—are these banks, and how able to contribute to economic recovery; (3) how is Treasury managing its interest in these banks; and (4) what are the possible consequences for the small bank sector—and the small bank participants—of the CPP?

This topic falls under the Panel's mandate to examine the Secretary of the Treasury's use of authority under EESA and the impact of purchases made under the Act on the financial markets and financial institutions.[9]

B. The Banking Sector: A Summary of the Current Profile

The banking sector in the United States is characterized by three main groups of banks: a very small number of massive institutions, a significant number of regional banks, and thousands of small banks. As part of its examination of non-stress-tested banks, the Panel analyzed banking sector data across bank asset sizes and compared TARP and non-TARP banks.[10] Although certain differences emerged in the results, there was no evidence supporting a hypothesis about why banks did or did not receive TARP funds, and no unexpected differences among banks in each asset category.[11] For example, no banks, TARP or non-TARP, seem to have escaped the housing bust. TARP and non-TARP banks may differ regarding which loan types currently comprise the bulk of their

[9] EESA, § 125(1)(A)(i)–(iii) (12 U.S.C. § 5233(b)(1)(A)(i–iii)).

[10] For the purposes of its analysis, the Panel used four categories based on bank asset sizes: Large Banks (those with over $100 billion in assets), Medium Banks (those with between $10 billion and $100 billion in assets), Smaller Banks (those with between $1 billion and $10 billion in assets), and Smallest Banks (those with less than $1 billion in assets). See Annex I, *infra*, for data.

[11] The Panel's findings, summarized here, are set forth in detail in Annex I, *infra*.

problem loans, but both have a similar proportion of problem loans to deal with compared to their total loan portfolios. TARP banks, however, seem to be disproportionately "Commercial Real Estate (CRE) Concentrated,"[12] requiring them to receive additional supervisory attention. On the other hand, from a capital perspective, all banks are doing relatively well. More than 97 percent of all banks are "well capitalized" in each bank asset category, with a negligible percentage undercapitalized.[13] The median Tier 1 Capital ratios are slightly higher at non-TARP banks, but without further information, this could as easily represent supervisory capital requirements in preparation for losses as it could good health.

The lack of distinctions between the groups poses difficulties not only for Treasury's approach to its investment going forward, but also for other policy makers. If it were possible to determine a shared quality or qualities among TARP banks that distinguish them from non-TARP banks, it might affect regulators' supervisory approaches or policy determinations, as well as Treasury's approach to divesting the CPP investments. But the potential explanations for differences or similarities among the groups are numerous and not clearly indicated by the data.

The program was designed for healthy banks, and from this starting point it might have been presumed that their performance—in lending, return on assets, or other factors—should have been superior to that of the banks that did not receive CPP funds. But this is not apparent from the data, and on some metrics TARP banks have fared worse than non-TARP banks. Assessing this assumption is also complicated by the relatively small number of banks that received CPP funds and the way the application process developed over time.[14] Banks that entered and exited early—the short-term participants—may have avoided the stigma that came to plague the program, while the long-term participants have been exposed not only to the stigma but also to a struggling sector and a higher likelihood that their capital would become impaired as losses mounted. It may be, however, that the recipient banks were (at best) marginally healthy, particularly given the unstable and declining state of the sector at that time. It is also possible that the healthiest of the banks that applied might have received CPP funds, but among the smaller banks, only the marginal banks

[12] An institution is "CRE Concentrated" when its total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total capital; or when its total CRE loans represent 300 percent or more of its total capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the past 36 months.

[13] Less than 1 percent of Smaller and Smallest Banks are undercapitalized using the Tier 1 Risk Ratio (5 and 44 banks, respectively). None of the Largest banks are undercapitalized. Over 97 percent of banks in each asset category are "well capitalized:" 82 out of 83 of the Medium Banks, 549 out of 558 of the Smaller Banks, and 7,134 out of 7,248 of the Smallest banks are well capitalized, with 100 percent—all 20—of Large Banks "well capitalized." According to the Tier 1 Leverage Ratio, less than 2 percent of banks in each asset category are undercapitalized: 1 out of 83 Medium Banks, 9 out of 558 Smaller banks, and 93 out of 7,248 Smallest banks. No Large Banks are undercapitalized according to this ratio. More than 97 percent of all banks in each asset category are "well capitalized" using the leverage ratio: 82 out of 83 of the Medium Banks; 541 out of 558 of the Smaller Banks, and 7,098 out of 7,248 of the Smallest Banks. See Annex 1 for further information, infra. It is important to note that Tier 1 capital, while it is a measure of a bank's health, is a snapshot that may not capture all of the stresses facing a bank. For example, a bank could be "healthy" according to its Tier 1 capital ratio but its profitability sluggish. Similarly, a supervisor could view a bank with high Tier 1 capital as nonetheless having a risky profile and could demand that the bank retain high capital in order to withstand future anticipated losses.

[14] May Oversight Report, *supra* note 6.

might have decided to apply, needing the funds despite the stigma that developed around the program.[15] Although the banking supervisors have articulated some of the processes whereby they determined eligibility for the program, the deliberate opacity of the application process, discussed in Section C, below, may also conceal commonalities. Other factors, not accounted for in an analysis of capital position or loan exposures, might explain the minor differences between the groups.

In the absence of clear distinguishing characteristics for the group of CPP banks, Treasury has two choices when evaluating its investment and the effect of that investment on the banking sector. It must either rigorously attempt to determine what, if anything, sets CPP banks apart or, failing that, operate under the assumption that nothing material sets CPP banks apart. If the latter is the case, then CPP banks will likely be subject to largely the same stresses as the sector as a whole. And the sector as a whole, which was declining in 2008, is still under substantial stress, with increased bank failures and consolidations, making Treasury a significant—$24.9 billion—investor in a struggling market. Since 2007 the number of bank failures has increased 4,567 percent, from 3 to 140, with failures concentrated in the Southeast, Midwest, and Southwest, the three areas with the greatest concentration of banks. The number of banks on the FDIC's Problem List has increased 824 percent over this same time period, from 76 to 702.

While acquisitions of troubled institutions allow for capital to continue to spread throughout the banking sector, the increased concentration also means that the troubled and non-performing assets become more concentrated in a shrinking sector, with potential implications for systemic stability.[16] The total amount of bank assets, a number that has actually increased by nearly $2 billion in the past three years, is now concentrated in an increasingly smaller number of banks. Mergers and acquisitions have occurred largely in the smaller bank categories. While it is the smaller institutions that have primarily driven these changes, failing, acquiring, and merging among themselves, as the banking sector becomes more concentrated in fewer banks, these institutions share larger pieces of the asset pie. Although the CPP was not designed to address bank consolidations, for those banks that participated and remain in the program, the CPP has the potential to pressure them into further consolidations in order to exit the program, while the large banks which exited quickly were unaffected.

C. Details of the TARP for Non-Stress-Tested Banks

Treasury announced the CPP on October 14, 2008. From the beginning, Treasury described the program as being intended to help healthy financial institutions.[17] While the relatively small number

[15] See Section E, *infra*.

[16] See Section E.2, *infra*, for a discussion of the effects of concentration on banking system stability.

[17] *See* Neel Kashkari, interim assistant secretary for financial stability, U.S. Department of the Treasury, Speech before the Institute of International Bankers, Washington, DC (Oct. 13, 2008) (online at www.ustreas.gov/press/releases/hp1199.htm) ("As with the other programs, the equity purchase program will be voluntary and designed with attractive terms to encourage participation from healthy institutions."). *See also* Senate Committee on Banking, Housing, and Urban Affairs, Testimony of Neel Kashkari, interim assistant secretary for financial stability,

of failures of CPP recipients may support this contention, the increasing number of CPP recipients that have missed dividend payments on their CPP preferred stock nonetheless calls into question the continuing health of many participants.[18] Although, as described above, CPP recipients appear to track broadly the larger banking sector in many ways, among CPP recipients, there are stark differences in size and date of entry into the program. Larger banks entered and exited first, while smaller banks both took longer to enter and are taking longer to leave. This subjects them to continued market and program pressure, contributing to a fundamentally different experience for smaller participant banks, compared to larger, CPP-recipient banks.[19]

EESA was signed into law on October 3, 2008. Two weeks later, Treasury announced that it would use its authority under EESA to inject capital into the banking system. On October 28, 2008, Treasury made its first capital injections by purchasing senior preferred stock (CPP Preferred). By December 31, 2009, the eventual deadline for Treasury's capital purchases, $204.9 billion had gone to 707 financial institutions, including $41.4 billion to 690 small and medium-sized institutions.[20]

Treasury made each capital purchase through a Securities Purchase Agreement (SPA). The terms of SPAs vary somewhat by institution type—public, private, S-corporation, mutual holding company or mutual bank—but are substantially similar.[21] CPP Preferred, which has no maturity date, pays quarterly dividends at a rate of 5 percent per year for the first five years that a financial institution remains in the program, and 9 percent thereafter.[22] For

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U.S. Department of the Treasury, *Turmoil in the Credit Markets: Examining Recent Regulatory Responses*, at 35 (Oct. 23, 2008) (online at www.gpo.gov/fdsys/pkg/CHRG-110shrg1014/pdf/CHRG-110shrg1014.pdf) (hereinafter "Kashkari Testimony before Senate Banking") (". . . this is a program that is meant for healthy institutions."). It is important to note that the first nine CPP recipients were not subject to an application process—then-U.S. Treasury Secretary Paulson told them that they would be taking the money. Congressional Oversight Panel, *December Oversight Report: Taking Stock: What Has the Troubled Asset Relief Program Achieved?*, at 16–17 (Dec. 9, 2009) (online at cop.senate.gov/documents/cop-120909-report.pdf) (hereinafter "December Oversight Report"). The remaining banks, to varying degrees, were subjected to a more rigorous application process.

[18] As discussed in Section C.4, *infra*, regulators can prevent a bank from making dividend payments if the bank's capital levels are too low to permit such payments. Accordingly, a missed dividend payment may signal capital adequacy problems.

[19] See Section E, *infra*, discussing the stigma on banks that participate and the looming pressures on banks arising from the inability to redeem.

[20] U.S. Department of the Treasury, *Treasury Announces TARP Capital Purchase Program Description* (Oct. 14, 2008) (online at www.financialstability.gov/latest/hp1207.html); U.S. Department of the Treasury, *FAQ on Application Deadline for the Capital Assistance Program* (online at www.financialstability.gov/docs/CPP/FAQ_CAPdeadline.pdf) (accessed July 9, 2010). At present, the smaller institutions owe $24.9 billion to Treasury.

[21] *See* Congressional Oversight Panel, *July Oversight Report: TARP Repayments, Including the Repurchase of Stock Warrants*, at 7 (July 10, 2009) (online at cop.senate.gov/documents/cop–071009-report.pdf) (hereinafter "July Oversight Report"). Because S corporations are legally allowed to issue only one class of equity, and it must be held by a natural person, Treasury structured subordinated debenture transactions, which pay interest quarterly at 7.7 percent per year for the first five years that the financial institution is in the program and 13.8 percent per year thereafter, rather than purchasing preferred stock. The interest rate is higher than the dividend rate to reflect that interest payments can be deducted for tax purposes while dividend payments cannot. Because of this distinction, the net amount of taxes effectively paid to Treasury would be less if it received a debt instrument versus an equivalently yielding share of preferred stock. The rate difference equalizes the effect on all taxpayers. Mutual banks also issue subordinated debentures.

[22] Dividends are cumulative for bank holding companies and their subsidiaries, and non-cumulative for banks. *See Id*. at 8. In late 2008, 5 percent was cheap: 9 percent will be expensive. Industry sources conversations with Panel staff (June 21, 2010). The dividend increase is intended to create an incentive for banks to repay. In order to qualify as Tier 1 capital, the invest-

Continued

most CPP-recipient banks, Treasury also received warrants to purchase common shares, allowing taxpayers to realize an upside on potential equity appreciation.[23]

The first nine CPP applicants agreed to participate prior to the institution of an application process.[24] Even after the process was formalized, Treasury's initial guidance as to the application process was produced hastily. In addition, according to the Federal Reserve's Office of Inspector General, the Federal Reserve's initial application process for bank holding companies that it regulated alerted it to issues that resulted in additional guidance from Treasury and procedures from the Federal Reserve. Accordingly, even aside from the largest CPP recipients, which applied before Treasury issued guidance, later applicants would have faced a more formal application process than earlier applicants.[25] Treasury acknowledges that the process of deciding whether to accept banks into the CPP became more detailed over time.[26]

When banks applied to the program also depended on their corporate form. Although the SPAs are substantially similar, application documents became successively available, with staggered deadlines. The original CPP application deadline for publicly held institutions was November 14, 2008.[27] The deadline for applications from eligible privately held financial institutions was December 8, 2008;[28] for S corporations it was February 13, 2009;[29] and for mutual organizations it was May 14, 2009.[30] On May 13, 2009, however, Treasury Secretary Timothy Geithner announced that Treasury was reopening the CPP application period for small banks, which were defined as banks with up to $500 million in assets.[31]

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ments cannot be "callable" and must be repayable only at the option of the bank. The 9 percent dividend shifts the investment from relatively cheap to fairly expensive, and thus provides an incentive for banks to repay. While the program was designed to create Tier 1 capital with built-in incentives to repay, it mimics the "teaser" rates that enticed many residential mortgage customers before the crisis, with some similar effects. A commitment that was cheap at the outset may prove burdensome when the rate increases.

[23] *See* Section B.2, *infra*. *See also* U.S. Department of the Treasury, *Factsheet on Capital Purchase Program* (Mar. 17, 2009) (online at www.financialstability.gov/roadtostability/CPPfactsheet.htm) (hereinafter "Factsheet on Capital Purchase Program"); July Oversight Report, *supra* note 21, at 7 ("[W]arrants may be traded on public or private markets, and they can be highly valued by investors who believe the share price of the issuing company is likely to rise above the strike price"). In the case of institutions that are not publicly traded, Treasury received warrants to purchase preferred stock or debt and these warrants were exercised immediately upon closing the initial investment so they are no longer outstanding.

[24] The first nine recipients were Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street, and Wells Fargo. Merrill Lynch also received funds, but it subsequently was acquired by Bank of America.

[25] *See* Board of Governors of the Federal Reserve System, Office of the Inspector General, *Audit of the Board's Processing of Applications for the Capital Purchase Program under the Troubled Asset Relief Program* (Sept. 30, 2009) (online at www.federalreserve.gov/oig/files/CPPFinal_Report_9.30.09_for-web.pdf) (hereinafter "CPP Applications Audit"). For a detailed discussion of the CPP application process, see Office of the Special Inspector General for the Troubled Asset Relief Program, Opportunities to Strengthen Controls to Avoid Undue External Influence over Capital Purchase Program Decision-Making (Aug. 6, 2009) (SIGTARP–09–002) (online at www.sigtarp.gov/reports/audit/2009/Opportunities_to_Strengthen_Controls.pdf).

[26] Treasury conversation with Panel staff (June 14, 2010).

[27] U.S. Department of the Treasury, *Process-Related FAQs for Capital Purchase Program* (online at www.treas.gov/press/releases/reports/faqcpp.pdf) (accessed July 9, 2010).

[28] U.S. Department of the Treasury, *Private Bank Program Q & A* (online at www.treas.gov/press/releases/reports/faq 111708 private.pdf) (accessed July 9, 2010).

[29] U.S. Department of the Treasury, *Treasury Releases Capital Purchase Program Term* (Jan. 14, 2009) (online at financialstability.gov/latest/hp1354.html).

[30] U.S. Department of the Treasury, *Treasury Releases Capital Purchase Program Term Sheet for Mutual Banks* (Apr. 14, 2009) (online at financialstability.gov/latest/tg88.html).

[31] Timothy F. Geithner, secretary, U.S. Department of the Treasury, Remarks at the Independent Community Bankers of America Annual Washington Policy Summit (May 13, 2009) (online at www.treasury.gov/press/releases/tg127.htm).

The small bank program remained open until December 31, 2009, with banks required to file applications by November 21, 2009.[32]

To apply, financial institutions first consulted with and then submitted applications directly to their primary federal regulators. Regulators reviewed the applications and then made recommendations to Treasury. The regulators were to base their recommendations on their conclusions about the overall viability, or health, of the applicants, prior to the injection of any CPP funds.[33] These recommendations were based both on the banks' capital levels at the time and their levels going forward under stressed scenarios.[34] Treasury then considered the application, gave significant weight to regulators' recommendations, and decided whether to make an investment. If the regulators were going to recommend denying the application, they would first inform the bank so as to provide it with the opportunity to withdraw: as a consequence, there were no public rejections from the program, although not all banks that applied withdrew voluntarily. Approved applications were publicly announced two days later, while withdrawn or denied applications were not disclosed.[35] This opaque process was designed to prevent adverse market consequences for banks that were not failing but also were not eligible for the CPP. For example, institutions with a CAMELS rating of two, which generally signifies a healthy institution, might nonetheless have been subject to further review because of the age of the examination finding and other such factors. Presumptive denials attached to CAMELS ratings of four or five.[36] The marginal twos, therefore, were not necessarily severely strug-

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[32] U.S. Department of the Treasury, *FAQ on Capital Purchase Program Deadline* (online at www.financialstability.gov/docs/FAQ%20on%20Capital%20Purchase%20Program%20Deadline.pdf) (accessed July 9, 2010).

[33] Treasury issued guidance to the regulators on October 20, 2008. It instructed the regulators to classify applications in one of three categories: presumptive approval, presumptive CPP Council review, or presumptive denial. The regulators were to make this determination based on the institution's financial performance ratios, the time that had elapsed since its last examinations, and its CAMELS rating. CPP Applications Audit, *supra* note 25.

The FDIC uses the CAMELS composite rating system to assess the health of FDIC-insured financial institutions. Uniform Financial Institutions Rating System, 62 Fed. Reg. 752, 753 (FDIC Jan. 6, 1997) (notice). The CAMELS composite rating is derived from six key components: (1) Capital adequacy; (2) Asset quality; (3) Management capability; (4) Earnings quantity and quality; (5) Liquidity; and (6) Sensitivity to market risk. A rating of 4 indicates that there is a distinct possibility of failure if the problems are not addressed and resolved. Under these circumstances, the FDIC may provide financial assistance to the bank to prevent its failure. A rating of 5 indicates that the institution has chronic problems and has a high probability of failure without immediate financial assistance and drastic reforms. *See* Federal Deposit Insurance Corporation, *Resolutions Handbook: Chapter 2—The Resolutions Process*, at 5 (Apr. 2003) (online at www.fdic.gov/bank/historical/reshandbook/ch2procs.pdf) (hereinafter "FDIC Resolutions Handbook").

[34] While the recommendations were based partly on forward-looking criteria, some banks that received CPP funds have experienced decreases in capital position as they have remained in the program. OCC conversations with Panel staff (July 6, 2010).

[35] Factsheet on Capital Purchase Program, *supra* note 23; U.S. Department of the Treasury, *Capital Purchase Program* (Nov. 3, 2009) (online at www.financialstability.gov/roadtostability/capitalpurchaseprogram.html). Some of the numbers of applications are, however, available. *See* Ryan Taliaferro, *How Do Banks Use Bailout Money? Optimal Capital Structure, New Equity, and the TARP*, Harvard Business School Working Paper, at 8 (online at papers.ssrn.com/sol3/papers.cfm?abstract_id=1481256) (hereinafter "Taliaferro Working Paper"); Office of the Inspector General of the Federal Deposit Insurance Corporation, *Controls Over the FDIC's Processing of Capital Purchase Program Applications from FDIC-Supervised Institutions*, at 3 (online at www.fdicoig.gov/reports09/Eval-09-004-508.shtml). The average wait time for applications from banks whose primary regulator was the FDIC was approximately one month at the FDIC level and seven to eleven days at Treasury. *Id*.

[36] CPP Applications Audit, supra note 25. Of course, none of these considerations attached to the first nine banks that entered the program, since they did not undergo a formal application process before receiving funds. Their health at the time cannot be presumed from participation in the program. *Id*.

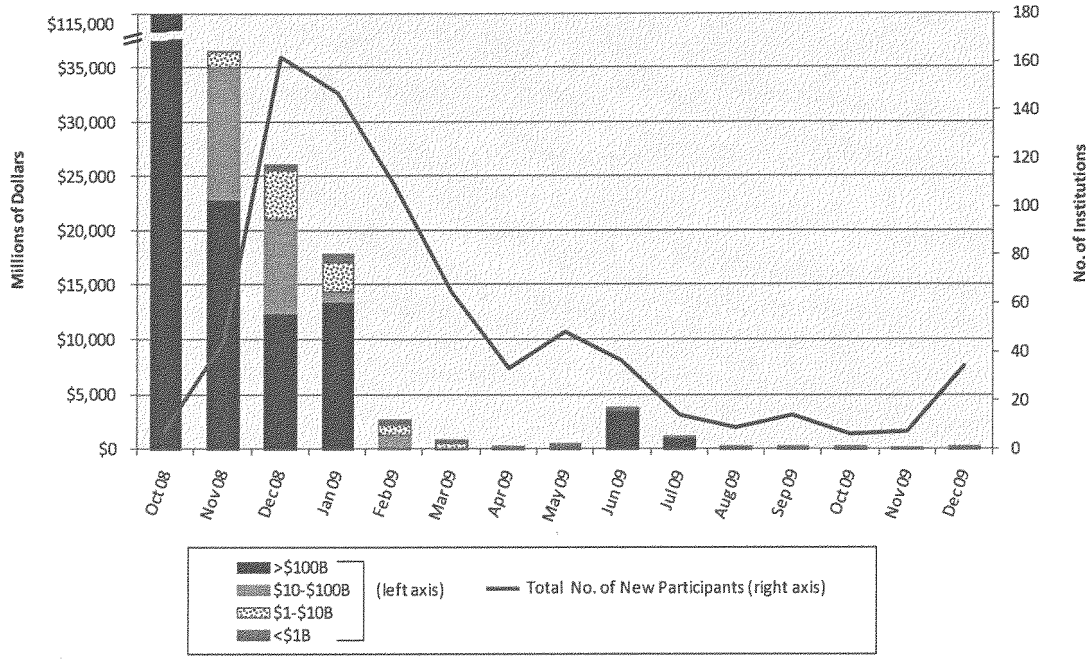
gling, but nonetheless may not have met the requirements established for the program.

1. When Did Banks Receive the Assistance?

One significant distinction between the stress tested institutions and non-stress tested institutions is when they received their CPP funds. The stress tested institutions received their CPP funds in late 2008, while the smaller institutions received them starting in December 2008 and extending through 2009. A practical consequence of this distinction is that, by 2009, Treasury and the supervisors had had more time to establish a more rigorous screening process.

As Figure 1 shows, the vast majority of CPP recipients received their funds between December 2008 and February 2009. Of those recipients, 23 banks had between $10 billion and $100 billion in assets, 146 had between $1 billion and $10 billion in assets, and 244 had less than $1 billion in assets. The number of banks receiving CPP funds then generally declined throughout 2009, with a small spike in December of 2009, as the program drew to a close.

FIGURE 1: TARP FUNDS INVESTED BY RECIPIENT ASSET SIZE (FROM OCTOBER 2008 THROUGH DECEMBER 2009) [37]



[37] U.S. Department of the Treasury, *Troubled Asset Relief Program Transaction Reports* (Nov. 17, 2008 - June 25, 2010) (online at www.financialstability.gov/latest/reportsanddocs.html); SNL Financial.

Between the reopening of the CPP for small banks in May 2009 and the program's subsequent closure at the end of 2009, 157 banks received funding.[38] These 157 small banks made up 22 percent of the 707 banks that received funding throughout the life of the CPP. They received $5.8 billion, or 2.8 percent of the total funds invested under the CPP.[39]

2. What Type of Assistance Did Smaller Banks Receive?

Treasury's investment in the large majority of CPP recipient-banks takes the form of preferred stock. Some banks, however, are barred from issuing preferred stock because they are S corporations or mutual banks. As discussed earlier, these banks instead issued debt to Treasury in the form of subordinated debentures.[40] Treasury also took warrants in the vast majority of banks that received CPP funds; these warrants give taxpayers the opportunity to benefit from appreciation in the value of the common equity in their investments in the banking sector.[41] For privately held banks that participate in the CPP, any warrants taken by Treasury would be relatively illiquid and therefore hard to sell. Consequently, when Treasury took warrants in private banks, the warrants were exercised, and preferred stock was purchased immediately.[42] The preferred shares that Treasury received upon exercise pay 9 percent interest.[43] The majority of Treasury's holdings were preferred stock with warrants and preferred stock with exercised warrants, available to public and private banks, respectively.

3. How Many Smaller Banks Have Paid Back Their CPP Assistance?

Financial institutions seeking to redeem their CPP securities must get approval from their primary federal regulator to do so.[44] According to bank supervisors, under the criteria used for CPP pre-

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[38] The Federal Reserve System's Office of Inspector General found that as of September 2009, few institutions had applied under the program for small banks, and it stated that it saw few indications that many more would apply, given the conditions imposed retroactively by Congress and the stigma associated with the funds. CPP Applications Audit, *supra* note 25. For a complete discussion of the stigma associated with taking CPP funds, particularly for smaller banks, see May Oversight Report, *supra* note 6. According to James Lundy, president and chief executive officer of the Alliance Bank of Arizona, the stigma developed over time. At the commencement of the program, taking CPP funds was viewed as an "endorsement" of the bank, but soon became a liability. *See* Congressional Oversight Panel, Testimony of James Lundy, president and chief executive officer, Alliance Bank of Arizona, *Transcript: Phoenix Field Hearing on Small Business Lending*, at 96 (Apr. 27, 2010) (publication forthcoming) (online at cop.senate.gov/hearings/library/hearing–042710–phoenix.cfm) (hereinafter "Phoenix Field Hearing on Small Business Lending").

[39] Panel staff analysis of Treasury's June 11 Transactions Report. Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2; SNL Financial.

[40] Treasury conversation with Panel staff (June 14, 2010); U.S. Department of the Treasury, *Term Sheet: TARP Capital Purchase Program (Subchapter S Corporations)*, at 1 (Jan. 14, 2009) (online at www.financialstability.gov/docs/CPP/scorp-term-sheet.pdf).

[41] A small number of banks certified as Community Development Financial Institutions (CDFIs), which lend in underserved communities, did not provide warrants to Treasury. House Financial Services, Subcommittee on Oversight and Investigations, Written Testimony of David N. Miller, chief investment officer, Office of Financial Stability, U.S. Department of the Treasury, *TARP Oversight: An Update on Warrant Repurchases and Benefits to Taxpayers*, at 2 (May 11, 2010) (online at www.house.gov/apps/list/hearing/financialsvcs__dem/miller__final__testimony__5-11-10.pdf).

[42] Exercising a warrant means that the holder of the warrant exercises the right to purchase the stock subject to the warrant.

[43] U.S. Department of the Treasury, *Term Sheet: TARP Capital Purchase Program (Non-Public QFIs, excluding S Corps and Mutual Organizations)*, at 6 (Nov. 17, 2008) (online at www.financialstability.gov/docs/CPP/Term%20Sheet%20-%20Private%20C%20Corporations.pdf) (hereinafter "CPP Term Sheet").

[44] 12 U.S.C. § 5221(g).

ferred redemptions, CPP preferred stock is not "special" by virtue of Treasury's involvement.[45] A CPP redemption is equivalent to any retirement of capital; the regulators must decide whether the institution will remain adequately capitalized after the capital retirement. After receiving the redemption request, Treasury consults with the primary regulator about the request. If the regulator approves the repayment, Treasury allows CPP preferred stock to be redeemed.[46] The redemption price of the CPP Preferred is set by the SPA, which provides that the shares are to be redeemed at the principal amount of the debt.[47] A CPP recipient must redeem a minimum of 25 percent of its shares during any redemption transaction.

Thirteen of the 17 largest recipients of CPP funding, all participants in the Federal Reserve's stress tests, have redeemed their preferred shares.[48] The remaining 690 small and medium-sized recipient banks received a total of $41.4 billion. Of those small and medium-sized institutions, 64 have redeemed CPP securities for $13.7 billion.[49] Forty-nine of those 64 financial institutions have fully repaid their CPP funds.[50] Additionally, Treasury has received $2.2 billion in interest and dividend payments from non-stress tested institutions,[51] plus $395.7 million in net income from warrant repurchases and third-party auction sales of warrants.[52] Aside from the larger banks repaying their shares earlier, there is no immediately identifiable pattern to the repayments.

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[45] OCC conversations with Panel staff (June 10, 2010); FDIC conversations with Panel staff (June 14, 2010); Federal Reserve conversations with Panel staff (June 29, 2010); OTS conversations with Panel staff (July 7, 2010).

[46] *See* July Oversight Report, *supra* note 21, at 1.

[47] *See* July Oversight Report, *supra* note 21, at 10–11.

[48] In the spring of 2009, the Federal Reserve and Treasury conducted a Supervisory Capital Assessment Program (SCAP) for the largest U.S. bank holding companies to assess the adequacy of their capital and potential need for an additional capital buffer at each company under two macroeconomic future scenarios. All domestic bank holding companies with more than $100 billion in assets as of year-end 2008 were required to participate in the assessment, with 19 institutions qualifying. Three other banks, HSBC USA, RBS Citizens, and TD Bank, met the asset criteria but are not wholly-owned by U.S. bank holding companies. Board of Governors of the Federal Reserve System, *The Supervisory Capital Assessment Program: Design and Implementation* (Apr. 24, 2009) (online at www.federalreserve.gov/bankinforeg/bcreg20090424a1.pdf). Furthermore, of the 19 institutions that underwent the SCAP assessment, or stress testing, only 17 received TARP CPP funds. MetLife was deemed to have sufficient capital, and GMAC received funds through the Automotive Industry Financing Program. Board of Governors of the Federal Reserve System, *The Supervisory Capital Assessment Program: Overview of Results*, at 30 (May 7, 2009) (online at www.federalreserve.gov/bankinforeg/bcreg20090507a1.pdf). The four stress-tested institutions that still hold their CPP funds are Fifth Third, KeyCorp, Regions, and SunTrust. Treasury's Transaction Reports state that $64 billion is outstanding under the program. This number includes $25 billion in Citigroup common stock, $14.3 billion in CPP Preferred held by Fifth Third, KeyCorp, Regions, and SunTrust, and $24.9 billion held by the non-stress-tested CPP participants.

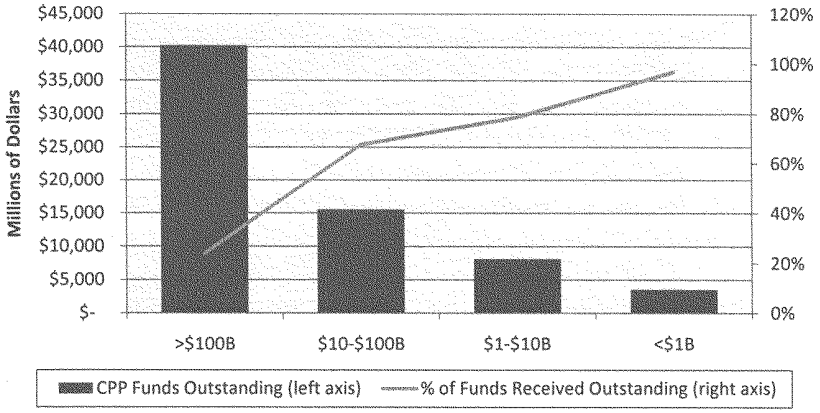
[49] Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2.

[50] These institutions have redeemed their preferred shares and Treasury no longer holds their warrants. Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2.

[51] U.S. Department of the Treasury, *Cumulative Dividends and Interest Report as of May 31, 2010* (June 11, 2010) (online at financialstability.gov/docs/dividends-interest-reports/May%202010%20Dividends%20and%20Interest%20Report.pdf) (hereinafter "Treasury Cumulative Dividends and Interest Report").

[52] Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2.

FIGURE 2: CPP FUNDS OUTSTANDING AND PERCENTAGE OF FUNDS RECEIVED OUTSTANDING, BY BANK SIZE [53]



4. How Many Smaller Banks Are in Arrears?

TARP-recipient financial institutions pay one of two kinds of quarterly dividends to Treasury—cumulative dividends, which are paid by bank holding companies and their subsidiaries, or non-cumulative dividends, which are paid by stand-alone banks. A bank's regulator can forbid it from paying dividends if the regulator believes that payment of the dividend would threaten the bank's safety and soundness. In addition, some banks require shareholder approval to pay capital distributions. When banks miss their dividend payments, the two different kinds of dividends have different consequences. If cumulative dividends remain unpaid, Treasury will be paid any accrued and unpaid dividends on redemption of the shares. However, non-cumulative dividend payments that are missed do not have to be paid on redemption, unless such dividends have been accrued.[54]

Approximately one-seventh, or 15 percent, of CPP-recipient banks have outstanding dividend payments. Throughout the life of the program, 105 CPP recipients have missed dividend payments to Treasury totaling approximately $159.8 million. Eighty CPP re-

[53] U.S. Department of the Treasury, *Troubled Asset Relief Program Transaction Reports* (Nov. 17, 2008–June 25, 2010) (online at www.financialstability.gov/latest/reportsanddocs.html); SNL Financial.

[54] Non-cumulative dividends are quarterly payments that require payment of the current quarter's accrued dividends upon redemption, but do not require payment of unpaid dividends from previous quarters. The non-cumulative dividends accrue when they are declared by the bank. Even though a bank that fails to declare a dividend will not have to pay it later, banks paying non-cumulative dividends have an incentive to pay quarterly dividends to demonstrate that they are healthy and viable. OTS conversation with Panel staff (July 7, 2010). Failure to pay a CPP dividend is public information.

Holders of non-CPP preferred shares in banks have an additional incentive to encourage the institution to pay non-cumulative dividends. So long as any dividends remain outstanding and unpaid on CPP preferred stock, the bank may not pay out dividends or redeem any common or other junior or parity stock. *See* U.S. Department of the Treasury, *Form of [Certificate of Designations] of Fixed Rate Non-Cumulative Perpetual Preferred Stock*, at A–4 (online at www.financialstability.gov/docs/CPP/Standard-Preferred-COD__Non-Cumulative-Private.pdf) (hereinafter "Form of [Certificate of Designations] of Fixed Rate Non-Cumulative Perpetual Preferred Stock") (accessed July 6, 2010).

cipients failed to pay cumulative dividends of roughly $153.3 million, and 25 failed to make non-cumulative dividend payments of about $6.5 million. Nineteen banks have missed four dividend payments totaling $72.9 million, eight have missed five payments totaling $25.0 million, and one has missed six payments totaling $117,663.[55] When a bank misses six dividend payments, Treasury has the right to appoint two board members.[56]

Of the 105 institutions that have missed dividend payments, 28 have missed one quarterly payment. Ten institutions have made no dividend payments, having missed between one and six payments. Six of these ten missed non-cumulative dividends, meaning that the dividends will not be paid on redemption.[57] Some banks have missed dividend payments in the past, but have since made late payments or repaid all delinquent dividends. One bank redeemed its CPP Preferred after missing three dividend payments. Banks that have missed at least one dividend payment received a total of $4.6 billion in CPP funds.[58] The outcome for banks that have missed dividend payments is mixed. While some have either failed or continued to miss payments, others have redeemed their CPP stock or become current on dividends.

5. How Many CPP Recipients Have Failed?

As of June 14, 2010, four CPP recipients have failed. Three were banks; one was CIT Group, a non-bank financial institution (with a bank subsidiary). CIT filed for bankruptcy on November 1, 2009.[59] The FDIC took United Commercial Bank into receivership on November 6, 2009.[60] On November 13, 2009, the FDIC took Pacific Coast National Bancorp into receivership;[61] it filed for bankruptcy on December 17, 2009.[62] The FDIC took Midwest Bank and Trust Co. into receivership on May 14, 2010.[63] Beyond dividend

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[55] Data provided by the U.S. Department of the Treasury.

[56] *See* U.S. Department of the Treasury, *Troubled Assets Relief Program Monthly 105(a) Report—May 2010*, at 9 (June 10, 2010) (online at www.financialstability.gov/docs/105CongressionalReports/May%202010%20105%28a%29%20Report_final.pdf) (hereinafter "TARP Monthly 105(a) Report—May 2010"); Form of [Certificate of Designations] of Fixed Rate Non-Cumulative Perpetual Preferred Stock, *supra* note 54, at A–8.

[57] SNL Financial.

[58] Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2.

[59] CIT Group, Inc., *Form 8–K for the Period Ended November 1, 2009*, at 1 (Nov. 4, 2009) (online at www.sec.gov/Archives/edgar/data/1171825/000095012309057703/y80157e8vk.htm). CIT Group exited bankruptcy in December 2009. CIT Group, Inc., *CIT Shares Commence Trading on New York Stock Exchange* (Dec. 10, 2009) (online at businesswire.com/portal/site/cit/index.jsp?ndmViewId=news_view&newsId=20091210005961&newsLang=en).

[60] Federal Deposit Insurance Corporation, *East West Bank, Pasadena, California Assumes All the Deposits of United Commercial, San Francisco, California* (Nov. 6, 2009) (online at www.fdic.gov/news/news/press/2009/pr09201.html). United Commercial Bank had received $298.7 million in CPP funds on November 14, 2008. According to the FDIC, United Commercial Bank failed because of concentrations in commercial real estate and associated sectors, possibly compounded by alleged fraud by senior management. Federal Deposit Insurance Corporation, *United Commercial Bank Fact Sheet: Discussion of Additional Issues* (Nov. 11, 2009) (online at www.fdic.gov/news/news/press/2009/pr09201c.html) (hereinafter "United Commercial Bank Fact Sheet").

[61] Federal Deposit Insurance Corporation, *Sunwest Bank, Tustin, California, Assumes All of the Deposits of Pacific Coast National Bank, San Clemente, California* (Nov. 13, 2009) (online at www.fdic.gov/news/news/press/2009/pr09207.html). Pacific Coast National Bancorp had received $4.1 million in TARP funds on January 16, 2009.

[62] Pacific Coast National Bancorp, *Form 8–K for the Period Ended December 17, 2009* (Dec. 22, 2009) (online at www.sec.gov/Archives/edgar/data/1302502/000092708909000240/pcnb-8k122209.htm).

[63] Federal Deposit Insurance Corporation, *Firstmerit Bank, National Association, Akron, Ohio, Assumes All of the Deposits of Midwest Bank and Trust Company, Elmwood Park, Illinois* (Mar. 14, 2010) (online at www.fdic.gov/news/news/press/2010/pr10116.html).

payments, the amount that can be recovered from failed institutions, if any, will depend on the outcome of the bankruptcy proceedings.[64] Treasury's investments in CIT and Pacific Coast National Bancorp are valued at zero.[65]

Excluding CIT, these three failures represent 0.4 percent of the total number of CPP recipients; by comparison, bank failures among non-TARP recipients represented 3 percent of all non-TARP banks.[66] It is possible that this difference can be attributed to the program's focus on healthy institutions.[67] Though a program for healthy banks should yield a lower rate of failures, it cannot necessarily be expected to yield no failures, particularly given shifting conditions in the sector. It also is possible that some institutions that were strong when they entered the CPP have since succumbed to negative market pressures in the prolonged recession.

6. TARP Bank Restructuring Policy

A CPP-recipient bank in danger of insolvency because of undercapitalization may submit to Treasury a proposed restructuring plan aimed at regaining stability. Treasury believes that if it makes concessions under the terms of its CPP investment, it may help the bank to raise private capital and improve its chances of survival, thus avoiding receivership and a total loss on the CPP Preferred.

During 2009, two restructuring transactions were completed. In August, Popular, Inc. completed an exchange of $935 million of preferred stock held by Treasury for an identical amount of newly issued trust preferred securities.[68] Similarly, on December 11, 2009, Superior Bancorp completed an exchange of $69 million of preferred stock held by Treasury for an identical amount of newly issued trust preferred securities.[69] Three more restructurings have occurred in 2010. In February, Midwest Banc Holdings exchanged $84.8 million of CPP Preferred, along with accrued dividends, for $89.4 million of mandatory convertible preferred stock. (Midwest

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[64] CIT Group's and Pacific Coast National Bancorp's bankruptcy proceedings have concluded with no recoveries made by the taxpayers. Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2, at notes 16, 19.

[65] Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2, at 4, 6. Any chance that the taxpayers will recoup any value from the investments depends on the results of the bankruptcy proceedings. There is an extraordinarily remote possibility that some amount will be recovered, but it is so unlikely as to be functionally zero.

[66] As of September 30, 2008, there were 7,677 banks that did not later receive TARP assistance. Federal Deposit Insurance Corporation, *FDIC Approves 2009 Operating Budget, Releases Third Quarter 2008 Results for the Deposit Insurance Fund* (Dec. 16, 2008) (online at www.fdic.gov/news/news/press/2008/pr08137.html). Of those banks, 239 had failed by July 9, 2010. Federal Deposit Insurance Corporation, *Failed Bank List* (online at www.fdic.gov/bank/individual/failed/banklist.html) (accessed July 12, 2010).

[67] *See also* Jeffrey Ng, Florin P. Vasvari, and Regina Wittenberg Moerman, *Were Healthy Banks Chosen in the TARP Capital Purchase Program?*, Chicago Booth Research Paper No. 10–10 (Mar. 6, 2010) (online at papers.ssrn.com/sol3/papers.cfm?abstract__id=1566284) (hereinafter "Ng, Vasvari and Moerman Research Paper").

[68] Popular, Inc. paid Treasury a $13 million exchange fee. *See* Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress,* at 61 (Oct. 21, 2009) (online at www.sigtarp.gov/reports/congress/2009/October2009__Quarterly__Report__to__Congress.pdf). *See also* Popular, Inc., *Form 10–Q for the Quarterly Period Ended September 30, 2009*, at 60 (Nov. 9, 2009) (online at www.sec.gov/Archives/edgar/data/763901/000095012309060126/g20716e10vq.htm).

[69] On December 14, 2009, Superior Bancorp filed with the SEC a Form 8–K that announced the completion of the exchange transaction with Treasury. Superior Bancorp, *Superior Bancorp Builds Equity Capital, Completes Exchange of TARP Securities with U.S. Treasury* (Dec. 14, 2009) (online at www.sec.gov/Archives/edgar/data/1065298/000114420409064449/v168906__ex99.htm).

Bank and Trust, which as discussed earlier was seized by the FDIC in May 2010, was a subsidiary of Midwest Banc Holdings.)[70] In April, Independent Bank Corp. exchanged $72 million in preferred stock issued under the CPP, plus accrued dividends, for $74.4 million of mandatory convertible preferred stock.[71] In June, First Merchants Corporation exchanged $46.4 million of its $116 million in CPP preferred stock for $46.4 million of non tax-deductible trust preferred securities.[72] At least two other CPP recipients, Sterling Financial Corp. and First BanCorp, have entered into an agreement to make a similar exchange of preferred stock for mandatory convertible preferred stock.[73] Treasury has stated that exchange transactions will be approved only on a case-by-case basis once all the relevant information is evaluated.[74]

In conclusion, of the 707 banks that received CPP funds, approximately one-seventh, or 15 percent, have experienced capital conditions that have prevented them from paying a dividend. Four institutions have failed, 105 institutions have unpaid dividends, and five banks have restructured their CPP preferred stock, including one that subsequently failed. These figures could portend future difficulties for Treasury's exit strategy.

D. Exit Strategy

Treasury has two options as it seeks to divest from smaller banks: either Treasury continues to hold its CPP investments until they are redeemed in full, or Treasury sells its investments to investors.[75] If Treasury determines that its best or most practical course is to hold until maturity or redemption, small banks, subject to their regulators' approval, must use cash on hand, raise public or private equity capital, or generate sufficient future earnings to repay.[76] For many smaller banks still in the CPP, current market

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[70] See Section B.5, *supra*.

[71] U.S. Department of the Treasury, *Troubled Assets Relief Program Monthly 105(a) Report—April 2010,* at 10 (May 10, 2010) (online at www.financialstability.gov/docs/105CongressionalReports/April%202010%20105(a)%20report_final.pdf).

[72] U.S. Department of the Treasury, *Troubled Assets Relief Program Monthly 105(a) Report—June 2010*, at 11 (July 12, 2010) (online at www.financialstability.gov/docs/105CongressionalReports/June%202010%20105(a)%20Report_Final.pdf).

[73] Sterling Financial Corp., *Form 10–Q for the Quarterly Period Ended March 31, 2010*, at 9 (May 3, 2010) (online at www.sec.gov/Archives/edgar/data/891106/000119312510102955/d10q.htm); First BanCorp, *Form 8–K: Current Report* (July 7, 2010) (online at www.sec.gov/Archives/edgar/data/1057706/000129993310002613/htm_38264.htm).

[74] Treasury conversations with Panel staff (Dec. 15, 2009).

[75] Subject to compliance with applicable securities laws, Treasury has the ability to "sell, assign, or otherwise dispose of" the CPP Preferred it holds. *See* U.S. Department of the Treasury, *Securities Purchase Agreement: Standard Terms*, at § 4.4 (online at www.financialstability.gov/docs/CPP/spa.pdf) (hereinafter "Securities Purchase Agreement: Standard Terms") (accessed July 9, 2010). This means that the CPP Preferred can be sold in private transactions to interested investors, or it can be offered to the public in a resale registered with the SEC. The CPP recipient institutions that report to the SEC are required, under the terms of the SPA, to file a shelf registration statement, which would permit sales to the public. A shelf registration statement allows the financial institution to offer and sell its securities for a period of up to two years. With the registration "on the shelf," the financial institution, by updating regularly filed annual and quarterly reports to the SEC can sell its shares in the market as conditions become favorable with a minimum of administrative preparation and expense. Private institutions, however, do not have the flexibility of using the shelf registration statement, and would have to engage in an initial public offering if they wished to sell equity to the public. For both public and private institutions, however, Treasury can make sales in private transactions exempt from or not subject to SEC registration.

[76] The CPP Preferred is Tier 1 capital, and it can only be replaced with equivalent capital, namely equity. For this reason, access to the debt markets is less relevant to the question of CPP exit. Retained earnings, however, are a component of Tier 1 capital, and so a bank that

Continued

conditions limit each of these options. This means smaller banks are more likely to stay in the program for an extended period.[77] In particular, because the equity capital markets are relatively expensive for smaller banks to access, Treasury's exit strategy for smaller banks will differ qualitatively from its approach to medium and larger banks.[78] To date, 13 of the 17 stress-tested BHCs that received CPP funds have fully repaid their assistance.[79] Each accessed the equity capital market prior to redeeming Treasury's investment. Some analysts expect the remaining stress-tested BHCs to follow a similar course and repay by 2011.[80] By contrast, of the 15 smallest banks that have fully redeemed Treasury's assistance so far, only two raised equity capital prior to exiting the program. With large institutions continuing to exit the CPP, Treasury's focus increasingly shifts to the several hundred smaller institutions that received CPP funds and have more limited options to repay them—626 of the 690 small and medium-sized banks that participated in the CPP have yet to redeem their CPP investments.[81] Additionally, because many of the smaller banks are light-

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cannot raise capital in the market might nonetheless earn its way out of the CPP. For a discussion of capital requirements for banks, *see* Congressional Oversight Panel, *June Oversight Report: Stress Testing and Shoring Up Bank Capital*, at 9–10 (June 9, 2009) (online at cop.senate.gov/documents/cop-060909-report.pdf) (hereinafter "June Oversight Report") ("tier 1 (core) capital is the sum of the following capital elements: (1) common stockholders' equity; (2) perpetual preferred stock; (3) senior perpetual preferred stock issued by Treasury under the TARP; (4) certain minority interests in other banks; (5) qualifying trust preferred securities; and (6) a limited amount of other securities. Tier 2 (supplementary) capital is made up of the following capital elements: (1) the amount of certain reserves established against losses; (2) perpetual cumulative or non-cumulative preferred stock; (3) certain types of convertible securities; (4) certain types of long-, medium-, and short-term debt securities; and (5) a percentage of unrealized gains from certain investment assets.").

[77] Treasury expected smaller banks to remain in the CPP for a longer period than larger banks. The original terms of the CPP required a bank to raise equity as a condition to exit in less than three years—a prospect substantially more prohibitive to smaller banks. Provisions in ARRA changed this requirement. *See also* Financial Crisis Inquiry Commission, Testimony of Henry M. Paulson, Jr., former secretary, U.S. Department of the Treasury, *The Shadow Banking System*, at 70 (Mar. 6, 2010) (online at www.fcic.gov/hearings/pdfs/2010-0506-Transcript.pdf) (hereinafter "The Shadow Banking System") (Then-Secretary Paulson testifying that the CPP was designed to have "two or three thousand banks" hold the CPP for "three to five years").

[78] ICBA conversations with Panel staff (June 23, 2010). *See also* Hal B. Heaton, *Valuing Small Businesses: The Cost of Capital*, The Appraisal Journal, at 13–16 (Jan. 1998) (online at lumlibrary.org/webpac/pdf/TAJ/ValuingSmallBusinesses.pdf) (hereinafter "Valuing Small Businesses") (concluding that the ability of small businesses to raise capital is hampered by increased systemic risks, non-systemic risks, and liquidity effects that increase the required rate of return for capital investment). Congressional Oversight Panel, *March Oversight Report: The Unique Treatment of GMAC Under TARP*, at 50–51 (Mar. 11, 2010) (online at cop.senate.gov/documents/cop-031110-report.pdf) (discussing Treasury's statements that some of the largest financial institutions had the ability to raise money from capital markets and existing shareholders).

[79] Of the 17 stress-tested BHCs that received CPP capital, Bank of America, JPMorgan Chase, Wells Fargo, Goldman Sachs, Morgan Stanley, PNC Financial, U.S. Bancorp, The Bank of New York Mellon, CapitalOne, State Street, BB&T, and American Express redeemed their CPP Preferred and warrants. Treasury is in the process of liquidating its common stock holdings in Citigroup; therefore, although Treasury still maintains an ownership position in Citigroup, for the purposes of this analysis it is deemed repaid. SunTrust Banks, Regions Financial Corp., Fifth Third Bancorp, and KeyCorp continue to have CPP Preferred and warrants outstanding. GMAC received TARP funds from Treasury's AIFP, not its CPP, and MetLife, although stress tested, never received TARP assistance. Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2. *See also* Congressional Oversight Panel, Written Testimony of Herbert M. Allison, Jr., assistant secretary for financial stability, U.S. Department of the Treasury, *COP Hearing on Assistance Provided to Citigroup Under TARP* (Mar. 4, 2010) (online at cop.senate.gov/documents/ testimony-030410-allison.pdf).

[80] *See* SNL data (Mean Estimates and Actuals Summary for Diluted Earnings per share ($)). *See also* Dan Freed, *Five Regional Banks With Dilution Potential*, TheStreet.com (May 21, 2010) (online at www.thestreet.com/offers/omnisky/html/ markets/marketfeatures/10763003.html).

[81] Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2.

ly traded or private, Treasury's divestment options, relative to the larger banks, are more limited.

After a financial institution redeems its CPP Preferred, it may also repurchase its warrants, which are "detachable" from the CPP Preferred, meaning that they can trade separately.[82] Treasury is required to purchase the warrants at "fair market value," although the warrants do not trade on any market and so have no observable market prices.[83] The fair market value is therefore determined using a negotiation and appraisal process between Treasury and the financial institution.[84] If a financial institution does not wish to repurchase its warrants,[85] or the parties cannot agree on a fair price, and neither party wishes to invoke the appraisal procedure, Treasury will, as a matter of policy, auction the warrants to the public.[86] Treasury intends to dispose of its warrants as soon as practicable.[87] Therefore, a financial institution may repurchase its warrants as soon as it redeems its preferred shares.[88] The warrants, which have a 10-year life, may be exercised at any time.[89] The exercise price of the warrants for public financial institutions is based upon the 20-day trailing average stock price of the under-

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[82] If Treasury sold its CPP Preferred to a third party, a financial institution would be allowed to repurchase its warrants once the sale is completed. Treasury conversations with Panel staff (Dec. 15, 2009).

[83] For a more complete discussion of warrants and the repurchase process, see the Panel's July 2009 report. July Oversight Report, *supra* note 21. *See also* Office of the Special Inspector General for the Troubled Asset Relief Program, *Assessing Treasury's Process to Sell Warrants Received from TARP Recipients*, at 10 (May 10, 2010) (SIGTARP–10–006) (online at www.sigtarp.gov/reports/audit/2010/Assessing%20 Treasury's%20Process%20to%20Sell% 20Warrants%20Received%20From%20TARP%20 Recipients_May_11_2010.pdf) (stating Treasury has generally succeeded in negotiating prices from recipients for the warrants at or above its estimated composite value); Securities Purchase Agreement: Standard Terms, *supra* note 75.

[84] The repurchase process for a financial institution is a multi-step procedure starting with the institution's proposal to Treasury of its determination of the fair market value of the warrants. Treasury has a choice of whether to accept this proposed fair value. If Treasury and the financial institution are unable to agree on the fair value determination, either party may invoke the appraisal procedure. In the appraisal procedure process, both Treasury and the financial institution select independent appraisers. If the appraisers fail to agree, a third appraiser is hired, and subject to certain limitations, a composite valuation of the three appraisals is used to establish fair market value. This composite valuation is determined to be the fair market value and is binding on both Treasury and the financial institution. If the appraisal procedure is not invoked, and neither party can agree on the fair market value determination, Treasury then sells the warrants through the auction process. *See* Robert A. Jarrow, *TARP Warrants Valuation Methods* (Sept. 22, 2009) (online at www.financialstability.gov/docs/ Jarrow%20TARP%20Warrants%20Valuation%20 Method.pdf).

In addition, the process is different for private banks. Treasury immediately exercises the warrants of private financial institutions. *See* CPP Term Sheet, *supra* note 43, at 6.

[85] After the CPP Preferred is redeemed, the financial institution has 15 days to decide whether it wishes to repurchase its warrants. *See* U.S. Department of the Treasury, *Treasury Announces Warrant Repurchase and Disposition Process for the Capital Purchase Program* (June 26, 2009) (online at www.financialstability.gov/latest/tg_06262009.html).

[86] Treasury has conducted a number of these auctions. *See* "TARP Updates Since Last Report" in Congressional Oversight Panel, *June Oversight Report: The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy,* at 298, 312–314 (online at cop.senate.gov/documents/ cop-061010-report.pdf).

[87] *See* Congressional Oversight Panel, Written Testimony of Secretary Timothy F. Geithner, *COP Hearing with Treasury Secretary Timothy Geithner*, at 5 (June 22, 2010) (online at cop.senate.gov/documents/testimony-062210-geithner.pdf) (hereinafter "COP Hearing with Treasury Secretary Timothy Geithner—Written Testimony"); U.S. Department of the Treasury, *Treasury Department Releases Text of Letter from Secretary Geithner to Hill Leadership on Administration's Exit Strategy for TARP* (Dec. 9, 2009) (online at www.ustreas.gov/press/releases/ tg433.htm).

[88] *See* July Oversight Report, *supra* note 21.

[89] U.S. Department of the Treasury, *TARP Capital Purchase Program Senior Preferred Stock and Warrants Summary of Senior Preferred Terms*, at 4 (Oct. 14, 2008) (online at www.financialstability.gov/docs/CPP/termsheet.pdf) (hereinafter "TARP Capital Purchase Program Senior Preferred Stock and Warrants Summary of Senior Preferred Terms"). Prior to December 31, 2009, the warrants could only be exercised in part. *Id.* at 4–5. *See also* July Oversight Report, *supra* note 21, at 12.

lying common shares.[90] For private financial institutions, the exercise price is $0.01 per share.[91]

1. Time Horizon and the Redemption Process

Although Treasury's authority to make additional commitments to employ TARP funds will expire on October 3, 2010, it will still hold a substantial pool of assets on that date.[92] The disposition of

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[90] The number of warrants issued is equal to 15 percent (5 percent for a private financial institution) of the face value of the preferred investment divided by the exercise price. *See* TARP Capital Purchase Program Senior Preferred Stock and Warrants Summary of Senior Preferred Terms, *supra* note 89, at 4. The warrant exercise price is calculated taking the average of the closing prices for the 20 trading days up to and including the day prior to the date on which the TARP Investment Committee recommends that the Assistant Secretary for Financial Stability approve the investment. For example, if the 20 day average stock price is $10, the holder of the warrant pays $10 for each share of stock when it exercises the warrant. If the share price exceeds $10 when the warrants are exercised, the holder of the warrants has paid less than market value for these shares, and can then sell them at market value and turn a profit. *See* U.S. Department of the Treasury, *FAQs on Capital Purchase Program Repayment and Capital Assistance Program*, at 2 (May 2009) (online at www.financialstability.gov/docs/FAQ__CPP-CAP.pdf) (hereinafter "FAQs on Capital Purchase Program Repayment and Capital Assistance Program"); July Oversight Report, *supra* note 21, at 12–13.

[91] CPP Term Sheet, *supra* note 43, at 6. As discussed above, EESA requires that Treasury receive warrants in exchange for all TARP investments. 12 U.S.C. § 5223(d). However, a "de minimis" provision allows Treasury to create exemptions from this requirement for small institutions. *See* 12 U.S.C. § 5223(d)(3)(A) ("The Secretary shall establish de minimis exceptions to the requirements of this subsection, based on the size of the cumulative transactions of troubled assets purchased from any one financial institution for the duration of the program, at not more than $100,000,000"). Treasury has not yet published any regulation establishing a formal de minimis exception. To date, only CPP participants that were certified CDFIs have been evaluated under this exception, and in particular, only those CDFIs receiving less than $50 million. Treasury conversation with Panel staff (Mar. 26, 2010). Banks that have received less than $100 million in TARP funds that are not CDFIs have had to issue warrants.

The 22 CDFIs that are part of the CPP may have an exit option not available to other CPP participants. Treasury's Community Development Capital Initiative (CDCI) is scheduled to invest capital at a dividend rate of 2 percent—compared to the 5 percent rate under the CPP—in eligible CDFIs to support credit access in underserved areas. Although Treasury has yet to make any investments under this program, the 22 CDFIs that received CPP funds will be able to exchange their CPP funds for securities issued under the CDCI, effectively swapping their 5 percent dividend rate for a 2 percent dividend rate, provided they meet certain "good standing" provisions. For those CDFIs that remain current on their dividend payments under the CPP and in compliance with the other covenants and conditions of the TARP—all criteria for the exchange—it seems likely they will exchange their CPP funds for the more favorable securities. Although this represents an exit from the CPP not currently available to other participants, the "good standing" provisions should restrict troubled CDFIs from switching from the CPP to the CDCI. As of June 11, 2010, 3 CDFIs had missed dividend payments owed to Treasury; each would be ineligible to exchange their securities. U.S. Department of the Treasury, Dividend and Interest Reports (online at financialstability.gov/latest/reportsanddocs.html). *See also* U.S. Department of the Treasury, *FAQ on the TARP Community Development Capital Initiative* (online at www.financialstability.gov/docs/CDCI/CDCI%20FAQs%20Updated.pdf) (accessed July 12, 2010); TARP Monthly 105(a) Report—May 2010, *supra* note 56; Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2. In March, a fourth CDFI's regulator determined it to be "in troubled condition" and imposed several limitations, including a restriction on paying dividends without written approval from the regulator's regional director. As of June 11, 2010, this CDFI was current on its dividend payments to Treasury. *See* Broadway Financial Corporation, *Form 10–K for the Fiscal Year Ended December 31, 2009*, at 24 (June 17, 2010) (online at www.sec.gov/Archives/edgar/data/1001171/000119312510141662/d10k.htm).

[92] Congressional Oversight Panel, *January Oversight Report: Exiting TARP and Unwinding its Impact on the Financial Markets*, at 4 (Jan. 13, 2010) (online at cop.senate.gov/documents/cop–011410–report.pdf) (hereinafter "January Oversight Report"). Treasury's authorization to expend TARP funds may expire earlier if the Dodd-Frank Wall Street Reform and Consumer Protection Act is passed. In an amendment to the Dodd-Frank Conference Report (H.R. 4173), Congressional negotiators agreed to an amendment that would reduce the total TARP funding to $475 billion and prohibit Treasury from using any TARP funds for any new program or initiative created after June 25, 2010. Until October 3, 2010, however, Treasury would still retain the ability to make additional commitments and changes to initiatives and programs, provided they were in operation prior to June 25, 2010. Treasury would also be prohibited from recycling TARP repayments into new obligations. *See Dodd-Frank Wall Street Reform and Consumer Protection Act*, Conference Report to accompany H.R. 4173, at 770 (June 29, 2010) (H. REP No. 111–517) (online at financialservices. house.gov/Key__Issues/ Financial__Regulatory__Reform/conference__report__FINAL.pdf) (hereinafter "Dodd-Frank Wall Street Reform and Consumer Protection Act"). The House of Representatives passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in a 237–192 vote on June 30, 2010, but as of July 13, 2010, the Senate has not yet taken action.

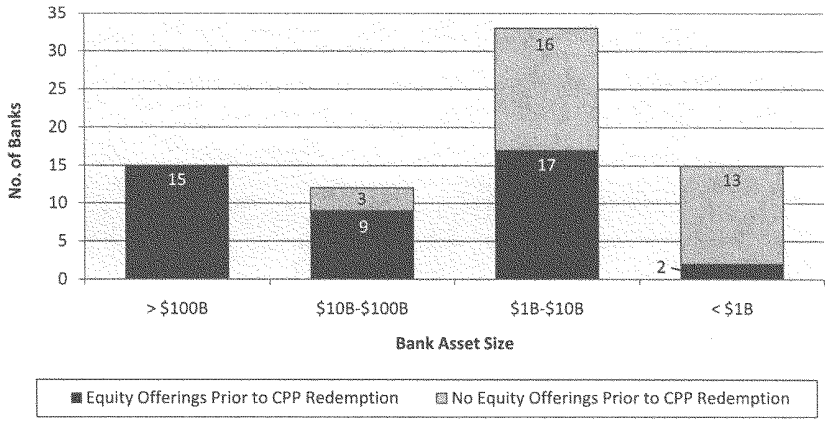
these assets may take many years. Under the original terms of the CPP, banks could not redeem their CPP Preferred for three years unless the institution completed a qualified equity offering of at least 25 percent of Treasury's CPP investment amount. Provisions in the American Recovery and Reinvestment Act (ARRA) changed the timing of repayment so that a bank, subject to the approval of its regulator, can redeem Treasury's investment without replacing capital or waiting a specified period.[93] Despite this change, Treasury is expected to continue to hold a significant stake in small banks for an extended period—thereby making the federal government a player in the small bank market into the indefinite future. As Treasury begins to lay the groundwork for an exit, however, the problem is that for certain CPP recipients, the path remains extremely unclear.

CPP recipients can be divided into two primary categories: those that can access capital, public or private, and those that face significant constraints in doing so.[94] About half of the smaller banks remaining in the program are privately held, meaning that they do not have access to the public capital markets. Of the publicly traded smaller banks, many are lightly traded and may not have ready access to public investors. These breakdowns correlate with size. Medium-sized banks were significantly more likely to tap the equity capital market prior to redeeming their assistance, while smaller banks have been unlikely to do so, and the smallest banks have been extremely unlikely to do so—instead repaying with cash on hand.

[93] FAQs on Capital Purchase Program Repayment and Capital Assistance Program, *supra* note 90, at 2.

[94] Only 4.3 percent of the smaller banks still in the CPP with less than $1 billion in assets held equity offerings between October 2008 and June 2010. Excluding private placements, just 2 percent of these institutions held offerings during this period. Data accessed through SNL Financial data service. Approximately 30 percent of banks still in the CPP with assets between $1 billion and $10 billion held equity offerings during this period; excluding private placements, 20 percent of banks this size held offerings. *Id.*

FIGURE 3: BANKS THAT RAISED EQUITY CAPITAL BEFORE REDEEMING THEIR CPP FUNDS [95]



Of the banks that redeemed Treasury's CPP investments as of June 17, 2010, only two banks with assets below $1 billion accessed the equity capital market—meaning that thus far, only 13 percent of banks of that size that have exited have been able to do so by raising equity capital. For banks with assets between $1 billion and $10 billion, 17 banks, or 49 percent, raised equity prior to redemption; and for banks with assets from $10 billion to $100 billion, 9 banks, or 75 percent, tapped the equity market prior to redemption.[96] Of banks with assets above $100 billion, 100 percent raised equity before redemption. All other redemptions came out of cash on hand. A bank's ability to use cash on hand to redeem depends on the capital position of the bank. A bank with substantial cash on hand that will nonetheless inappropriately reduce its capital position through a CPP redemption will be prevented by supervisors

[95] Data from SNL Financial. Among the 15 banks with over $100 billion in total assets to raise equity through capital markets prior to CPP redemption, only Hartford Financial Services Group (Hartford Financial) and Lincoln National Corporation (Lincoln National) were not subject to the stress tests. *See* The Hartford Financial Services Group, Inc., *Form 10–Q for the Quarterly Period Ended March 31, 2010*, at 7 (Apr. 29, 2010) (online at www.sec.gov/Archives/edgar/data/874766/000095012310040660/c99142e10vq.htm); Lincoln National Corporation, *Form 10–Q for the Quarterly Period Ended March 31, 2010*, at 1 (May 7, 2010) (online at www.sec.gov/Archives/edgar/data/59558/000005955810000159/d10q.htm). Hartford Financial and Lincoln National entered the CPP in June and July 2009, respectively, after the Federal Reserve conducted and released the results of its May 2009 stress tests. Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2.

[96] Debt financing is also significantly more available to larger banks, especially those with equity traded on a stock exchange, than to smaller banks. Debt proceeds, however, do not count as Tier 1 capital and cannot replace Tier 1 equity capital for supervisory purposes. Large banks may have raised debt prior to exiting the CPP and applied the debt proceeds toward their CPP redemption, provided the large bank, despite the redemption, continued to maintain an adequate capital cushion as determined by its regulator. For example, Bank of America used a combination of $19.3 billion raised from a common stock offering and $25.7 billion from excess liquidity to redeem its CPP Preferred. Debt proceeds may have comprised a portion of the "excess liquidity," although precise usage of debt proceeds is difficult to track. *See* Bank of America Corporation, *Form 10–K for the Fiscal Year Ended December 31, 2009*, at 18 (Feb 26, 2010) (online at www.sec.gov/Archives/edgar/data/70858/000119312510041666/d10k.htm). But because any redemption or retirement of Tier 1 capital that results in an inappropriately reduced capital position must be accompanied by a replacement of equivalent capital from a regulatory perspective, however, excess liquidity will not suffice for redemption under those circumstances. These requirements apply to both large and small institutions. OCC conversations with Panel staff (July 6, 2010).

from redeeming until it replaces CPP shares with equivalent Tier 1 capital. Those institutions that quickly redeemed their CPP shares and avoided exposure to balance sheet risks that would have impaired their capital position were able to do so out of cash on hand. In essence, their capital position did not change from the time of the application to the time of the redemption. But if a bank holds CPP funds for longer, the bank's capital condition could become impaired while it continues to hold CPP funds. In that case, even if CPP funds were not necessary for the bank's capital cushion at the time of its CPP application, supervisors could later require the bank to increase its capital cushion, increasing its need for CPP capital and delaying its exit from the program.[97]

Smaller banks that have strong capital positions face a variety of factors that affect the timing of their exits. Factors that press for quick repayment include the costs of the program. TARP banks are required to make quarterly dividend payments at an annualized rate of 5 percent, and these payments increase to 9 percent if a bank does not repay its CPP funds within five years.[98] The cost of TARP funds is not solely quantitative, however; it is also reputational. With some banks' competitors seizing on the TARP label in negative advertising, TARP assistance may have commercial consequences. Accordingly, the TARP stigma—discussed in detail in the Panel's May 2010 report—may place pressure on institutions to exit the program as soon as possible.[99]

On the other hand, even those smaller institutions with strong capital positions, the ability to access the capital markets, and no difficulties paying their dividends, may face a variety of pressures that counsel against prompt repayment.[100] At present, that a participant bank has yet to redeem its CPP investment does not necessarily signal to the market or its competitors that it cannot.[101] Relative to other capital, CPP funds, particularly before the increase in the dividend rate, and setting aside concerns about stigma and industry perception, may constitute cheap capital for a particular bank.[102] Banks of all sizes may continue to hold CPP capital for a number of reasons, including to build loan loss reserves, to make new loans, or to deploy that capital at a later date. Previous Panel reports have documented several existing pressures that could lead to capital preservation: severe commercial real es-

[97] OCC conversations with Panel staff (July 6, 2010).

[98] See note 22, *supra*.

[99] May Oversight Report, *supra* note 6, at 68–72. For more detail on the effect of the TARP stigma, see Section E, *infra*.

[100] This exposes Treasury to additional risk if a bank's financial condition deteriorates in the meantime. For a discussion of how Treasury balances its policy objectives, see Section D.3, *infra*. For banks that are in the program and are making dividend payments, Treasury earns 5 percent annually on its investment for five years, and 9 percent after.

[101] This signal may shift after five years when the dividend rate rises from 5 to 9 percent, at which point the market may assume that a bank that has not redeemed is unable to do so.

[102] Although industry analysts may view the capital as costly, the cost to the individual bank depends on the alternatives available for that bank. A bank that would experience high costs in accessing the capital markets or private investors might choose to retain its CPP rather than experiencing dilution or incurring offering fees. *See* note 22, *supra*. As of the first quarter of 2010, the median cost of borrowing for a bank falls between 2 percent and 3 percent for banks of all sizes, although it is higher for smaller banks. Median cost of borrowing includes all debt and preferred shares, but does not include deposits. SNL Financial data. Because these are medians, however, a particular bank may have a significantly harder time borrowing at those rates. These numbers differ from dividend rates for perpetual preferred shares. From 2004 to 2006 the median dividend rate for a perpetual preferred share investment was 6.6 percent. SNL Financial data.

tate exposure,[103] foreclosures in the residential housing market,[104] capital scarcity, the prospect of tighter requirements, and interest rate risk.[105] In light of this pervasive uncertainty, it may be prudent policy for small banks, even those that can repay, to use Treasury's investment to enhance their capital cushions. Consistent with these pressures, Treasury expects many smaller banks to hold their CPP investments for the full five years, until the dividend requirements increase.[106]

For smaller public banks, access to the equity capital markets is limited because of the fixed costs tied to the issuance, and the inability of smaller banks, which are not actively traded, to sell a sufficient volume of stock to support these fixed costs.[107] This places some smaller banks that have not repaid in a difficult situation, leaving them more dependent on the capital provided by Treasury, as their only other options to raise comparable equity capital are private investors. For other smaller banks, this concern may be tempered because of the relatively small amount of assistance they received and their ability to generate sufficient retained earnings to redeem Treasury's investment prior to the dividend step-up. For many affected banks, however, the sector's returning to health will be an essential part of this equation.

Raising private capital for smaller banks is challenging in general, but it is particularly challenging in the current economic climate for several reasons. First, smaller banks often rely on local networks of investors, including existing shareholders and board members, to raise cash. Given the underlying weaknesses in the banking sector, these investors may be reluctant to part with additional capital; it may also be difficult to attract new investors. Reliance on local investors also subjects banks to geographic vulnerability, as small banks may face acute challenges in raising capital

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[103] Congressional Oversight Panel, *February Oversight Report: Commercial Real Estate Losses and the Risk to Financial Stability*, at 2 (Feb. 10, 2010) (online at cop.senate.gov/documents/cop-021110-report.pdf) (hereinafter "February Oversight Report") ("The Congressional Oversight Panel is deeply concerned that commercial loan losses could jeopardize the stability of many banks, particularly the nation's mid-size and smaller banks, and that as the damage spreads beyond individual banks that it will contribute to prolonged weakness throughout the economy."). *See also* Sheila C. Bair, chairman, Federal Deposit Insurance Corporation, Remarks at the Independent Community Bankers of America's 2010 National Convention (Mar. 19, 2010) (online at www.fdic.gov/news/news/speeches/chairman/spmar1910.html) (hereinafter "Commercial Real Estate: A Drag for Some Banks but Maybe Not for U.S. Economy") ("And you are seeing your nonperforming loans continue to rise."). Unlike larger banks, which are more likely to hold an array of secondary market securities on their balance sheets, smaller banks are significantly less exposed to the complex financial instruments that fed the financial crisis. *See* Rajeev Bhaskar, Yadav Gopalan, and Kevin L. Kliesen, *Commercial Real Estate: A Drag for Some Banks but Maybe Not for U.S. Economy*, The Regional Economist, at 1 (Jan. 2010) (online at research.stlouisfed.org/publications/regional/10/01/commercial-real-estate.pdf); February Oversight Report, *supra*, at 130.

[104] *See generally* Congressional Oversight Panel, *April Oversight Report: Evaluating Progress of TARP Foreclosure Mitigation Programs* (Apr. 14, 2010) (online at cop.senate.gov/documents/cop-041410-report.pdf) (hereinafter "April Oversight Report").

[105] May Oversight Report, *supra* note 6, at 53.

[106] Treasury conversations with Panel staff (June 14, 2010).

[107] ICBA conversations with Panel staff (June 23, 2010); private investors' conversations with Panel staff (July 2, 2010). *See also* Denis Boudreaux, Tom Watson, and James Hopper, *A Behavioral Approach To Derive The Cost Of Equity Capital For Small Closely Held Firms*, Journal of Business & Economics Research, at 71 (Oct. 2006) (online at www.cluteinstitute-onlinejournals.com/PDFs/2006402.pdf) ("Recent studies have provided evidence that the degree of risk and the corresponding cost of capital increase with the decreasing size of the company."); Valuing Small Businesses, *supra* note 78, at 16 ("Numerous studies give overwhelming evidence of discounts of 20%–40% for stocks that are not actively traded compared with equities that are actively traded.").

from investors in areas that were hard hit by the collapse of the real estate bubble.

Second, a number of factors minimize the likelihood that private equity funds will be a dependable source of capital for small banks.[108] Private equity funds typically focus their investments in banks exceeding $1 billion in assets, and industry sources state that private equity investors are currently more interested in purchasing institutions in distressed sales at a greater discount than in investing in going concerns. The term "private equity" includes firms that specialize exclusively in financial institutions, as well as those that do not specialize in the field but are interested nonetheless in making investments in this area. While there are many private equity firms interested in investing in financial institutions, the level of interest in the small bank sector specifically is unclear. There are large players in the private equity business generally, but there is no clear group of dominant players that focus specifically on the small bank market. In fact, some private equity firms participate only in FDIC-assisted transactions because such transactions offer more downside protection than open-bank transactions.[109] Nor are private equity funds likely to become a larger share of the market because there are significant barriers to entry. Most notably, if a fund's investment makes it the owner of more than 24.9 percent of the bank, that bank must apply and be approved by the Federal Reserve Board as a bank holding company.[110] Even a smaller interest, such as a 10 percent stake in a bank, could subject the fund to a certain amount of disclosure requirements and other vetting processes.[111] In most cases, the cost of qualifying to make a significant investment in a small bank is not worth the potential return, especially since such investment would carry certain risks if the bank's portfolio contained weaknesses not easily discovered through due diligence.

Third, many of these banks hold substantial portfolios of CRE loans, which are poised to experience a new wave of losses in the coming years. This risk of future losses further strains small banks' resources and undermines confidence in them,[112] while putting additional pressure on the due-diligence process for any potential buyer. As the bank gets smaller, however, it becomes less valuable for a private equity investor to expend resources on an elaborate

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[108] Private equity firm conversations with Panel staff (June 21, 2010). Private equity funds typically consist of pooled funds contributed by institutional or other sophisticated investors into a business venture that makes a variety of investments.

[109] Private investor conversations with Panel staff (June 21, 2010).

[110] 12 U.S.C. § 1841(a); 12 C.F.R. § 225.11.

[111] Even under circumstances in which a private equity fund holds less than 25 percent of voting securities, it may nevertheless be subject to regulation by the Federal Reserve as a bank holding company. *See* 12 U.S.C. § 1841(a); 12 CFR 225.31(d). In addition, a private equity fund wishing to bid on a failed FDIC-insured institution must first obtain a charter from its primary regulator to be eligible to bid on the failing institution. After obtaining a charter, the fund must then be approved by the appropriate regulator. FDIC Resolutions Handbook, *supra* note 33, at 9. The private equity fund may be required to "complete and submit transaction specific qualification requests and other bidder qualification materials as well as confidentiality agreements, financial and other information" to the FDIC. The FDIC can require the fund to supply its private financial information and subject it to a credit investigation. Federal Deposit Insurance Corporation, *Memorandum to Prospective Bidders*, at 1–3 (online at www.fdic.gov/buying/financial/memo_bidder.pdf).

[112] *See* February Oversight Report, *supra* note 103, at 2; May Oversight Report, *supra* note 6, at 29 ("In addition, banks experiencing capital weakness—due to anticipated losses in the CRE market or balance sheets still plagued by troubled assets—may hold cash as a means of buttressing their capital position.").

examination of the bank's books, because the return from the bank may never be enough to justify those costs. In sum, the combination of these factors may cause small banks to be perceived as an even riskier investment.

Given these multiple stresses on smaller banks' ability to raise capital, public or private, many of them may struggle to repay. In discussions with Panel staff prior to the release of its January 2010 report, Treasury stated that it would focus on an institution-by-institution approach, a tactic that is well suited to the exit of large institutions. However, Treasury also indicated that it would be open to other possibilities, such as "bundling" multiple investments for sale, that might be particularly conducive to unwinding the large number of small investments in small institutions. Bundling, or creating a pool of disparate bank investments, would create a mutual fund-like investment composed of shares of multiple smaller banks. It would have the advantage of creating diversity in the investment; where an investor might be reluctant to be exposed to one smaller bank, or several smaller banks in the same region, the possibility of diversifying across multiple banks in multiple regions might be more attractive, provided that Treasury avoided correlated risks in the pools. Such pools would have to be sold consistent with existing securities laws, but there is ample precedent for such pooled investments generally. Treasury is continuing to evaluate its disposition alternatives, including bundling, but as of the release of this report has yet to finalize an approach.[113]

Although banks continue to redeem their CPP shares, the redemption approval criteria, like other supervisory standards, remain opaque. Regulators have indicated that repayment of CPP capital receives no special supervisory treatment: it is treated the same as any other decision to redeem capital. Redemption of CPP shares is simply included as part of the routine considerations of capital adequacy, earnings, asset quality, and liquidity.[114] Industry groups maintain, however, that some banks have been confused about repayment criteria, as Treasury and regulators have neglected to articulate clear standards.[115] Industry sources state that transparency is a question of balance: while too much transparency may allow banks to "play" to the criteria, too little may leave banks uncertain about how to plan for the future. Bank supervisors note, however, that they have clear processes for repayment. The Federal Reserve, for example, has issued a supervisory letter that publicly sets forth considerations for redemption of capital, including redemptions of public funds.[116] It is nonetheless possible that small

[113] One possibility—one that would bolster banks further—would be for Treasury to convert its investment to common, which is less costly for the bank and is higher quality tier-1 capital. This would place Treasury further down the priority list and deprive it of its dividend payments, which would deprive taxpayers of revenue from their investments. For the smallest banks, those that do not have reasonable access to the capital markets, a conversion to common might both maintain an illiquid investment while depriving the taxpayers of the dividend stream owed.

[114] Federal Reserve conversations with Panel staff (June 29, 2010). *See also* FAQs on Capital Purchase Program Repayment and Capital Assistance Program, *supra* note 90, at 2 ("Supervisors will carefully weigh an institution's desire to redeem outstanding CPP preferred stock against the contribution of Treasury capital to the institution's overall soundness, capital adequacy, and ability to lend, including confirming that the institution has a comprehensive internal capital assessment process.").

[115] Industry sources conversations with Panel staff (June 10, 2010).

[116] Board of Governors of the Federal Reserve System, *SR 09–4 Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases*

banks may depend on clarity about repayment criteria even more than large banks because they have limited staff and resources for formulating a comprehensive exit strategy and because they have fewer options for exit.[117]

2. Monitoring of Investments/Treasury's Engagement With Smaller CPP Recipients

Treasury has hired outside asset managers to monitor the credit risk posed by its CPP-recipient institutions.[118] The asset managers monitor CPP-recipient banks on an ongoing basis, and Treasury officials regularly meet with the asset managers to discuss their reports. Using publicly available information, or information obtained pursuant to the SPAs in the case of private banks, the asset managers assign each participant bank a credit score and provide regular write-ups to Treasury. The asset managers look to a variety of capital ratio markers to evaluate the investment. For certain institutions, Treasury and its external asset managers engage in heightened monitoring and due diligence, and the asset manager may receive non-public information from the CPP-recipient bank, although Treasury typically tries to distance itself from such non-public information. Treasury states that it leans heavily on the expertise and knowledge of its asset managers.[119]

Asset managers are paid fees based on a sliding scale relative to the number of institutions they manage: for the first 50 institutions, the asset manager receives an annualized fee of $50,000 per financial institution; for the next 50, the asset manager receives an annualized fee of $40,000 per financial institution, and for each subsequent institution, the asset manager receives an annualized fee of $30,000 per financial institution. Asset managers also receive incentive fees based on overall returns to Treasury.[120] Treasury also relies on federal banking regulators in monitoring recipients, but it does not have access to non-public information collected by the regulators. According to the Government Accountability Office (GAO), Treasury's distance from this non-public information is deliberate: Treasury maintains a separation between its responsibilities as an investor and its duties as government entity. A GAO audit of the TARP found that Treasury uses the data gathered through the monitoring process, in consultation with its external

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at Bank Holding Companies (Mar. 27, 2009) (online at www.federalreserve.gov/boarddocs/srletters/2009/SR0904.pdf).

[117] Industry sources conversations with Panel staff (June 10, 2010).

[118] Treasury has contracted with nine asset managers: AllianceBernstein LP, FSI Group, LLC, and Piedmont Investment Advisors, LLC were selected in April 2009. In December 2009, Treasury added Avondale Investments, LLC, Bell Rock Capital, LLC, Howe Barnes Hoefer & Arnett, Inc., KBW Asset Management, Inc., Lombardia Capital Partners, LLC, and Paradigm Asset Management, LLC. U.S. Department of the Treasury, *Treasury Hires Asset Managers under the Emergency Economic Stabilization Act* (Apr. 22, 2009) (online at www.financialstability.gov/latest/tg100.html); U.S. Department of the Treasury, *Treasury Department Hires Asset Managers to Serve as Financial Agents for Wind-Down Phase of EESA* (Dec. 23, 2009) (online at www.financialstability.gov/latest/pr_12232009.html).

[119] Treasury conversations with Panel staff (June 14, 2010).

[120] Incentive compensation fees are determined collectively for the Asset Managers. Asset managers are responsible for payments to any subcontractors they hire. *See, e.g.,* U.S. Department of the Treasury and Piedmont Investment Advisors, LLC, *Financial Agency Agreement for Asset Management Services for Equity Securities, Debt Obligations, and Warrants,* at 9, 25 (Apr. 21, 2009) (online at www.financialstability.gov/docs/ContractsAgreements/Piedmont%20FAA%20Equity%20Asset%20Manager%20FINAL.pdf). All of the financial agency agreements are available online. *See* U.S. Department of the Treasury, *Office of Financial Stability Contract Detail* (online at www.financialstability.gov/impact/contractDetail2.html) (accessed July 7, 2010).

managers and legal advisors, to determine a proper course of action for a stressed institution. Treasury may make recommendations to the bank's management or work with the management and other security holders to improve the financial condition of the bank, including through recapitalizations or other restructurings. GAO notes that these actions are "similar to those taken by large private investors in dealing with troubled investments" and that "Treasury does not seek to influence the management of TARP recipients" for its own investment purposes.[121] Because these asset managers are acting on behalf of Treasury in its capacity as an investor, they do not have any powers that Treasury itself does not have. For example, the asset managers have no input as to whether the FDIC takes a bank into receivership.

Consistent with this approach, Treasury has repeatedly referred to itself as a "reluctant shareholder," emphasizing that it does not plan to interfere in the day-to-day management of the institutions that have received TARP funds.[122] The precise boundaries of this approach are unclear, particularly in light of the fact that Treasury has taken a more active stance with certain of its institutions, like General Motors,[123] although it does seem Treasury is currently adhering to a "hands-off" approach for smaller banks. Although industry sources maintain that smaller banks have had mixed experiences in the CPP, and smaller institutions expressed frustration with initial delays in rolling out the program and with the stigma that has become attached to it, those sources have not reported concerns about any management role Treasury has played thus far.[124] Likewise, supervisors have informed the Panel that they have received no complaints about Treasury's management approach from the institutions they supervise.[125]

For CPP participants that miss six consecutive dividend payments, Treasury has the ability to appoint an independent member to its Board of Directors.[126] A bank's regulator can suspend pay-

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[121] U.S. Government Accountability Office, *Financial Audit: Office of Financial Stability (Troubled Asset Relief Program) Fiscal Year 2009 Financial Statements*, at 56 (Dec. 2009) (GAO–10–301) (online at www.gao.gov/new.items/d10301.pdf) (hereinafter "Financial Audit: Office of Financial Stability Fiscal Year 2009 Financial Statements").

[122] *See* House Oversight and Government Reform, Subcommittee on Domestic Policy, Written Testimony of Herbert M. Allison, Jr., assistant secretary for financial stability, U.S. Department of the Treasury, *The Government As Dominant Shareholder: How Should the Taxpayers' Ownership Rights Be Exercised?,* at 5 (Dec. 17, 2009) (online at oversight.house.gov/images/stories/Allison_Testimony_for_Dec-17-09_FINAL_2.pdf) (hereinafter "Allison Testimony before House Oversight and Government Reform Subcommittee on Domestic Policy") ("[T]he U.S. government is a shareholder reluctantly and out of necessity" and Treasury "intend[s] to dispose of [its] interests as soon as practicable, with the dual goals of achieving financial stability and protecting the interests of the taxpayers").

[123] *See, e.g.,* Congressional Oversight Panel, *September Oversight Report: The Use of TARP Funds in the Support and Reorganization of the Domestic Automotive Industry*, at 20–21 (Sept. 9, 2009) (online at cop.senate.gov/documents/cop-090909-report.pdf) (describing Treasury's role in initiating board and management changes at General Motors).

[124] Industry sources conversations with Panel staff (June 10, 2010).

[125] The supervisors also do not report significant contacts with Treasury about its investments. OCC conversations with Panel staff (June 10, 2010); FDIC conversations with Panel staff (June 14, 2010); Federal Reserve conversations with Panel staff (June 29, 2010); OTS conversations with Panel staff (July 7, 2010).

The OTS has stated that Treasury has called to inform them that an OTS-supervised bank has missed a dividend payment. Federal Reserve conversations with Panel staff (June 29, 2010).

[126] Although Treasury has established how it will manage its appointment of board members to TARP recipients in which it holds common shares, its plan for the degree of intervention that it thinks appropriate to board members for preferred share holdings is not yet formulated. It is therefore not clear how its approach will mesh with its "reluctant shareholder" policy. *See* Allison Testimony before House Oversight and Government Reform Subcommittee on Domestic Policy, *supra* note 122, at 5–6.

ment of dividends. As discussed below, CPP capital receives no special treatment by virtue of being a Treasury investment, and therefore supervisors do not accord CPP Preferred "special" treatment when evaluating an institution's ability to pay a dividend. Rather, dividend payments are evaluated under standard supervisory criteria, and an institution that would impair its capital position by paying a dividend may not do so, although regulators do not disclose the approach they use in applying their standard criteria.[127] As of the release of this report, one bank has missed six payments. This bank missed its sixth dividend payment in May 2010. Treasury has not yet appointed any board members to its board.

Treasury is developing policies and procedures for appointing board members for banks that have missed six dividend payments. Some of the issues it is considering include the willingness of skilled and innovative potential board members to serve on the boards of geographically diverse small struggling banks, members' ability to sit on more than one board,[128] whether board members must live in the same geographic area as the bank, and the need to purchase directors' and officers' liability coverage for board members.[129] Treasury has informed the Panel that it is also taking into account state corporate law as well as bank supervisory requirements as it develops its plan to appoint board members. Treasury is reviewing the potential use and cost of search firms to find qualified board members.[130]

If, during the course of monitoring, the asset manager finds that a bank is undercapitalized, the asset manager or Treasury may contact the bank and suggest that it raise private capital; typically, though, according to Treasury, the bank's regulator will have already made this recommendation. If the bank decides to seek additional capital, it submits a formal request to Treasury.[131] As part of the bank's submission, it requests that Treasury perform a formal review and evaluation of its recapitalization plan. An asset manager hired by Treasury then conducts due diligence on the

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[127] *See* Section C, *supra*.

[128] A board member who sits on the boards of two directly competing institutions could implicate the directors' duty of loyalty, depending on state law, or could also possibly implicate antitrust laws. *See* American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, at § 5.06 ("Competition with the Corporation") (2005) (stating that antitrust laws might be implicated when a director sits on the board of competing corporations).

[129] One study found that small banks have mixed results identifying board members. According to a December 2008 survey by the Federal Reserve Bank of Kansas City, 70 percent of community bankers "do not anticipate difficulty filling director positions over the next five years." They also reported, however, that "an increasing percentage of bankers are finding director recruitment more problematic; the percentage of bankers expecting greater problems meeting their director needs increased by more than 60 percent from the 2001 survey." In this survey, 66.7 percent of respondents cited director liability as a factor making it difficult to recruit directors. Other factors hampering respondents from finding directors included time and work involved, and difficulty in finding qualified applicants. Federal Reserve Bank of Kansas City, *The 2008 Survey of Community Banks in the Tenth Federal Reserve Circuit, Financial Industry Perspectives*, at 14 (Dec. 2008) (online at www.kansascityfed.org/banking/bankingpublications/prs08-2.pdf). Directors are compensated, but the amounts may not be substantial: under $10,000 for a bank of under $500 million is common. Industry sources conversations with Panel Staff (July 8, 2010).

Others state, however, that as long as Treasury provides fairly broad indemnification to appointees, it should not have a problem finding qualified directors. In addition, serving as Treasury's appointee on the board of a bank might be prestigious. Industry sources conversations with Panel staff (July 8, 2010). There are various potential sources of directors, such as associations of bank directors. Because Treasury is still formulating its process, it is not clear as to whether it will ultimately have difficulty filling board seats.

[130] Treasury conversations with Panel staff (June 14, 2010).

[131] Treasury conversations with Panel staff (June 14, 2010).

bank and analyzes the recapitalization plan. In the course of its diligence, the asset manager may interview bank managers, gather non-public information, including the bank's loan book and the bank management's analysis of loan losses, and conduct its own loan loss estimates and capital structure analysis.[132] Treasury reviews the work of the asset manager and decides whether to approve the plan. Among the principles Treasury considers in determining whether to approve the proposal are: pro forma capital position of the institution; pro forma position of Treasury investment in the capital structure; overall economic impact of the transaction to the government; guidance of the institution's primary regulator; and consistent pricing with comparable marketplace transactions.[133] Treasury has also stated that it considers whether the concessions it would make under the deal are fair, and that it will negotiate the deal's terms, as necessary, to ensure that it is commercially reasonable, fair, and in the best interests of taxpayers.[134] In evaluating whether to accept concessions proposed by the bank, Treasury states that it seeks information from the bank to determine the size of the concessions being proposed for other debt and equity holders. Treasury states that it makes sure that its concessions are on an equal footing with those made by other debt and equity holders, and that it will not grant a larger concession than subordinate debt holders do.[135]

Treasury will also consider restructuring its investment such that it might take a loss when the alternative would be letting the bank fail, resulting in an even greater loss to the taxpayer.[136] Treasury has guidelines that provide that a bank that wants to restructure can only do so in the context of private capital raising that will provide a more stable footing for the bank going forward: if the bank can be saved, Treasury is willing to make concessions in furtherance of that goal. Treasury states generally that it will not approve transactions that will adversely affect its holdings.[137] Treasury also says that in these circumstances, while it will not make additional capital infusions, it has little to lose by agreeing to concessions with regard to banks that are quickly approaching FDIC resolution, at which point Treasury would lose its entire investment in any event. Treasury also states that it has no role in determining whether a CPP-recipient bank fails: that responsibility falls to the bank's regulators.[138] Both the FDIC and the Office of Comptroller of the Currency (OCC) informed the Panel that Treasury has not inserted itself into their decision-making, and is not involved in the decision to close a bank.[139] The supervisors have also

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[132] Treasury conversation with Panel staff (June 14, 2010). *See also* Office of the Special Inspector General for the Troubled Asset Relief Program, *Quarterly Report to Congress*, at 84 (Apr. 20, 2010) (online at www.sigtarp.gov/reports/congress/2010/April2010__Quarterly__Report__to__Congress.pdf) (hereinafter "SIGTARP April 2010 Quarterly Report").

[133] Financial Audit: Office of Financial Stability Fiscal Year 2009 Financial Statements, *supra* note 121, at 56. *See also* January Oversight Report, *supra* note 92, at 42–43.

[134] Treasury conversation with Panel staff (Mar. 19, 2010).

[135] Treasury conversation with Panel staff (Mar. 19, 2010).

[136] Treasury conversation with Panel staff (June 14, 2010). *See also* SIGTARP April 2010 Quarterly Report, *supra* note 132, at 84.

[137] Treasury conversation with Panel staff (June 14, 2010).

[138] Treasury conversations with Panel staff (Mar. 19, 2010 and June 14, 2010).

[139] OCC conversations with Panel staff (June 10, 2010); FDIC conversations with Panel staff (June 14, 2010).

stated that a bank's receipt of CPP funds is not a factor in the decision to close a bank—they do not consider CPP funds to be "special" or different in any way from other forms of equivalent bank capital.[140] Treasury has performed restructurings of its holdings in four institutions; one of these institutions, Midwest Bank Holding, was later taken into receivership by the FDIC.[141]

Treasury's remedy for missed dividend payments and restructuring activities is similar to that of a private investor, but its position as both a government entity and an investor complicates its exercise of the private investor role. First, Treasury may not appoint its own employees to a board position, thereby limiting itself to third-party individuals and non-employees. A private investor, on the other hand, would be able to appoint one of its own officers or employees, which would provide the private investor with a ready pool of representatives to further its interests.

Second, as an investor in over 700 institutions, most of them smaller and some of them struggling, Treasury could potentially need to fill a number of seats from a small available pool. As noted above, Treasury is currently evaluating how it will find a large number of qualified people willing to sit on the boards of troubled institutions.[142] At present, Treasury's shareholder rights have only been triggered with respect to the one institution that has missed six dividend payments. As CPP investments continue, however, and are further exposed to the banking sector, Treasury's need to find qualified board members who are willing to serve will become more acute.

Third, if a CPP-recipient institution has been mismanaged—United Commercial Bank of San Francisco, for example, went into FDIC receivership amid allegations that its downfall was hastened by fraud at the senior management level[143]—where a private investor might take more aggressive action, Treasury's hands-off stance leaves it dependent on the relevant bank's supervisors to maintain a clean house. While a well-run bank may ultimately find private or public capital after significant effort, any weaker or mismanaged recipients may have been buoyed along by taxpayer funds, merely delaying the inevitable FDIC resolution or sale. Thus, Treasury's failure to act promptly, in light of the fact that a private investor would not hesitate to exercise its rights or discipline management, creates competitive disparities between CPP-recipient banks and banks that did not take CPP funds.

Further, if Treasury delays action, it is potentially in the position of subsidizing mismanaged institutions, which carries moral hazard concerns. Because the decision to close a bank is made by supervisors pursuant to preset supervisory criteria, Treasury does not

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[140] OCC conversations with Panel staff (June 10, 2010); FDIC conversations with Panel staff (June 14, 2010); Federal Reserve conversations with Panel staff (June 29, 2010); OTS conversations with Panel staff (July 7, 2010).

[141] *See* TARP Monthly 105(a) Report—May 2010, *supra* note 56, at 9 ("Treasury had exchanged its CPP preferred stock ($84.8 million in initial investment plus $4.3 million in unpaid and accrued dividends) into $89.1 million of mandatorily convertible preferred stock"); Federal Deposit Insurance Corporation, *Failed Bank Information for Midwest Bank and Trust Company*, Elmwood Park, IL (May 19, 2010) (online at www.fdic.gov/bank/individual/failed/midwestil.html).

[142] Treasury conversations with Panel staff (June 14, 2010).

[143] *See* United Commercial Bank Fact Sheet, *supra* note 60. The Panel has no non-public information relating to mismanagement at CPP-recipient banks.

have the capacity to determine whether an institution will close.[144] Treasury's remedies under the CPP could have been considerably stronger: for example, in the 1930s, the Reconstruction Finance Corporation's voting rights doubled if the entities in which it was invested missed two dividends.[145] By contrast, CPP SPAs are far weaker, requiring at least a year and a half of missed dividends before Treasury can have a say in management. The result is that Treasury may have overly restricted its ability to address problem institutions.

Finally, also unlike a private investor, which can choose to write off an investment that is too costly to maintain, Treasury has policy and statutory concerns that impact its ability to write off its investments. Treasury has stated that it will consent to a restructuring that might impair the investment's value if the alternative is losing the investment entirely. Treasury could determine that the policy and maintenance costs of remaining invested in the last CPP banks [146] warrants consideration of writing off its investments in still-functioning institutions, in part because the remaining investments represent a small portion of the TARP. However, despite the small size of the remaining investments, this action could have moral hazard consequences, and might also contradict EESA's mandate to "maximize overall returns to the taxpayers." [147]

3. Systemic Considerations for Exit

Treasury has devised a "three pillar" exit strategy that it applies to all TARP recipients. It plans to unwind its investments in a manner that: (1) maintains systemic stability; (2) maximizes return on investment; and (3) preserves the stability of individual institutions.[148] In conversations with Panel staff, Treasury did not specify how it plans to balance these priorities against each other or resolve conflicts between them when they occur, although Treasury stated the first two concepts are of higher priority.[149] The interplay between the three pillars is vitally important because there may be tension among them. For example, for those larger banks that remain in the program, Treasury's attempts to expedite its exit at the point of maximum value to the taxpayer could threaten its other policy goals, particularly in increasing the access to credit, given the continued size and scope of Treasury's investments.[150]

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[144] Like any private sector investor, Treasury and its asset managers could determine which banks are likely to close, based on publicly available data.

[145] Benton E. Gup, *Bank Failures in the Major Trading Countries of the World*, at 80 (1998). *See also* Congressional Oversight Panel, *April Oversight Report: Assessing Treasury's Strategy: Six Months of TARP*, at 40 (Apr. 7, 2009) (online at cop.senate.gov/documents/cop-040709-report.pdf).

[146] For a discussion of the future difficulties that may arise for CPP banks that are unable to exit the program, *see* Section D.3, *infra*.

[147] 12 U.S.C. 5201(2)(C).

[148] January Oversight Report, *supra* note 92, at 29–30 (citing Treasury conversations with Panel staff (Dec. 3, 2009)). In the Panel's June hearing, Secretary Geithner further elaborated on this strategy, stating that moving forward Treasury will also "dispose of investments as soon as practicable . . . encourage private capital formation to replace government investments . . . not intervene in the day-to-day management of private companies in which we have invested, and, as we implement this strategy, we will seek out the best advice available." COP Hearing with Treasury Secretary Timothy Geithner—Written Testimony, *supra* note 87, at 5.

[149] January Oversight Report, *supra* note 92, at 5 ("The Panel is also concerned that, although Treasury has been consistent in articulating its principles, the principles as announced are so broad that they provide Treasury with a means of justifying almost any decision").

[150] Treasury has responded to this concern by stating that it interprets its obligation to sell at an "optimal" time to mean that it cannot enter a sale that would undermine systemic stability. Of course, a bank that fails—after attempts at raising private capital and restructuring—

This concern may be somewhat assuaged in the context of small banks. Whereas sales of preferred shares in the world's largest financial institutions could have systemic consequences, intermittent sales of shares of individual small banks are less likely to have a systemic effect. Accordingly, the different nature of sales of large and small institutions, respectively, may permit Treasury to employ an exit strategy that hews more closely to objective measurements: the size of profit realized by the taxpayer and the strength of the financial institution seeking exit—provided, of course, that the investments are liquid enough to sell.

Treasury maintains that it is still considering a variety of approaches for smaller bank repayments,[151] but the current repayment outlook for many smaller banks is challenging. If they continue to face a sluggish recovery, balance sheet pressure, and severe capital-raising challenges, some of these smaller banks have few obvious options and are likely to remain in the TARP for an extended period.[152] As Treasury's exit strategy continues to evolve, Treasury states it will give particular consideration to the smaller private institutions that now comprise the bulk of CPP participants. Because these banks' assets are generally illiquid and offer "no logical buyer," Treasury is planning for the "friction costs" associated with their disposition.[153] In conclusion, although Treasury has or is in the process of formulating procedures for managing and disposing of its interest in smaller banks, unless the economy

provides for Treasury's exit, albeit with the loss of the taxpayers' investment. Whether that failure-as-exit is systemically significant depends on the size of the bank. January Oversight Report, *supra* note 92, at 47 ("One form of exit from the TARP that has not drawn much attention from commentators involves those TARP-recipient financial institutions that fail, an event that can be expected to wipe out the taxpayers' investment. Ironically, when no further government intervention occurs, this kind of early and involuntary exit from TARP may have the effect of reducing moral hazard and restoring market discipline.").

[151] Treasury conversations with Panel staff (June 14, 2010).

[152] Treasury's proposed SBLF program may present another CPP exit option for some smaller banks: some banks may be able to convert their CPP funds to the more favorable terms of the SBLF. However, according to legislation currently under consideration, at the end of a four and one half year period, the dividend or interest rate increases to 9 percent. As an incentive to lend, banks with less than $10 billion in assets that participate in the SBLF pay a dividend or interest rate based on the amount of small business lending reported in their call reports during the quarter immediately preceding Treasury's capital investment—which then forms a baseline figure. The dividend or interest rate for participating institutions is initially set at 5 percent. During the first two years after an institution receives its capital investment, the rate is adjusted to reflect changes in the amount of small business lending relative to its baseline. For every 2.5 percent that an institution increases its small business lending above its baseline, the rate drops by 1 percent. The dividend or interest rate may fall as low as 1 percent. The rate reduction will be limited to the dollar amount of the increase in lending. If an institution's small business lending remains equivalent to its baseline or decreases at the end of a two-year period, the dividend or interest rate increases to 7 percent. The precise details of the conversion process are unclear, as the legislation provides few specifics and instead requires the Secretary to issue regulations that will govern the process. Small Business Jobs Act of 2010, H.R. 5297 (online at www.congress.gov/cgi-lis/query/z?c111:H.R.5297:). Although the CPP–SBLF conversion could delay the step-up in dividends for institutions that participate, and lower its dividend payment in the interim, the SBLF dividend also increases to 9 percent after 4.5 years, posing some similar difficulties to those presented by the CPP's design. CPP participants that have missed more than one dividend payment are not permitted to convert their CPP capital to the terms of the SBLF.

[153] Treasury conversations with Panel staff (June 14, 2010). These "friction costs" may also include disposition of illiquid warrants for public institutions. There are several ways in which the disposition of warrants for smaller banks could be challenging. First, it is unlikely that the financial condition of many smaller institutions will permit these banks to repurchase their warrants from Treasury (i.e., they lack the capital base to do so). Second, because the stock of smaller institutions is not as widely traded as that of larger institutions, it is more challenging to formulate the "fair market value" for the warrants of smaller institutions. July Oversight Report, *supra* note 21, at 28. Third, in the event that Treasury decides to auction its warrants in these banks, the value of the small banks' warrants may fall short of minimum auction size requirements. In this case, Treasury can continue to hold the warrant and exercise it at its discretion; this situation has yet to arise. See note 83, *supra*.

and the banking sector recover, in many cases it is not clear that Treasury has many, if any, options other than "wait and see"—an unacceptable degree of uncertainty for the taxpayers' investment.

E. The Smaller Banking Sector and Treasury

1. Has Including Smaller Banks in the CPP Furthered Treasury's Initial Objectives?

Any assessment of the merits of including small banks in the CPP must begin with an understanding of Treasury's objectives for the program. Treasury has stated that the CPP was necessary to stabilize the financial system and that, further, including small banks was necessary for three principal reasons: (1) to stabilize the system and strengthen financial institutions so that (2) businesses and individuals would have access to credit; and (3) to ensure that small banks were treated fairly relative to larger institutions.

a. Reason One: The CPP Was Necessary to Stabilize the Financial System

In the fall of 2008, by many measures, the financial system was on the brink of collapse. At that time and in the days since, Treasury has argued that the TARP was necessary to avoid systemic disruptions and to stabilize the financial system.[154] Less than six weeks after EESA was passed, then-Secretary Henry M. Paulson, Jr. stated that the TARP was a "necessary" step to "prevent a broad systemic event."[155] Likewise, in testimony before Congress, then-Interim Assistant Secretary Neel Kashkari stated that stabilizing financial markets and reducing systemic risk were "critical objectives" of the TARP.[156]

Systemic stability, however, does not seem to have driven Treasury's decision to include small banks in the program. As discussed in Section E.2, small banks may play a vital role in the economy—by using unique lending technologies to provide credit to small businesses and by expanding the types of banking services available to consumers—but the failure of a small bank is not systemically significant.[157] Failures of one, or even many, of the small banks that participated in the CPP are unlikely to cause the sorts of shocks that froze the credit markets in September 2008.[158] Fur-

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[154] Neel Kashkari, interim assistant secretary for financial stability, U.S. Department of the Treasury, *Remarks before the Institute of International Bankers* (Oct. 13, 2008) (online at www.financialstability.gov/latest/hp1199.html) (hereinafter "Kashkari Remarks before the Institute of International Bankers") ("The law gives the Treasury Secretary broad and flexible authority . . . to purchase any other financial instrument that the Secretary, in consultation with the Federal Reserve Chairman, deems necessary to stabilize our financial markets—including equity securities.").

[155] U.S. Department of the Treasury, *Remarks by Secretary Henry M. Paulson, Jr. on Financial Rescue Package and Economic Update* (Nov. 12, 2008) (online at www.financialstability.gov/latest/hp1265.html).

[156] House Committee on Financial Services, Written Testimony of Neel Kashkari, interim assistant secretary for financial stability, U.S. Department of the Treasury, *Oversight Concerns Regarding Treasury Department Conduct of the Troubled Assets Relief Program,* at 1 (Dec. 10, 2008) (online at financialservices.house.gov/hearing110/kashkari121008.pdf) (hereinafter "Kashkari Written Testimony").

[157] FDIC conversations with Panel staff (June 14, 2010); Treasury conversations with Panel staff (June 14, 2010).

[158] It is possible that, particularly given the pressures on the FDIC fund (discussed in Section E.1.b.i, *infra*), there is some number of small bank failures that could have created similar widespread freezing of the credit markets. It is, however, difficult to evaluate this possibility in the abstract.

thermore, as Treasury described the program as one for healthy banks, Treasury could not have intended it to prevent a large number of small bank failures. The allocation of CPP funds was consistent with this premise: 17 stress-tested banks received 81 percent of the total CPP funds disbursed, while the other 690 CPP recipient banks received 19 percent.[159] The average allocation per institution was $9.76 billion for stress-tested banks and $60 million for the others. As discussed above, only 9 percent and 37 percent of Smallest and Smaller banks, respectively, received TARP funds, whereas of Medium and Large banks, 53 percent and 85 percent, respectively, received CPP funds.[160]

Moreover, long before many small banks entered the CPP, Treasury already had asserted that the program had contributed to stabilizing the financial system. On December 10, 2008, just over two months after EESA was passed, then-Interim Assistant Secretary Kashkari announced that the program had succeeded because the financial system had not collapsed and instead had become "fundamentally more stable."[161] Yet on that date, for the most part only the larger institutions had entered the program—it would be a year before the smaller banks that were to participate would complete their entry.[162] There may therefore have been longer-term systemic reasons for including small banks in the CPP, but the timeline above suggests that Treasury believed that advancing CPP money to the largest banks was sufficient to immediately stabilize the system in the fall of 2008.

b. Reason Two: Including Smaller Banks in the CPP Was Necessary to (1) Strengthen Banks so that They Could (2) Continue to Make Credit Available

Treasury has also stated that the TARP was necessary to strengthen financial institutions so that they could keep credit flowing during a period of economic duress. Although Treasury designed the CPP to "attract broad participation by healthy institutions,"[163] the program was announced during a period of fundamental weakness in the banking sector. The FDIC's Deposit Insurance Fund was under significant stress, the credit markets had frozen, and the entire sector was experiencing a wave of bank failures

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[159] *See* Annex I.2.a, *infra.* In addition, programs like the TALF address aspects of the banking industry—such as securitization—that are less relevant to small institutions. Of course, many aspects of the government's interventions benefit smaller banks even when they do not target them directly. Without active securitization markets, for instance, smaller banks would be less able to recycle capital and continue lending. Nonetheless, several of the largest government programs primarily targeted the largest institutions.

[160] *See* Annex I.2.a, *infra.*

[161] Kashkari Written Testimony, *supra* note 156, at 5.

[162] By December 1, 2008, of the 52 banks that had received CPP funds, 22 of them had less than $10 billion in assets. By that time, however, 73.9 percent of the CCP funds had already been disbursed. SNL Financial. *See also* Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2.

[163] U.S. Department of the Treasury, *Statement by Secretary Henry M. Paulson, Jr. on Capital Purchase Program* (Oct. 20, 2008) (online at www.treasury.gov/press/releases/hp1223.htm) (hereinafter "Statement by Secretary Henry M. Paulson, Jr. on Capital Purchase Program"); Kashkari Written Testimony, *supra* note 156, at 5; CPP Applications Audit, *supra* note 25, at 7 ("Under the CPP, Treasury provides funds to viable financial institutions through the purchase of preferred stock shares or senior securities, at market value, on standardized terms."). Despite Treasury's statements about concentrating the CPP on healthy institutions, it is possible that some institutions that were healthy upon entry into the program are not healthy now. When Treasury reviewed applications, it based its decisions on an assessment of an institution's health. The accuracy of these assessments depended in part on assumptions about future market conditions that may have differed from the state of the market in reality.

with rapid declines in asset valuations, attendant uncertainty, and retrenchment. Further, in 2008 and early 2009, many smaller banks faced severe capital shortages. A stress test of smaller banks conducted by SNL Financial in May 2009 found that of 418 smaller banks, 367 (87.8 percent) needed to raise a total of $75 billion in additional capital.[164] Although SNL Financial has since revised that figure to $43 billion or $35 billion, depending on which methodology is used, the $75 billion estimate was cited in several major media sources at the time.[165] Given the size of the capital hole and the myriad pressures faced by smaller institutions during this period, while stabilizing the small bank sector may not have been a critical objective of the CPP, it is possible—though impossible to determine—that providing smaller banks with funds increased confidence in the sector as a whole, and that if the CPP had not been extended to smaller banks, credit markets might have been even more restricted or there would have been additional bank failures.[166]

Treasury intended the CPP to provide capital in order to maintain the flow of credit to the economy. When EESA was passed, then-Secretary Paulson announced that the law "contains a broad set of tools that can be deployed to strengthen financial institutions, large and small, that serve businesses and families."[167] Similarly, in a speech on October 13, 2008, then-Interim Assistant Secretary Kashkari stated that EESA would "empower[ ] Treasury to design and deploy numerous tools to attack . . . the capital hole created by illiquid troubled assets," which would in turn "enable our banks to begin lending again."[168] As the Panel has stressed repeatedly, these twin objectives were inextricably linked; the CPP could never be deemed a success if it used taxpayer funds to shore up bank balance sheets but had no effect on credit availability. A taxpayer-funded capital infusion that stops at a bank without flowing to the larger economy in the form of credit largely serves that bank, not the small businesses and families that depend upon it.[169]

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[164] SNL Financial.

[165] *See, e.g.* Tenzin Pema, *Analysis-Small Bank Share Offers May Find Fewer Takers,* Reuters (May 27, 2009) (online at www.reuters.com/article/idUKN2744940120090527); Cyrus Sanati, *Stress Testing the Rest of the Banks,* New York Times (May 13, 2009) (online at dealbook.blogs.nytimes.com/2009/05/13/ stress-testing-the-rest-of-the-banks/).

[166] For additional discussion of these issues, see the Panel's May 2010 report. May Oversight Report, *supra* note 6. For example, Treasury asserted at the outset that all banks would benefit from the confidence inspired by government actions taken to quell the crisis, whether they participated in the CPP or not. Kashkari Remarks on Financial Markets and TARP Update, *supra* note 3.

[167] U.S. Department of the Treasury, *Paulson Statement on Emergency Economic Stabilization Act* (Oct. 3, 2008) (online at www.ustreas.gov/press/releases/hp1175.htm).

[168] Kashkari Remarks before the Institute of International Bankers, *supra* note 154 ("The law empowers Treasury to design and deploy numerous tools to attack the root cause of the current turmoil: the capital hole created by illiquid troubled assets. Addressing this problem should enable our banks to begin lending again."). *See also* Kashkari Written Testimony, *supra* note 156, at 5 ("We firmly believe that healthy banks of all sizes should use this program to continue making credit available in their communities.").

[169] December Oversight Report, *supra* note 17, at 38 ("Treasury has stated that it limited capital injections from the CPP to healthy banks in order to ensure that the funds were used for lending, and not merely to bolster recipient banks' balance sheets."); Congressional Oversight Panel, *May Oversight Report: Reviving Lending to Small Businesses and Families and the Impact of the TALF,* at 6 (May 7, 2009) (online at cop.senate.gov/documents/cop-050709-report.pdf) ("The TARP, and the Administration's broader Financial Stability Plan, will be successful only if they can revive lending on economically appropriate terms to meet the credit needs of the American people.").

i. Strengthening Banks

Evaluated against these two metrics of bank strength and bank lending, it is difficult to evaluate clearly Treasury's "success" in realizing these goals for small banks. Data indicate that while capital may have assisted small banks to some extent, the sector has not yet recovered from the financial crisis. Industry sources assert that small banks used CPP funds for several purposes, including shoring up their capital bases and replacing loans that were rolling off.[170] One study found that CPP recipients were healthier than non-CPP recipients and had a "higher profitability, a lower ratio of non-performing loans to total loans and a lower book-to-market ratio in the quarter prior to the program's initiation."[171]

Even so, banks continue to face a wide variety of pressures, including looming losses on CRE loans, the risk of future interest rate increases, and the prospect of tighter capital requirements.[172] CRE losses may hit CPP-recipient banks particularly hard: as of the first quarter of 2010, approximately 40 percent of banks that received CPP funds have CRE concentrations compared with approximately 19 percent of non-CPP banks.[173] According to a Standard & Poor's study, 10 percent of banks in 2009 were assigned a "D" rating, which reflects payment defaults or deferred payments.[174] More than 700 banks remain on the FDIC's Problem List, and while not all of them will fail, past experience suggests that roughly 20 percent will.[175] In addition, more than 30 percent of FDIC-insured institutions were unprofitable in 2009.[176] Some of these banks returned to profitability in the first quarter of 2010—

[170] Industry sources conversations with Panel staff (June 10, 2010).

[171] Ng, Vasvari and Moerman Research Paper, *supra* note 67. The authors also found that CPP recipients were perceived negatively by the equity market, an indication that factors unrelated to program design may have hindered recipients' performance. By contrast, this Panel report examines certain, but by no means all, correlations among CPP recipient banks and finds that differences were generally insignificant. These findings and differences may reflect the challenges of isolating the effect of the CPP from other variables.

[172] May Oversight Report, *supra* note 6, at 53. *See also* Ronald Charbon and Rodrigo Quintanilla, *Small U.S. Community Banks Face Another Tough Year,* Standard & Poor's, at 2 (June 14, 2010) (hereinafter "Small U.S. Community Banks Face Another Tough Year").

[173] Data provided by Foresight Analytics. Guidance established by federal regulators in 2006 set two commercial real estate measures to denote an institution's CRE concentration. An institution was deemed to have a CRE concentration, and therefore warrant extra regulatory scrutiny, if the ratio of its Construction and Land Development loans over its total risk-based capital exceeded 100 percent or if the ratio of the institutions' total CRE loans over total risk-based capital exceeded 300 percent. Although the Guidance does not place any explicit limits on the ratio of commercial real estate loans to total assets, it states that "if loans for construction, land development, and other land and loans secured by multifamily and nonfarm, nonresidential property (excluding loans secured by owner-occupied properties) were 300 percent or more of total capital, the institution would also be considered to have a [commercial real estate] concentration and should employ heightened risk management practices." Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. 74580, 74581 (Dec. 12, 2006). The supervisors also classify a bank as having a "CRE Concentration" if construction and land loans are more than 100 percent of total capital. U.S. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices,* at 7 (Dec. 12, 2006) (online at www.occ.treas.gov/ftp/release/2006-2a.pdf). For further discussion of these guidelines, please see February Oversight Report, *supra* note 103, at 108–109, 113.

[174] Small U.S. Community Banks Face Another Tough Year, *supra* note 172, at 7.

[175] FDIC conversations with Panel staff (June 14, 2010) (stating that according to historical data, 19 percent of banks on the Problem List fail).

[176] Federal Deposit Insurance Corporation, *Quarterly Banking Profile: First Quarter 2010,* at 5 (May 2010) (online at www2.fdic.gov/qbp/2010mar/qbp.pdf) (hereinafter "FDIC Quarterly Banking Profile: First Quarter 2010").

only 19 percent were unprofitable—but it is unclear whether this change will hold.

While these studies help to provide some insight into the CPP, it is difficult to draw definitive conclusions from the data, principally due to the challenge of isolating the effect of the CPP from other economic trends and pressures.[177] Although many small banks were not plagued by problems from the complicated financial instruments that caused profound damage to large institutions, they have nonetheless suffered from stresses in the broader economy, including high unemployment rates, substantial CRE pressures, and sluggish growth. Regulatory factors have also affected the small bank sector: as the Panel noted in its May 2010 report, the prospect of tighter capital requirements has contributed to uncertainty in the sector.[178] In addition, the CPP was not the only government program designed to assist small banks, so positive results may reflect the effects of other programs.[179] It is also difficult to assess the impact of the CPP because it appears that short-term participants were able to capture more of the program's benefits than long-term participants, while avoiding many of its costs. Short-term participants received a confidence boost from the bolstered capital cushion, but avoided being substantially impaired by the stigma and restrictions that have imposed costs on long-term participants.

ii. Lending

The CPP's effect on lending is inconclusive. Different measures produce different results. Many institutions that received CPP funds did not increase their lending, and some experienced a decrease in loan value relative to non-CPP institutions.[180] According to data provided to the Panel by Treasury, aside from banks of less than $1 billion in total assets, non-CPP institutions increased their loan value relative to CPP institutions between the third quarter

[177] *See* May Oversight Report, *supra* note 6, at 26 (stating that it is "nearly impossible to make a useful evaluation of the effectiveness of capital infusion programs for the purposes of increasing lending"). Other methodological difficulties may further complicate the analysis. For instance, it is possible that CPP participants share certain common characteristics that distinguish them from non-CPP banks and skew the results. So few smaller banks participated in the CPP relative to the number of banks in the sector that selection bias could have a significant effect. Treasury has identified one key factor affecting the sample. Because the largest 21 banks participated in the CPP and because their total assets dwarf the total assets of smaller banks, aggregate CPP results functionally reflect the experience of large banks and provide little indication of small bank performance. Treasury conversations with Panel staff (June 11, 2010).

[178] May Oversight Report, *supra* note 6, at 53.

[179] For example, multiple industry sources cited the FDIC's Transaction Account Guarantee (TAG) program as a resource that has provided significant support to smaller banks. Industry sources conversations with Panel staff (June 23, 2010). According to the FDIC, the program provides customers of "participating insured depository institutions" with "full coverage on qualifying transaction accounts." Federal Deposit Insurance Corporation, *FDIC Board Adopts Final Rule Extending Tag Program and Maintains Current Deposit Insurance Assessment Rates* (June 22, 2010) (online at www.fdic.gov/news/news/press/2010/pr10139.html). The TAG program also has much broader participation than the CPP, possibly based in part on an opt-out design. While roughly 700 institutions participate in the CPP, over 6,300 have participated in the TAG, and there are no reports that participants have been stigmatized. Federal Deposit Insurance Corporation, *Final Rule Regarding Amendment of the Temporary Liquidity Guarantee Program to Extend the Transaction Account Guarantee Program,* at 5 (June 22, 2010) (online at www.fdic.gov/news/board/rule2.pdf).

[180] Data provided by Treasury (June 11, 2010). It is worth noting, however, that neither Treasury nor federal financial regulators have pushed big banks to deploy their TARP funds in lending to consumers, small businesses, and smaller banks to "unfreeze" the financial markets the way they have pushed small banks. This may be in part because the larger institutions have largely exited, and therefore are not subject to the public pressure arising from the lingering credit crunch.

of 2008 and the first quarter of 2010.[181] According to these measures, participation seems to be correlated with declining loan value for all but the smallest banks. The Panel reached a similar conclusion in its May 2010 report, finding that "most" CPP recipients decreased their lending, but it also cited data from SNL Financial indicating that banks between $10 billion and $100 billion grew their lending portfolios.[182]

One research paper found that CPP recipients used the bulk of the capital infusions to increase their Tier 1 capital ratios, rather than to increase their lending.[183] The paper also concluded, however, that the CPP had a measurable effect on lending, as CPP recipients used about 13 cents out of every CPP dollar to increase their lending.

However, the paper's findings must be analyzed in light of two of its core assumptions: first, that selection bias does not distort comparisons between TARP recipients and non-TARP assisted banks,[184] and second, that the measurement period from September 2008 until June 2009 accurately captures loan growth as a result of the CPP. In June 2009, many banks—predominantly the smaller ones—had not even entered the program,[185] and some of the banks that had already received capital investments may not yet have realized the effects of the program. Accordingly, there are no strong data to conclude that a substantial portion of the taxpayer dollars provided to small banks made it into small business lending or other forms of credit.[186]

c. Reason Three: Including Smaller Banks in the CPP Was Necessary to Ensure That All Banks Were Treated Fairly

Treasury also maintains that including small banks in the CPP served fairness.[187] That said, while small banks were eligible to re-

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[181] Data provided by Treasury (June 11, 2010). It is difficult to evaluate this data because it does not account for the influence of demand on loan value and because it does not account for the effect of selection bias.

[182] May Oversight Report, *supra* note 6, at 3, 62 ("Treasury has launched several TARP initiatives aimed at restoring health to the financial system, but it is not clear that these programs have had a noticeable effect on small business credit availability."). The SNL data was for the period between 2008 and 2009. On the other hand, SIGTARP found that CPP funds helped some banks to continue lending despite the downturn. More generally, SIGTARP found that TARP funds were used for lending, capital reserves and investments. Office of the Special Inspector General for the Troubled Asset Relief Program, *Survey Demonstrates that Banks Can Provide Meaningful Information on their Use of TARP Funds,* at 5, 7 (Jul. 20, 2009) (SIGTARP–09–001) (online at www.sigtarp.gov/reports/audit/2009/SIGTARP_Survey_Demonstrates_That_Banks_Can_Provide_Meaningful_Information_On_Their_Use_Of_TARP_Funds.pdf). SIGTARP distributed its survey letters in February 2009, surveying only 364 of the 707 CPP participants.

[183] Taliaferro Working Paper, *supra* note 35, at 2. In the Panel's May Report, the Panel also noted that the Federal Reserve's practice of paying interest on excess reserves may have also created an incentive for banks to hold cash. *See* May Oversight Report, *supra* note 6, at 29.

[184] As noted above, because many institutions withdrew their applications after consultation with bank regulators but were never formally rejected, it is hard to know what, if any, characteristics distinguish participants from non-participants.

[185] *See* Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2. As noted above, the first nine banks that participated did so without a formal application. Subsequent banks were required to apply and undergo an evaluation.

[186] *See* also May Oversight Report, *supra* note 6, at 58–66.

[187] *See* Congressional Oversight Panel, Testimony of Timothy F. Geithner, secretary, U.S. Department of the Treasury, *Transcript: COP Hearing with Treasury Secretary Timothy Geithner* (June 22, 2010) (publication forthcoming) (online at cop.senate.gov/hearings/library/hearing-062210-geithner.cfm). Prior to this testimony, Treasury's statements about the CPP implied that it took the principle of fairness into account when it designed the program. *See* Statement by

Continued

ceive TARP funds, there were still differences in access and experience in comparison to the larger institutions. For example, the largest banks received funds almost immediately, but many small banks experienced delays in entering the program.[188] When they were eventually granted access, they found themselves in a program that by then much of the public viewed negatively. As the Panel's May 2010 report documented, a TARP "stigma" attached to TARP recipients, and for many of them, their businesses suffered as a result. Moreover, industry sources maintain that restrictions that were applied after banks accepted TARP funds have made banks hesitant to participate in the TARP, as they have no guarantee that the restrictions in place at the time they accept government funds will remain constant.[189] Thus, CPP capital that might have seemed cheap in late 2008 or early 2009, when the financial system was reeling, may have become more expensive today.[190] As a result, some institutions that initially applied to the CPP subsequently withdrew their applications, and an unknown number of institutions decided not to apply. Others had already accepted TARP funds, but for reasons discussed in more detail in Section D, have been unable to raise capital to exit the program. Consequently, as large banks tap capital markets and existing shareholders to raise the funds necessary to exit the program, some smaller banks remain trapped in a program that may harm their businesses.[191] Ultimately, despite Treasury's attempt to design the program so that it would provide broad support to healthy banks of all sizes, the experience of the smaller banks has been fundamentally different from the experience of the largest banks.

2. How Will the CPP Affect the Smaller Bank Sector in the Future?

In spite of the CPP, the small bank sector is generally unhealthy now, although it may improve if market conditions improve. While it is difficult to reach any definitive conclusion about the role of the CPP in strengthening or weakening the sector, several challenges face the smaller banks that received CPP funds as these banks seek to exit the program. The first option for exit is simply to redeem Treasury's investments. As discussed above, it is not at all clear, however, that these banks will have the means to do so any time soon.[192]

Secretary Henry M. Paulson, Jr. on Capital Purchase Program, *supra* note 163 ("This program is designed to attract broad participation by healthy institutions and to do so in a way that attracts private capital to them as well. . . . In addition to the nine banks who announced their participation last week, we have received indications of interest from a broad group of banks of all sizes.").

[188] *See* Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2.

[189] May Oversight Report, *supra* note 6, at 68–72.

[190] As discussed above, the cost to a bank of retaining CPP capital depends on the particular bank, its access to alternative sources of capital, and the degree of stigma it may be experiencing (e.g. is it the only bank in its market to have accepted or to retain CPP funds). As time has passed, further, the perception has become more negative over time. *See* Phoenix Field Hearing on Small Business Lending, *supra* note 38, at 98 (stating that CPP funds were initially perceived as an endorsement of the bank).

[191] *See* Section E.2, *infra* (discussing the consequences for banks that cannot exit the CPP).

[192] Small banks are largely unable to access the capital markets at reasonable cost or to tap existing shareholders in order to raise capital and, in the current economy, many who might normally invest in small banks are unwilling to take the risk or are short on investment capital themselves. *See* Section D, *supra*.

Smaller banks also could face stiffer competition from the 19 stress-tested banks—CPP recipients or otherwise—since those banks have been the beneficiaries of an implicit guarantee conferred by their status as "too big to fail."[193] Officials have recognized that this guarantee could threaten the competitiveness of the banks that were not included in the stress tests.[194] Chairman Bernanke proclaimed that the guarantee could create "competitive inequities that may prevent our most productive and innovative firms from prospering"[195] and Chairman Bair stated that this "regulatory structure as it stands today puts community banks at a sizeable competitive disadvantage."[196] Such disadvantage is likely to impair further these banks' ability to raise capital, and smaller private banks may struggle significantly to find a clear way out of the CPP.[197]

The second option for these banks is to keep the funds and continue paying dividends. This would require ongoing monitoring by Treasury, as well as oversight by several bodies including the Financial Stability Oversight Board, SIGTARP, and GAO, which have mandates to oversee the TARP until all TARP investments are repaid.[198] As the number of CPP recipients still in the program dwindles, and small institutions' share of the program increases, Treasury will have to make a decision about what its role will look like in handling these small, scattered investments. Treasury should disclose operational and strategic elements of the program—such as its approach to recapitalizations and its reluctance to take losses—making generally available its management and invest-

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[193] Large institutions may benefit from an implicit guarantee. *See* January Oversight Report, *supra* note 92, at 14 ("The decisions to rescue certain financial institutions have created an implicit government guarantee, the limits of which are unknown and the reasons for which are not fully articulated."). The ramifications of this implicit guarantee may be visible in certain comments by rating agencies with regard to Citigroup. In its July 31, 2009 report, Standard & Poor's gave Citigroup a credit rating of "A" but noted "the potential for additional extraordinary government support, if necessary," and further stated that Citigroup's rating "reflects a *four-notch uplift* from our assessment of Citigroup's stand-alone credit profile." Standard & Poor's, *Global Credit Portal, Citigroup Inc.* (July 31, 2009) (emphasis added). Treasury has also stated that it could not allow any of the 19 stress-tested institutions to fail and that doing so would have constituted a breach of the government's promise to ensure that any stress-tested institution would have access to government support. Treasury conversations with Panel staff (Feb. 18, 2010).

[194] These banks have, in effect, a hidden subsidy. In September 2009, Dean Baker and Travis McArthur of the Center for Economic and Policy Research conducted a study on implicit subsidies received by banks considered "too big to fail" during the height of the financial crisis. To determine the value of these subsidies, Baker and McArthur compared the average cost of funds for banks with more than $100 billion in assets and for banks with under $100 billion in assets. With respect to banks with more than $100 billion in assets, the average cost of funds was 0.78 percentage points lower than the cost of funds for smaller banks from the final quarter of 2008 to the second quarter of 2009. Based on their calculations, this spread would translate into a subsidy of $6.28 billion (low scenario) or $34.16 billion (high scenario) for the large banks. Baker and McArthur's subsidy estimates represent 8.8 percent and 47.7 percent, respectively, of projected profits in 2009 for their sample institutions. Dean Baker and Travis McArthur, *The Value of the "Too Big to Fail" Big Bank Subsidy,* Center for Economic and Policy Research Paper, at 4 (Sept. 2009) (online at www.cepr.net/documents/publications/too-big-to-fail-2009-09.pdf).

[195] Ben S. Bernanke, chairman, Board of Governors of the Federal Reserve System, *Preserving a Central Role for Community Banking,* Speech before the Independent Community Bankers of America, at 4 (Mar. 20, 2010) (online at www.federalreserve.gov/newsevents/speech/bernanke20100320a.pdf) (hereinafter "Bernanke Speech before ICBA").

[196] Commercial Real Estate: A Drag for Some Banks but Maybe Not for U.S. Economy, *supra* note 103.

[197] As of June 23, 2010, 75 banks have redeemed their CPP investments, leaving 625 still in the program. Of banks with less than $1 billion in assets, 3.5 percent have repaid. Although some have found the means to exit, the overwhelming majority have not. *See* Linus Wilson and Yan Wendy Wu, *Escaping TARP* (June 3, 2010) (online at papers.ssrn.com/sol3/papers.cfm?abstract_id=1619689).

[198] 12 U.S.C. §§ 5214(h), 5226(e), 5231(k).

ment approach. It should not, however, reveal non-public information about individual institutions.[199]

Indefinite participation may, however, be unsustainable for other reasons, such as the scheduled increase in the CPP dividend after five years. Since the dividend increase was designed to provide an incentive to repay the investments, presumably those banks that can pay off the investment at that point will do so. Banks that do not pay may run the risk of signaling to the market that they are unable to redeem, which may have the effect of creating further instability. In addition, the jump in payments, coupled with the other pressures on small banks—most notably troubled real estate loans—and continued sluggishness in economic growth overall, may force banks to miss dividend payments or default on other obligations. Even without these pressures, a 9 percent dividend is expensive, and bank earnings may be insufficient to cover the increased dividend. Banks that cannot redeem their CPP shares may be forced to find a buyer to take over the bank, or wind up in FDIC receivership. A struggling bank with certain attractive features, such as a desirable branch network, may be able to find another bank interested in expanding. Other banks may be unable to find a buyer, especially in the current economic environment, and will wind up in the FDIC's resolution process.[200] If a buyer can be found for a failing CPP bank, the CPP investment may be redeemed. If the bank fails and is put into FDIC receivership, it is unlikely that the money will be repaid.

Whether a bank is acquired by another bank or is completely unwound by the FDIC, the result will be a concentration in the banking sector resulting from consolidations or closures among banks. Even before the dividend increase may have the potential to force banks to sell or merge, the CPP had the effect of increasing concentration in the banking sector: the largest banks, after all, got most of the CPP funds. Of course, it is also possible that certain mergers did *not* happen because of the CPP: a small bank that would otherwise have been acquired by a larger bank was instead able to continue operations on its own because of the infusion of TARP capital. The question of concentration was, however, a side issue in late 2008 when the TARP was first developed. Former Treasury Secretary Paulson noted in testimony in November 2008 that individual instances of bank consolidation may be beneficial overall: "I will make the general point that, if there is a bank that is in distress and it is acquired by a well capitalized bank, there is more capital in the system, more available for lending, better for communities, better for everyone."[201] Interim Assistant Secretary for Financial Stability Neel Kashkari expressed a similar senti-

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[199] *See* January Oversight Report, *supra* note 92, at 45 ("This traditional position of the regulators conflicts with the need for Treasury as investor in particular banks to know as much as possible about the financial condition of those banks. In these circumstances, the regulators' traditional lack of transparency may do a disservice to the taxpayers, investors, and to the marketplace in financial institutions' securities.").

[200] *See* Annex I.C.4, *infra.*

[201] House Committee on Financial Services, Testimony of Henry M. Paulson, Jr., secretary, U.S. Department of the Treasury, *Oversight of the Implementation of the Emergency Economic Stabilization Act of 2008 and of Government Lending and Insurance Facilities: Impact on the Economy and Credit Availability,* at 34 (Nov. 18, 2008) (online at frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110__house__hearings&docid=f:46593.pdf).

ment in his testimony before the Senate Committee on Banking, Housing, and Urban Affairs just a month earlier:

> To the point of consolidation, I do not think we have any specific program focus on consolidation. Again, I think it will be a case-by-case analysis with our regulatory colleagues. The example I gave I think is a good one. If you had a small failing institution that was being acquired by a much healthier, stronger institution, the idea of putting Government/taxpayer dollars into that combined entity, we think that is a good use of taxpayer dollars because that community is well served now by that combined stronger institution.[202]

Although those working on the development of the TARP and the CPP were aware of the potential for increased concentration, they do not appear to have viewed the CPP's role as either explicitly encouraging or discouraging such a trend.

Recently, however, the question of whether increased bank concentration may have a positive, negative, or neutral effect on financial stability has become a contested topic, particularly in light of proposed changes to financial regulation.[203] Former Treasury Secretary Paulson testified in May that "I think that the level of concentration where we have ten big institutions with 60 percent of the financial assets . . . this is a dangerous risk."[204] Economist Simon Johnson has also argued in favor of breaking up large banks as a means of increasing stability.[205] Others, however, have argued that banking concentration actually increases financial stability. White House financial advisor Lawrence Summers recently explained that observers who study this issue have found that:

> to try to break banks up into a lot of little pieces would hurt our ability to serve large companies and hurt the competitiveness of the United States . . . [And most observers who study this issue] believe that it would actually make us less stable, because the individual banks would be less diversified and, therefore, at greater risk of failing, because they wouldn't have profits in one area to turn to when a different area got in trouble. And most observers believe that dealing with the simultaneous failure of many—many small institutions would actually generate more need for bailouts and reliance on taxpayers than the current economic environment.[206]

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[202] Kashkari Testimony before Senate Banking, *supra* note 17, at 35.

[203] The proposed Safe, Accountable, Fair, and Efficient Banking Act of 2010 or the SAFE Banking Act of 2010, would cap at 10 percent the total U.S. assets that any one bank holding company could own. Safe, Accountable, Fair, and Efficient Banking Act of 2010, S.3241 (online at thomas.loc.gov/cgi-bin/bdquery/z?d111:s3241:).

[204] The Shadow Banking System, *supra* note 77, at 46.

[205] Simon Johnson, *Make the Call or Get Out of the Booth: After the President's "Wall Street" Speech*, The Baseline Scenario (Apr. 22, 2010) (online at baselinescenario.com/2010/04/22/make-the-call-or-get-out-of-the-booth-after-the-president's-wall-street-speech/) (supporting the Brown-Kaufman amendment on the grounds that it is "our best near-term chance to reduce the size of Wall Street megabanks that are too big to fail and that threaten our economy.").

[206] Lawrence Summers, director, White House National Economic Council, PBS NewsHour (Apr. 22, 2010) (online at www.pbs.org/newshour/bb/business/jan-june10/summers_04-22.html). To the extent that a financial crisis is geographically or industry-specific, a banking system populated with smaller, regional banks may be better able to keep the crisis confined to those regions or industries. While a large number of banks in one area or that cater to one industry

Continued

And some researchers have found that: "[financial] crises are less likely in economies with (i) more concentrated banking systems, (ii) fewer regulatory restrictions on bank competition and activities, and (iii) national institutions that encourage competition."[207] While the debate over whether increased concentration in the banking sector will have a positive or negative effect on our national economy is ongoing, the trend toward concentration is clear.[208]

This trend was firmly established even before the current crisis, but the trend has accelerated since the crisis, and Treasury should evaluate the effect of the CPP on concentration.[209] Since 2006, there have been 860 bank purchases and mergers of banks by other banks and bank holding companies.[210] In bank-to-bank acquisitions, the smallest banks were targets for many consolidations, including those involving other banks with less than $1 billion in total assets, acting as a buyer for 379 transactions. In bank-to-bank transactions, banks with $1 billion to $10 billion in assets completed 214 purchases and mergers. Banks with $10 billion to $100 billion in assets executed 49 bank-to-bank deals, while the largest banks or bank holding companies were involved in 44 deals.[211] Acquiring banks generally targeted other banks in asset groups smaller than their own, and the location of the targets of acquisition was generally consistent with the distribution of banks across regions.[212]

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may suffer, the banking system as a whole may be less vulnerable. On the other hand, however, large banks are more likely to have diversified business units and therefore be able to absorb loss in one industry or region without facing the collapse of the bank as a whole. And, given the concentration that already exists in the sector, the smaller banks may be an insufficient counterweight to any serious threat to the largest institutions.

[207] Thorsten Beck, Asli Demirgüç-Kunt, and Ross Levine, *Bank Concentration and Crises*, National Bureau of Economic Research Working Paper, No. 9921 (Aug. 2003) (online at www.nber.org/papers/w9921.pdf).

[208] In addition, there are commercial pressures that may lead towards concentration. Small banks may be unable to compete with larger institutions as their customers demand certain complex services that are beyond the capacity of small banks to provide. This pressure may contribute to the trend toward concentration.

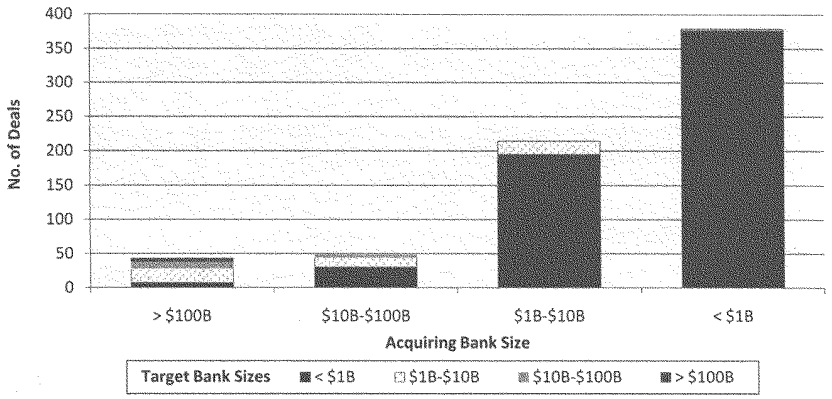
[209] See Annex I, *infra*.

[210] This number references bank purchases by other banks and bank holding companies. A total of 916 purchases and mergers were completed during this period; the remaining banks were purchased by investor groups, management groups, and private investors.

[211] A significantly larger proportion of acquisitions, therefore, are performed by Large/Medium banks relative to their numbers in the market. However, these figures do not account for buyers that do not report their size in regulatory filings, such as some smaller bank holding companies, de novo bank purchasers, and other similar entities. However, the bank holding companies with over $100 billion in assets are accounted for in these numbers.

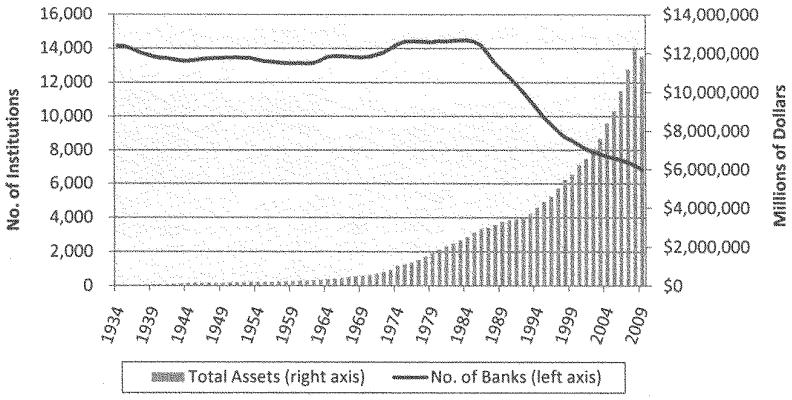
[212] SNL Financial. The targets were concentrated in the Midwest, with the Southeast next, followed by the Southwest, then the Mid-Atlantic, the West, and the Northeast. Banks are generally concentrated in the Midwest, followed by the Southwest, the Southeast, the Mid-Atlantic, the West, and the Northeast.

FIGURE 4: NUMBER OF PURCHASES AND MERGERS BY SIZE OF TARGET BANK (2006–2010) [213]



Further bank failures either as a result of the crisis alone, or as a result of some banks' inability to repay the funds they received from Treasury, may accelerate the trend. Because the largest banks that were included in the stress tests were deemed to be too big to fail, the rate of small and medium bank failures is much greater than the rate of large bank failures. The result is that fewer banks serve a growing population, and a greater percentage of those banks are large institutions. As assets in the industry have grown, the number of banks has fallen precipitously.

FIGURE 5: TOTAL BANKING ASSETS FROM 1934 TO 2009 COMPARED TO NUMBER OF INSTITUTIONS [214]



[213] SNL Financial. As noted above this chart does not account for buyers that do not report their size in regulatory filings, such as some smaller bank holding companies, de novo bank purchasers, and other similar entities. However, the bank holding companies with over $100 billion in assets are accounted for in these numbers.

This increase in concentration could potentially have the ancillary, and likely unpopular, effect of reducing competition and giving the remaining banks a freer hand in setting terms for their depositors, possibly resulting in higher fees and more restrictions on account holders. Individuals and families with smaller accounts may receive diminished customer service, and smaller businesses are likely to suffer as well. Moreover, the limited systemic effect of small banks belies the critical role they can play in local economies.[215] For example, community banks play a critical role in providing loans to small businesses and farmers, representing 38 percent of all loans to those businesses, despite holding only 11 percent of bank industry assets.[216] Smaller institutions are likely to play an even more important role in lending in the wake of the crisis, as large banks have cut back on lending to an even greater degree than have smaller banks.[217] The shift is due in part to the increasing prevalence of "relationship lending" and the decreasing use of credit scoring. The former—which requires the use of "soft data" such as personal knowledge of the individual or business seeking the loan—is practiced almost exclusively by small banks, and the latter almost exclusively by large banks.[218] It is possible, of course, that financial institutions would fill any void left by failed smaller banks. In particular, larger banks would likely pursue the profitable business opportunities previously performed by those failed small banks, although the reduction in competition in a particular market may raise fees. Further, mismanaged banks that fail may enhance competition and market discipline, which is good for the sector as a whole and leads to better services for customers. In addition, Treasury should not provide unquestioning support for weak banks. Swift exercise of its shareholder rights

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[214] Data provided by Federal Deposit Insurance Corporation and Rochdale Securities. Adjusted for inflation into 1982–1984 dollars. Bureau of Labor Statistics, *Consumer Price Index* (Instrument: Annual, All Urban Consumers) (online at www.bls.gov/cpi/).

[215] *See* Section D.3, *supra*. Although community banks are not systemically critical in terms of their effect on the capital markets, there is still reason to be concerned that if a large number of community banks were to fail, there could be substantial economic effects, including job losses and a contraction in lending. It is possible that these effects would be mitigated by the FDIC, which in the past has relied successfully upon its resolution authority and deposit insurance fund to address small bank failure. *See* Bernanke Speech before ICBA, *supra* note 195, at 2 ("A prototype for such a framework already exists—namely, the rules set forth in the Federal Deposit Insurance Corporation Improvement Act of 1991 for dealing with a failing bank."). *See also* Sheila C. Bair, chairman, Federal Deposit Insurance Corporation, Remarks to the Council of Institutional Investors-Spring Meeting (Apr. 12, 2010) (online at www.fdic.gov/news/news/speeches/chairman/spapr1210.html). However, because the FDIC fund was under tremendous pressure in 2008 and 2009, it is unlikely that it could have served as an exclusive source of support for small banks, and it might not have been well positioned to maintain systemic continuity. Federal Deposit Insurance Corporation, *2009 Annual Performance Plan* (Apr. 29, 2009) (online at www.fdic.gov/about/strategic/performance/2009/insurance.html) (Bank failures in 2008 resulted in significant losses to the Deposit Insurance Fund, causing the reserve ratio to decline from 1.22 percent at the beginning of the year to 0.4 percent on December 31, 2008); Federal Deposit Insurance Corporation, *FDIC-Insured Institutions Report Earnings of $914 Million in the Fourth Quarter of 2009* (Feb. 23, 2010) (online at www.fdic.gov/news/news/press/2010/pr10036.html) (stating that the balance of the fund was negative $20.9 billion on December 31, 2009). In fact, as a result of the crisis' sharp, steady drain on the fund, the FDIC took the unusual step of requiring insured institutions make a lump sum prepayment of 3.25 years' worth of insurance premiums. Federal Deposit Insurance Corporation, *Banks Tapped to Bolster FDIC Resources FDIC Board Approves Proposed Rule to Seek Prepayment of Assessments* (Sept. 29, 2009) (online at www.fdic.gov/news/news/press/2009/pr09178.html).

[216] Congressional Oversight Panel, Written Testimony of Stan Ivie, San Francisco regional director, Federal Deposit Insurance Corporation, *Phoenix Field Hearing on Small Business Lending*, at 8 (Apr. 27, 2010) (online at cop.senate.gov/documents/testimony-042710-ivie.pdf).

[217] May Oversight Report, *supra* note 6, at 62.

[218] May Oversight Report, *supra* note 6, at 64–65.

may help create discipline. Nonetheless, in light of the role community banks play in real estate lending[219] and lending to small businesses,[220] a further concentration in the small bank sector could have challenging and possibly systemic spillover effects, and large banks might choose not to pursue some bank services for which there is a minimal but not non-existent market. To the extent that participation in the CPP contributes to this process, it would be regrettable.

Finally, the potential consolidations among smaller CPP banks should be examined in comparison to another crisis program, the FDIC's Transaction Account Guarantee (TAG) program. This program insures amounts in non-interest bearing accounts at participating institutions, including amounts over and above the $250,000 deposit insurance that is currently provided to all member institutions.[221] Originally set to expire on December 31, 2009, the program has been extended twice: once to June 30, 2010 and most recently to December 31, 2010.[222] If signed into law, the Dodd-Frank Wall Street Reform and Consumer Protection Act would extend the TAG an additional two years.[223]

The design of the TAG differed in a number of respects from that of the CPP. Unlike the CPP, which required banks to apply for funds, the TAG is an opt-out program; any FDIC insured institution is included in the program unless it affirmatively opts out. The result is that 80 percent of institutions are covered.[224] Further, in addition to being more widely available than the CPP, the TAG quite specifically comes into play only when an institution fails, but the confidence it provides is available to all participants. While it is widely available to all banks, healthy or otherwise, it only matters when the bank fails. By using an opt-out and a guarantee structure, the TAG side-stepped some of the primary issues that have come to plague the CPP—stigma and repayment.

Industry sources state repeatedly that the TAG provided a calming effect by assuring depositors that their money would be as protected in a small TAG-participating bank as in one of the largest stress tested banks. This may modulate the anti-competitive effect of the implicit guarantee for the too-big-to-fail stress-tested banks, preventing potential runs on smaller banks, and stabilizing the sector. On the other hand, the TAG may add to concentration in the sector, as depositors with more than $250,000 may have less of a need to diversify by searching out a second or third bank to provide insurance on their deposits, and may therefore make depositors less likely to use a smaller bank. As the Panel has stressed repeatedly, "too big to fail" continues to be a factor in the capital

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[219] *See* Federal Deposit Insurance Corporation, *The Future of Banking in America: Community Banks: Their Recent Past, Current Performance, and Future Prospects* (Jan. 2005) (online at www.fdic.gov/bank/analytical/banking/2005jan/article1.html) (noting that "[a]lthough community banks control less than 14 percent of banking-sector assets, they fund almost 29 percent of the industry's commercial real estate lending").

[220] May Oversight Report, *supra* note 6, at 64–65.

[221] 12 CFR § 370 (online at www.fdic.gov/news/board/08BODtlgp.pdf).

[222] 12 CFR § 370 Amendment RIN 3064–AD37 (online at www.fdic.gov/news/board/rule2.pdf).

[223] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, *supra* note 92, at § 343. The House of Representatives passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in a 237–192 vote on June 30, 2010, but as of July 13, 2010, the Senate has not yet taken action.

[224] 12 CFR 370 (online at www.fdic.gov/news/board/08BODtlgp.pdf).

markets, and it provides large institutions with competitive advantages over small institutions.[225]

The TAG, and its reputed success, have implications for program design going forward. If the TAG, rather than the CPP, is responsible for the current relative stability of the smaller banking sector, then it might have been possible to stabilize the non-systemic smaller banks using less aggressive, but ultimately less destabilizing, means than the CPP. Of course, although the TAG may have diminished the likelihood of bank runs, it did not help small banks to remedy their capital deficits. The TAG did not provide a critical benefit that was provided by the CPP: capital. While the TAG may have assisted in preventing the flight of deposits from small banks, these deposits are not classified as Tier 1 capital, and so maintaining a deposit base would not have helped small banks to plug the serious capital holes they faced in 2008 and 2009. For this reason, it is unlikely that the TAG would have been sufficient on its own. An additional weakness of the TAG is that it may create moral hazard problems by creating disincentives for depositors to evaluate the strength of their institutions.

The final chapter to this story has not yet been written. Although not every bank on the FDIC's problem list fails, there are several hundred banks on the list, and more failures are likely to come, some of them, to be sure, unavoidable and appropriate given the weakness of the bank.[226] But when the story is complete, it is likely that the largest banks will have fewer competitors, that consumers will have a more limited slate of banking options, and that fewer smaller banks will exist to provide the services that make them a distinctive player in the banking industry.[227] Depending on the scope and scale of future bank failures, the smaller bank sector may look very different at the end of the crisis than it did at the beginning. The likelihood that participation in the CPP will produce divergent outcomes for small banks and large banks underscores their different experiences in the program.

F. Conclusion

The banks that remain in the CPP are numerous, diverse, and, in many cases, still stressed. Most importantly, many of them, particularly the smaller or private institutions, have no clear path for repaying their CPP investment and exiting the program. Facing weak profits, without practical or cost-efficient access to the capital markets, and generally below the radar of private equity investments, these banks may be dependent on retained earnings or neighbors, family, friends, or angel investors to help them raise sufficient capital to repay their CPP investments. The willingness of such informal networks of investors to invest depends, of course, at least in substantial part on whether a given bank is a good bet, which in turn depends not only on the bank itself, but on broader economic markers—real estate values and exposure, the prognosis

[225] *See* January Oversight Report, *supra* note 92, at 14–15.

[226] *See* Annex I.2.c, *infra*.

[227] For example, community banks inject a specific culture into the market, a culture that results in the provision of specific services that larger institutions may be unable to provide. The Panel's May report, for example, documented the importance of "relationship lending" to small businesses. Small banks are most likely to engage in this type of lending. May Oversight Report, *supra* note 6, at 64–65.

for the banking sector, and the outlook for the economy as a whole. This may, ultimately, be one of the biggest differences between the experiences of smaller and larger banks in the CPP. For the stress-tested banks, the CPP proved to be a short-term investment. They entered early, and most have exited early—beneficiaries of capital market confidence resulting, in part, from their status as "too big to fail." For them, the stigma and uncertainty associated with the program is time-limited. For smaller banks, by contrast, the CPP is a long-term investment, subject to market uncertainty, stigma, and pressure. Without the benefits of the implicit government guarantee, they enjoy no comparable capital market confidence, because investors in smaller banks are more likely to pay the price of making a bad bet.

Meanwhile, if the economy stays sluggish, Treasury will continue to hold a large portion of functionally illiquid investments in the banking sector. Although at approximately $24.9 billion these investments are small relative to the size of the TARP overall, they leave Treasury with difficult challenges.

Treasury has no concrete plan for exiting its CPP investments in smaller institutions. Treasury has, at present, not laid out a concrete path for divestment of many of the assets it holds, and it has not yet developed a plan for appointing board members to institutions with the requisite number of dividends in arrears, although it is in the process of developing board-appointment policies and procedures. Further, although Treasury is in the process of evaluating its options for both elements of the ongoing investment, the long term nature of the investment may give rise to additional complex management concerns.

Treasury may remain invested in smaller banks through the CPP for years to come, which could destabilize the sector. The CPP was designed to provide Tier 1 capital to banks, so under the terms of the program, Treasury cannot call the investments; Treasury must remain invested in the CPP recipient until such time as the relevant regulator and the bank determine that the bank is able to pay off the CPP Preferred. While the dividend increase in 2013 may create an incentive for banks to repay, whether those repayments will be possible will depend on a variety of concerns particular to each individual bank, and a bank's inability to repay after the dividend increase may signal weakness and increase stigma. Meanwhile, 9 percent may prove a costly dividend, and indeed some, or many, smaller CPP recipients may be forced to downsize or merge in order to pay off their investments. Treasury's long time frame increases uncertainty, and subjects the investments to future financial shocks, management stresses, and other contingencies. In the face of these concerns, and in view of the relatively small sums involved, Treasury could consider writing off the investments. A write-off, however, would not only increase moral hazard, but might also contradict EESA's mandate.

If the CPP's design ultimately pushes smaller institutions towards merger or sale, then the small bank sector may refuse to participate in future financial stability efforts. The Panel's May 2010 report discussed the consequences of stigma and after-the-fact restrictions on CPP participants in the context of participation in the Small Business Lending Fund (SBLF). If pressures

from the CPP push smaller banks to merge or sell, in particular banks that would not have done so if they were not in the CPP, the effects could extend beyond the SBLF. Negative consequences from the CPP could tie policymakers' hands and impair the use of capital infusions as a tool in a future crisis. Further, while the effect of banking concentration on systemic stability is unclear, less competition may nonetheless have negative consequences for the communities that lose their banks, including higher fees and fewer services.

In light of the potentially long time frame and the increased uncertainty of CPP investments in smaller banks, the Panel recommends that Treasury:

- Analyze ongoing information on which smaller banks took CPP funds and which smaller banks have repaid CPP funds, in order to determine commonalities among them and use those commonalities to create a strategy for exit, to help anticipate risks in the portfolio, and to evaluate the effectiveness of capital infusions for stabilizing smaller banks, given the program design of the CPP (compared, for example, to that of the TAG);
- Review the CPP's impact on bank consolidations and concentration in the banking sector generally. Although concerns about bank consolidation may not have informed the program at the outset, increasing concentration in the banking sector could have adverse effects on competition and services offered to customers, and, potentially, systemic stability;
- Articulate and determine options for the illiquid portions of its portfolio, such as warrants that are too small to be listed on an exchange, including bundling or pooling investments if that makes them more attractive to investors;
- Articulate clear measures for risk-testing its own portfolio;
- Expeditiously determine and articulate its process and considerations for appointing board members to banks that are in arrears, including the way in which it will locate board members for those banks;
- For banks that Treasury's asset manager believes should raise additional capital, retain or create a workout team that will swiftly negotiate a deal;
- In order to keep CPP-recipient banks diligently searching for capital and to avoid moral hazard concerns, clearly articulate its restructuring policy and indicate to CPP participants that it will protect the priority of its investments; and
- Aggressively exercise its shareholder rights, such as appointing directors, in those banks that have missed the requisite number of dividends, in order to protect the taxpayers' investment and maintain market discipline.

Annex I: U.S. Banking Sector Data [228]

The U.S. banking sector is dominated by a small number of enormous institutions, followed by a larger number of regional banks of significant size, and finally thousands of small banks. Of the 17 stress-tested bank holding companies (BHCs) that received CPP funds, all but four have repaid, leaving $14.3 billion in CPP funds outstanding for larger BHCs and approximately $24.9 billion outstanding for all other CPP participants.[229] The likelihood of repayment of CPP funds by smaller BHCs is largely dependent on their overall health. This annex of the report compares CPP-recipient institutions, using data at the bank level, to the overall banking sector and to non-TARP recipients, evaluating their capital condition, key business characteristics, and exposure levels, in an effort to determine correlations among them.[230] As in the report, banks have been broken into four asset categories: those with more than $100 billion in assets (Large Banks),[231] those with $10-$100 billion in assets (Medium Banks), those with $1–$10 billion in assets (Smaller Banks), and those with less than $1 billion in assets (Smallest Banks).

1. Amount of CPP Funds

BHCs were initially limited to receiving CPP funds of only a set percentage of risk-weighted assets.[232] Those with less than $500 million in assets could take CPP funds in an amount up to 5 percent of risk-weighted assets.[233] Those with more than $500 million in assets could take CPP funds up to the lesser of 3 percent of risk-

[228] All data in this annex is derived from SNL Financial unless otherwise noted. Due to GMAC receiving assistance under the Automotive Industry Financing Program rather than the CPP, Ally Bank, a commercial bank subsidiary of GMAC, is excluded from this analysis. Also, although KeyCorp's first quarter 2010 total assets were below $100 billion, KeyCorp is included in the greater than $100 billion bucket due to its inclusion in the Supervisory Capital Assessment Program (SCAP). Furthermore, banks in organization have been excluded from this analysis.

[229] On September 11, 2009, Treasury's original $25 billion preferred stock investment in Citigroup, Inc. was converted to 7.7 billion shares of common stock. Treasury is in the process of liquidating its common stock holdings in Citigroup. Therefore, although the Treasury department still maintains an ownership position in Citigroup, for the purposes of this analysis it is deemed repaid. Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2, at 15.

[230] Although TARP CPP funds were distributed at the BHC level, the data presented in this section is at the bank level. For example if a BHC has five subsidiary banks, then the data for those five banks is used in this section's analysis, with the understanding that those banks roll up to the BHC level that received CPP funds. Thus, TARP-assisted banks include all the subsidiary banks that roll up to a TARP-assisted BHC.

[231] When referring to Large Banks in the population of all banks, three are included that did not receive TARP funding: HSBC USA, RBS Citizens, and TD Bank. GMAC is also included in the Large Banks population when analyzing "all banks," but it is not included in the data when only TARP or non-TARP banks are compared, because, as discussed further below, it did not receive CPP funds, although it received TARP AIFP funds. The inclusion of these banks in the "all banks" category further distorts the data skew in all banks caused by a few large banks holding the majority of total assets.

[232] House Financial Services, Subcommittee on Financial Institutions and Consumer Credit, Written Testimony of David N. Miller, acting chief investment officer, Office of Financial Stability, U.S. Department of the Treasury, *The Condition of Financial Institutions: Examining the Failure and Seizure of an American Bank,* at 2 (Jan. 21, 2010) (online at www.house.gov/apps/list/hearing/financialsvcs_dem/miller_house_testimony_final_1-21-10_5pm.pdf).

[233] U.S. Department of the Treasury, *Frequently Asked Questions regarding the Capital Purchase Program (CPP) for Small Banks* (online at www.financialstability.gov/docs/CPP/FAQonCPPforsmallbanks.pdf) (accessed July 7, 2010).

weighted assets or $25 billion.[234] Because CPP funds were based on risk-weighted assets, of which larger BHCs hold more than smaller BHCs, the larger BHCs received more funds than smaller BHCs, even though smaller BHCs were able to receive a larger proportion of funds relative to risk-weighted assets. The ultimate effect was that 81 percent of all CPP funds went to the 17 stress-tested BHCs that received funding, with the remaining 19 percent was disbursed among 690 other banks. Even though BHCs were able to take CPP funds of up to 3 or 5 percent, depending on their size, of their risk-weighted assets, many chose to take less.

Although many of the Large Banks have repaid their CPP funds, five of these institutions still make up over half of the CPP funds outstanding as of June 30, 2010.[235] As illustrated in Figure 2 in Section C.3 above, approximately 75 percent of the funds received by Large Banks has been repaid. The amount outstanding for the remaining banks (Medium, Smaller, and Smallest) is $24.9 billion but is held by over 500 institutions. Furthermore, almost 70 percent, 80 percent, and 100 percent of CPP funds received by Medium, Smaller, and the Smallest Banks, respectively, are still outstanding.

2. Key Characteristics of Banks

The health of the CPP recipients remaining in the program is a fundamental concern when reviewing the CPP. The health of CPP recipients, however, is best evaluated in the context of the larger banking sector, and as compared to non-CPP recipients. This comparison helps determine whether there are particular or unusual stresses on CPP recipients that will impact their ability to raise capital or garner earnings sufficient to repay Treasury. The U.S. banking sector, however, has a distribution of assets that can obscure some characteristics of the data, particularly when discussing CPP recipients. Bank asset size is skewed toward a very small number of very large banks. This distribution can distort data when viewed in the aggregate.[236] This report uses the aforemen-

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[234] U.S. Department of the Treasury, *Application Guidelines for TARP Capital Purchase Program* (Oct. 20, 2008) (online at www.financialstability.gov/docs/CPP/application-guidelines.pdf).

[235] Citigroup, SunTrust, Regions Financial, Fifth Third Bancorp, and KeyCorp are the five Large Banks with CPP funds outstanding of $25 billion, $4.8 billion, $3.5 billion, $3.4 billion, and $2.5 billion, respectively. Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2, at 1, 4.

[236] For example, in a group of 10 banks, in which nine banks have $1 billion in assets and one has $100 billion, the mean asset size will be $10.9 billion. The mean asset size of those 10 banks in the example, however, misrepresents the small size of the majority of these 10 banks, as well as the large size of the single exception. In some cases, therefore, the use of a median figure rather than a mean more accurately portrays certain data. With respect to the banking system, the differentiation between mean and median is important because the largest banks sometimes obscure categorical averages. For example, the mean asset value held by banks with over $100 billion in assets is $637.7 billion. However, when one removes the three banks with the most assets in the sample, the average declines markedly to $313.4 billion. Therefore, the average is primarily a reflection of a handful of banks at the very top of the respective category.

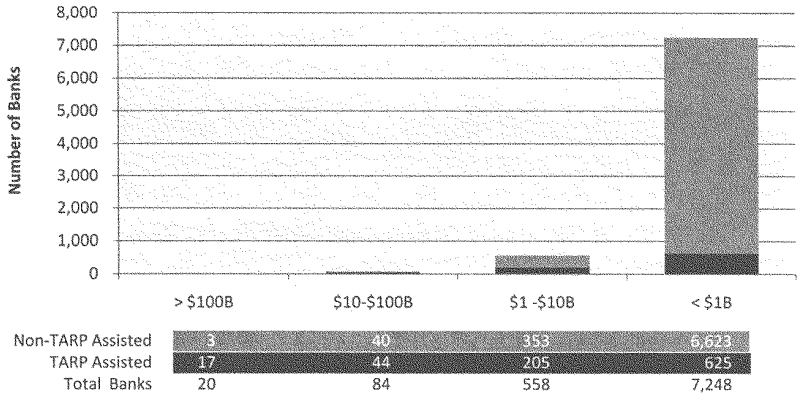
However, performing the same exercise with the median is illustrative. The median asset value of banks with over $100 billion in assets is $193.3 billion, not even a third of the mean for the same sample. Furthermore, when one removes the three banks with the most assets in the sample, the median declines comparatively slightly to $172.3 billion. Therefore, the median is less a reflection of the handful of banks at the top of the respective category and more a reflection of relative asset distribution throughout the category. Both categories, mean and median, are important when looking at the banking sector. However, the relative strengths of each also must be recognized and appreciated. The mean can disproportionately represent the top-end of banking samples while providing a relatively narrow view of the sample's distribution. The median can offer a more accurate view of the middle quartiles of the distribution but it

tioned groupings of banks based on asset sizes—Large, Medium, Smaller, Smallest—as a way to demonstrate the effect of the distribution.

a. Number of Banks

The vast majority of banks fall into the category of Smallest Banks. As shown in Figure 6, 92 percent of banks have less than $1 billion in assets. Smaller Banks, those with between $1 billion and $10 billion in assets, make up 7 percent of all banks. Medium Banks[237] and Large Banks comprise only 1 percent and 0.3 percent, respectively, of all banks.

FIGURE 6: NUMBER OF TARP-ASSISTED AND UNASSISTED BANKS, BY SIZE



The distribution of asset categories among unassisted banks is fairly consistent with that among all banks, with Smallest Banks making up 94 percent of the pool, Smaller Banks making up 5 percent, and Medium/Large Banks comprising a combined 1 percent of all unassisted banks. Only one of the 19 stress-tested BHCs with assets over $100 billion did not receive TARP funds.[238] The com-

obscures the effect of outliers because it is less affected by the extreme ends of the respective distribution. When viewed in concert, the mean and median offer more accurate observation points for scrutinizing the data than would be the case if either measure were to be presented on its own.

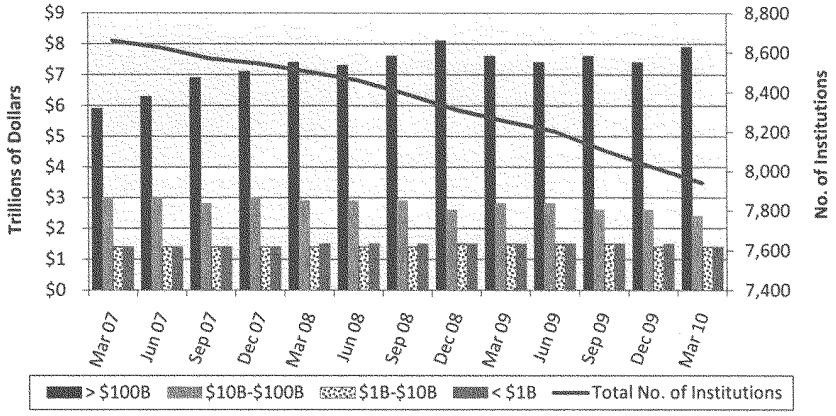
[237] Banks of this size are also known as "regional" banks.

[238] As noted above, in the spring of 2009, the Federal Reserve along with the other bank supervisors engaged in a stress test of the 19 largest bank holding companies. All banks with over $100 billion in assets were stress tested, except for three banks not wholly owned by U.S. bank holding companies (HSBC USA, RBS Citizens, and TD Bank), as mentioned earlier. Although not stress-tested and not part of TARP banks, they are included in data referencing all banks with over $100 billion in assets. In addition, KeyCorp was stress tested, even though it currently holds less than $100 billion in assets. Because it was stress tested, it will be included in this Report's group of Large Banks, in order to keep it with the other stress tested banks. MetLife, which became a BHC in 2001, was the only stress tested BHC that did not receive TARP funds. As mentioned earlier, GMAC is included in Large Banks' data for the population of all banks. GMAC received TARP AIFP funds, the terms of which were substantially similar to the CPP funds. For purposes of this section of the report, however, GMAC is not included in TARP banks. Similarly, Bank of America and Citigroup received part of their TARP funds under the Targeted Investment Program (TIP). Although the TIP funds carried a higher dividend rate, for purposes of this report, they will be counted as equivalent to CPP funds. Thus, the Large Banks category used in this section of the report is an imperfect proxy for stress-tested banks but provides the best reference data for those banks. *See* Board of Governors of the Federal Reserve System, *Order Approving Formation of a Bank Holding Company and Determination on a Fi-*

Continued

position of TARP-assisted banks is slightly different, with Smallest and Smaller Banks making up 70 percent and 23 percent, respectively, and Medium and Large Banks making up 5 percent and 2 percent, respectively, of all assisted banks. Thus, for TARP-assisted banks, there is a lower concentration of Smallest Banks than that seen in the overall population of banks, and a higher concentration of the other bank asset sizes. Although Smallest and Smaller Banks dominate the population of TARP-assisted banks, they represent only 9 percent and 37 percent, respectively, compared to the total number of banks in those asset categories. Conversely, for Medium and Large Banks, 53 percent and 85 percent of all banks in those asset categories received CPP funds.

FIGURE 7: CONCENTRATION OF BANK ASSETS, BY SIZE (2007–2009) [239]



As shown in Figure 7, the number of banks has decreased by 719 banks from the third quarter of 2007 to the first quarter of 2010, while the total assets of all banks has increased by approximately $2 billion, primarily driven by the increase in Large Banks' assets. The total assets of Medium Banks decreased by roughly $500 million during this same period, suggesting that they were either acquired by Large Banks or grew into Large Banks through their own acquisitions and mergers. The total assets of Smaller and Smallest Banks remained relatively constant, which, when combined with the total decrease in overall number of banks, suggests that these banks cannibalized among themselves, or failures and acquisitions in these bank categories allowed the remaining banks to gain the leftover market share. Overall, the graph clearly shows a more concentrated banking sector in 2010 compared to before the economic crisis.

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nancial Holding Company Election, at 7 (Feb. 12, 2001) (online at www.federalreserve.gov/boarddocs/press/BHC/2001/20010212/attachment.pdf).

[239] Data compiled using the Federal Deposit Insurance Corporation's Statistics on Depository Institutions. Four asset categories were created in order to facilitate a snapshot of the industry at the end of each financial quarter. Federal Deposit Insurance Corporation, *Statistics on Depository Institutions* (online at www3.fdic.gov/sdi/) (Instrument: Past Due 90+ Days 1–4 Family Residential) (accessed July 1, 2010).

b. Bank Asset Sizes and Regional Distribution

Large Banks hold 58 percent of the total assets of all banks, followed by Medium Banks, Smallest Banks, and Smaller Banks with 17 percent, 15 percent, and 10 percent, respectively. Isolating TARP-recipient banks produces a greater skew towards Large Banks, as they hold 80 percent of all assets for CPP recipients. Medium, Smaller, and Smallest Banks' assets comprise 12 percent, 6 percent, and 2 percent of the total bank assets for CPP recipients.[240]

Functionally, in addition to holding the vast majority of TARP funds, banks with more than $100 billion in assets hold the vast majority of assets held by all assisted banks. Of the $11.8 trillion of assets held by all assisted banks, 80 percent is held by banks with more than $100 billion in assets. Banks with between $10 and $100 billion hold 12 percent of the assets. Banks with assets between $1 and $10 billion hold 6 percent. Finally, banks with less than $1 billion, which represent 70 percent of all assisted banks, hold only 2 percent of the assets held by assisted banks.[241]

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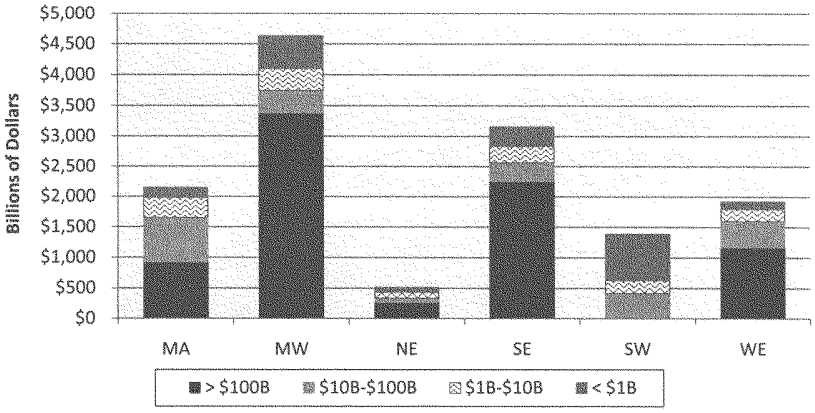
[240] Within size groups, assisted banks tend to be slightly larger than non-TARP assisted banks. Of the banks with assets under $1 billion, the median size of non-TARP banks is $125 million. Among assisted banks, the median size among banks under $1 billion is $267 million. A comparison within the $1 to $10 billion groups shows a similar trend: the median size of banks in this group among non-TARP banks is $1.67 billion, while the median size of assisted banks in this group is $1.96 billion. Among banks with between $10 and $100 billion in assets, the trend reverses, with TARP banks holding a median of $17.58 billion and non-TARP assisted banks holding a median of $19.25 billion.

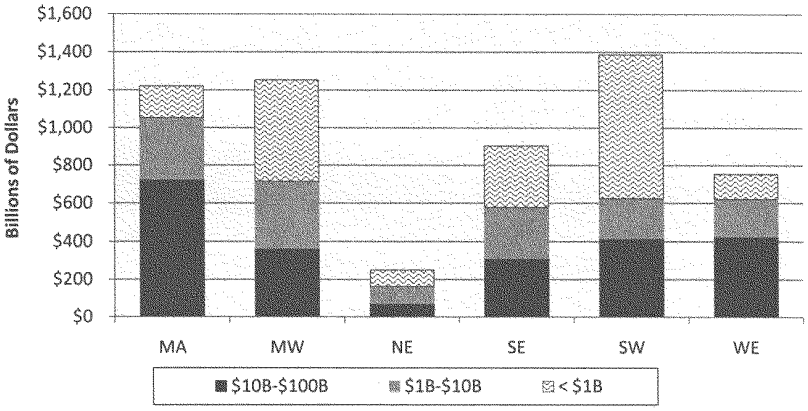
[241] The small percentage of Smaller and Smallest TARP Banks compared to the total population of Smaller and Smallest Banks may reflect a variety of factors. To begin with, nearly 50 percent of the Large Banks received funds prior to the institution of a formal application process and were thus simply enrolled in the program without application evaluation. This not only skews the percentage of Large Banks, but it also means that the application process differed enormously for Large Banks. By way of comparison, the equivalent for the Smallest Banks would be if 3,000 of them had simply been enrolled without a required application evaluation, making it more of an opt-out program than an opt-in program. CPP Applications Audit, *supra* note 25, at 9. For the Smaller and Smallest banks that did apply, it is possible that the cost of the TARP application process is more burdensome on those banks, as they do not have specialized staff or excess resources to cover the time and costs. Smaller institutions generally face higher compliance costs than larger institutions, and it is reasonable to assume that a bank with few employees will be more burdened by the application process than one with many. *Cf.* May Oversight Report, *supra* note 6, at note 325. Time of entry may also have affected willingness to participate: although the largest banks received their funds early, smaller banks did not begin to enter the TARP until early 2009, at which point a stigma had begun to develop around banks that accepted TARP funds, and many withdrew their applications as a result. Congressional Oversight Panel, Written Testimony of Candace Wiest, president and chief executive officer, West Valley National Bank, *Phoenix Field Hearing on Small Business Lending*, at 2 (Apr. 27, 2010) (online at cop.senate.gov/documents/testimony-042710-wiest.pdf). An unknown number presumably decided not to apply.

FIGURE 8: TOTAL BANK ASSETS, BY REGION AND SIZE [242]



Generally, the total number of banks by region mirrors the asset distribution across regions. Banking assets are concentrated in the Midwestern and Southeastern banks, but this is largely due to the presence of Large Banks in those regions.

FIGURE 9: TOTAL BANK ASSETS, BY REGION AND SIZE, EXCLUDING BANKS WITH MORE THAN $100 BILLION IN ASSETS [243]



[242] Region in which the company is headquartered. Mid-Atlantic (MA): DC, DE, MD, NJ, NY, PA, PR; Midwest (MW): IA, IL, IN, KS, KY, MI, MN, MO, ND, NE, OH, SD, WI; New England (NE): CT, MA, ME, NH, RI, VT; Southeast (SE): AL, AR, FL, GA, MS, NC, SC, TN, VA, VI, WV; Southwest (SW): CO, LA, NM, OK, TX, UT; West (WE): AK, AS, AZ, CA, FM, GU, HI, ID, MT, NV, OR, WA, WY.

[243] Region in which the company is headquartered. Mid-Atlantic (MA): DC, DE, MD, NJ, NY, PA, PR; Midwest (MW): IA, IL, IN, KS, KY, MI, MN, MO, ND, NE, OH, SD, WI; New England (NE): CT, MA, ME, NH, RI, VT; Southeast (SE): AL, AR, FL, GA, MS, NC, SC, TN, VA, VI, WV; Southwest (SW): CO, LA, NM, OK, TX, UT; West (WE): AK, AS, AZ, CA, FM, GU, HI, ID, MT, NV, OR, WA, WY.

When banks with assets over $100 billion are removed, banking assets are concentrated in Southwestern banks, with Mid-Atlantic and Midwestern banks close behind. The Southwest has the largest concentration of Smallest Banks. The Northeast holds the smallest portion of banking assets.

FIGURE 10: TOTAL ASSETS BY REGION [244]

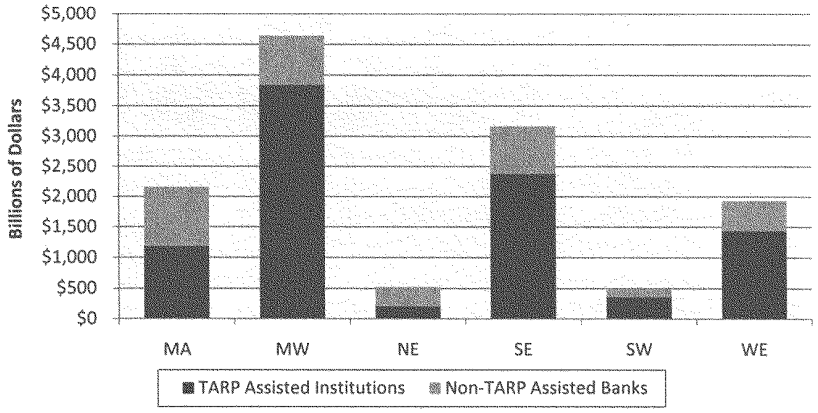
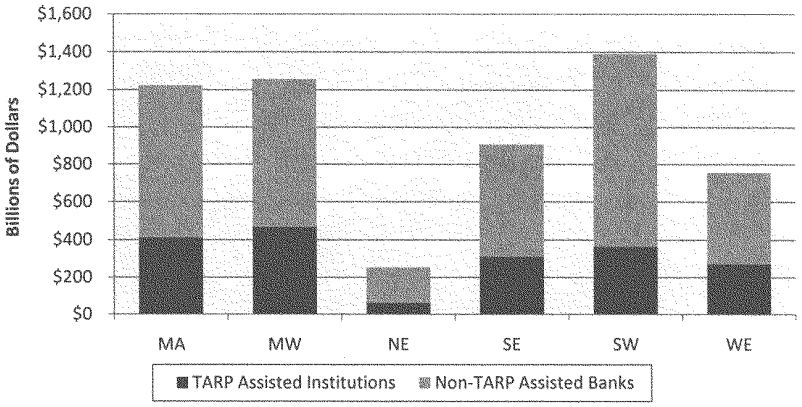


FIGURE 11: TOTAL ASSETS BY REGION, EXCLUDING BANKS WITH MORE THAN $100 BILLION IN ASSETS [245]



[244] Region in which the company is headquartered. Mid-Atlantic (MA): DC, DE, MD, NJ, NY, PA, PR; Midwest (MW): IA, IL, IN, KS, KY, MI, MN, MO, ND, NE, OH, SD, WI; New England (NE): CT, MA, ME, NH, RI, VT; Southeast (SE): AL, AR, FL, GA, MS, NC, SC, TN, VA, VI, WV; Southwest (SW): CO, LA, NM, OK, TX, UT; West (WE): AK, AS, AZ, CA, FM, GU, HI, ID, MT, NV, OR, WA, WY.

[245] Region in which the company is headquartered. Mid-Atlantic (MA): DC, DE, MD, NJ, NY, PA, PR; Midwest (MW): IA, IL, IN, KS, KY, MI, MN, MO, ND, NE, OH, SD, WI; New England (NE): CT, MA, ME, NH, RI, VT; Southeast (SE): AL, AR, FL, GA, MS, NC, SC, TN, VA, VI,

Continued

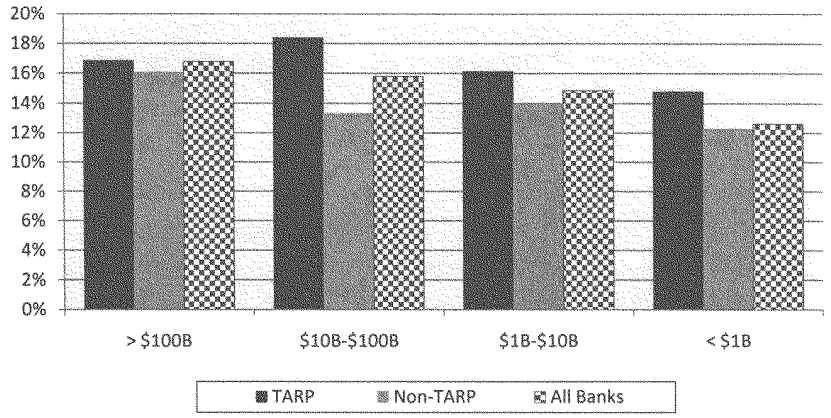
The distribution of TARP-assisted institutions is fairly proportional to the total asset concentration in each region, with the Southwest being an outlier, although this is due to the absence of banks with assets over $100 billion in this region. The Southwest exhibits similar proportions to the other regions when banks with assets over $100 billion are excluded from the population. As TARP-assisted institutions are proportional across regions, an initial comparison shows no regional distinction or preference for TARP-recipient banks versus those that did not receive funding. Accordingly, TARP banks are not necessarily any more exposed to particular regional stresses or concentrations than non-TARP banks.[246]

c. Loan Exposures and Delinquencies, by Type

Loan exposures, loan delinquencies, and non-performing loans provide greater insight into the health of a bank and the strength of its assets.[247] Exposures provide detail about the types of loans banks have originated and their susceptibility to negative market trends relating to those loans, as well as the diversification of their loan portfolios. Delinquencies show the actual balance sheet effects of poor loans or market-related factors. As more loans become past due for longer periods of time, the likelihood they will be repaid decreases. This has immediate cash-flow implications and can cause long-term liquidity concerns.

i. Commercial and Industrial (C&I) Loans

FIGURE 12: C&I LOANS AS A PERCENTAGE OF TOTAL LOANS, BY SIZE



Large and Medium Banks hold a slightly greater percentage of Commercial and Industrial (C&I) loans than Smaller and Smallest Banks. C&I loans are generally issued by Large and Medium Banks because of the loan size and exposure to industrial sectors

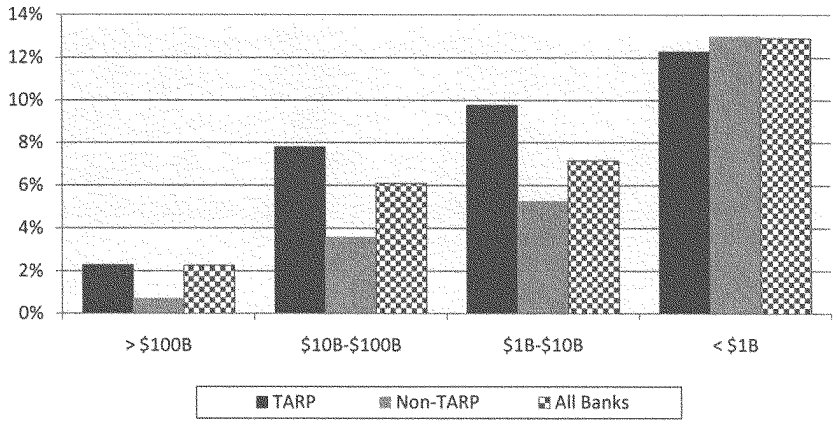
WV; Southwest (SW): CO, LA, NM, OK, TX, UT; West (WE): AK, AS, AZ, CA, FM, GU, HI, ID, MT, NV, OR, WA, WY.

[246] SNL Financial data.

[247] For the purposes of this report, a delinquent loan is one that is over 30 days past due, and a non-performing loan is one that is over 90 days past due.

and commercial projects. It is possible that because TARP banks held a larger percentage of C&I loans than non-TARP banks, they were more susceptible to the economic downturn.

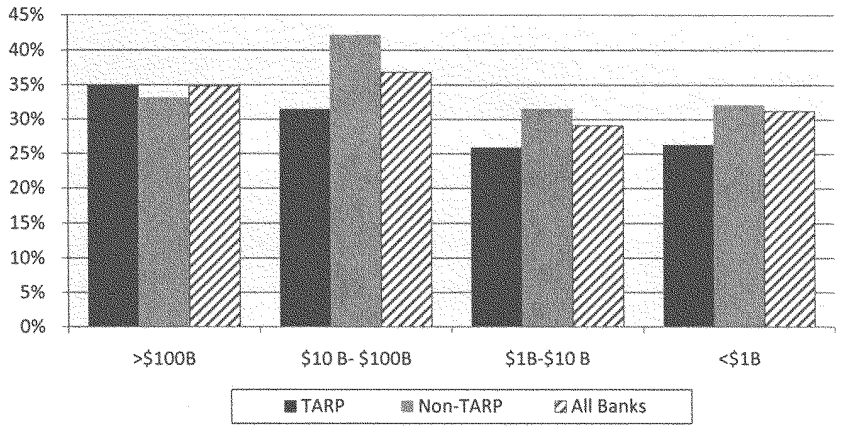
FIGURE 13: C&I LOANS 90+ DAYS PAST DUE AS A PERCENTAGE OF ALL LOANS 90+ DAYS PAST DUE, BY SIZE



The percentage of non-performing C&I loans to all non-performing loans for Smallest Banks is approximately equal to the percentage of C&I loans to all loans at those banks. This is the expected trend, as the proportion of non-performing C&I loans mirrors the proportion of all C&I loans. For the other bank categories, however, the percentages of non-performing C&I loans to all non-performing loans are much lower than that of C&I loans to all loans, which implies that the C&I portfolio is healthier than that of other loan types at those banks.

ii. Single Family Residential Loans

FIGURE 14: 1–4 FAMILY RESIDENTIAL LOANS AS A PERCENTAGE OF TOTAL LOANS, BY SIZE



As exhibited in Figure 14 above, banks' exposure to 1–4 family residential (single family) loans is fairly equal across bank asset categories, varying between roughly 28 and 37 percent of total loans.[248] The exposure to single family loans is slightly higher at non-TARP banks, except in the case of Large Banks. Although the percentages of single family loans 30–89 days past due mirror the proportions of single family loans as a percentage of all loans across bank asset sizes, the non-performing loans, or those 90 days or more past due, show significant differences.

[248] The data on single family loans in Figures 14, 15, and 16 includes revolving and permanent loans secured by real estate as evidenced by mortgages (FHA, Farmers Home Administration, VA, or conventional) or other liens secured by 1–4 family residential property, for domestic offices only. It includes liens on: nonfarm property containing 1–4 dwelling units or more than 4 dwelling units if each is separated from other units by dividing walls that extend from ground to roof, mobile homes where (a) state laws define the purchase or holding of a mobile home as the purchase of real property and where (b) the loan to purchase the mobile home is secured by that mobile home as evidenced by a mortgage or other instrument on real property, individual condominium dwelling units and loans secured by an interest in individual cooperative housing units, even if in a building with 5 or more dwelling units, vacant lots in established single-family residential sections or areas set aside primarily for 1–4 family homes, housekeeping dwellings with commercial units combined where use is primarily residential and where only 1–4 family dwelling units are involved. *See generally* Congressional Oversight Panel, *March Oversight Report: Foreclosure Crisis: Working Toward a Solution* (Mar. 6, 2009) (online at cop.senate.gov/documents/cop-030609-report.pdf); Congressional Oversight Panel, *August Oversight Report: The Continued Risk of Troubled Assets* (Aug. 11, 2009) (online at cop.senate.gov/documents/cop-081109-report.pdf); Congressional Oversight Panel, *October Oversight Report: An Assessment of Foreclosure Mitigation Efforts After Six Months* (Oct. 9, 2009) (online at cop.senate.gov/documents/cop-100909-report.pdf); April Oversight Report, *supra* note 104.

FIGURE 15: 1–4 FAMILY RESIDENTIAL LOANS 90+ DAYS PAST DUE AS A PERCENTAGE OF ALL LOANS 90+ DAYS PAST DUE, BY SIZE

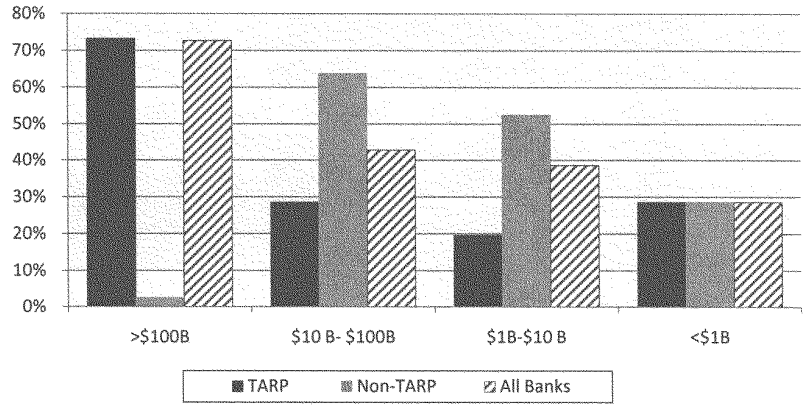
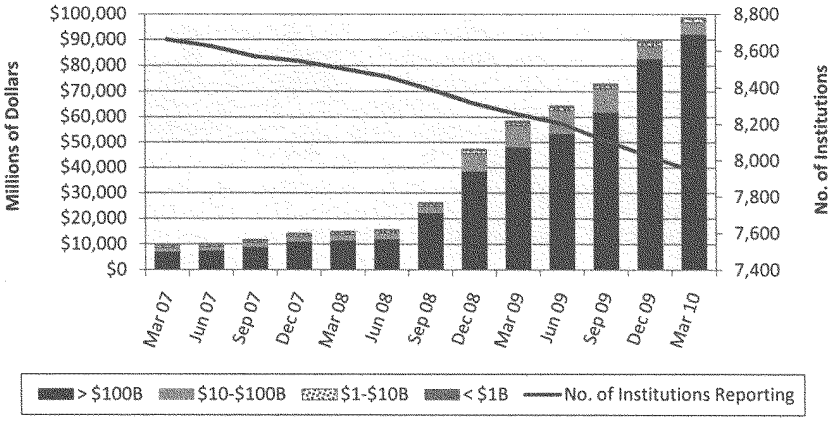


FIGURE 16: SINGLE FAMILY LOANS 90+ DAYS PAST DUE (Q1 2007—Q1 2010), BY SIZE [249]



As noted in Figure 14, in the case of Large Banks, single family loans comprise 35 percent of the total loan portfolio, but, as Figure 16 shows, non-performing single family loans represent over 70 percent of all non-performing loans at these banks. Thus, delinquent single family loans comprise over two-thirds of Large Banks' non-performing loans, whereas these loans drive only one-third of

[249] Data compiled using the Federal Deposit Insurance Corporation's Statistics on Depository Institutions. Four asset categories were created in order to facilitate a snapshot of the industry at the end of each financial quarter. Federal Deposit Insurance Corporation, *Statistics on Depository Institutions* (Instrument: Assets and Liabilities) (online at www3.fdic.gov/sdi/) (accessed July 1, 2010).

the total loan portfolio.[250] Conversely, as shown when comparing Figures 14 and 15 above, although there are only three non-TARP Large Banks, their percentage of single family loans to all loans is similar to that of Large TARP Banks, but the proportion that are non-performing compared to all non-performing loans is nearly zero.[251] The comparative results for Large TARP and non-TARP Banks are statistically significant, meaning there is a 95 percent confidence level that the observed results indicate a more than random variability.[252]

The other bank asset categories' percentages of non-performing single family loans to all non-performing loans are proportional to their percentages of these loans to all loans for TARP banks, with the percentage that is non-performing being slightly higher than the percentage of all single family loans at non-TARP banks. This suggests either that single family loans at non-TARP banks are potentially of lower credit quality than those at TARP banks, or that non-single family loans at TARP banks are of proportionally lower quality than those at non-TARP banks. As shown in Figure 16, the value of single family loans 90+ days past due has increased significantly over the past three years, as the number of institutions has decreased. The non-performing single family loans as of the first quarter of 2010 show increases of 1,195 percent, 191 percent, 132 percent, and 52 percent at Large, Medium, Smaller, and Smallest Banks, respectively, from the first quarter of 2007. Thus, while Large Banks comprise the bulk of these non-performing loans, the defaults seen currently are not the historical norm. Furthermore, as the concentration of banks increases, fewer banks share a higher value of non-performing loans.

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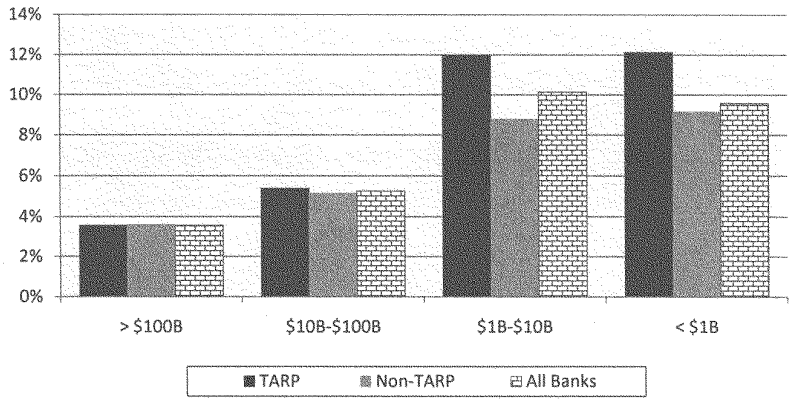
[250] In the case of Large Banks, because the pool of banks is much smaller, results at one bank can greatly impact the results for all Large Banks. For instance, JPMorgan Chase Bank accounts for 51.5 percent of non-performing loans at Large Banks, due to its acquisition of Washington Mutual, which was at one time the third largest mortgage lender in the United States. Wells Fargo, Citibank, and Bank of America hold a combined 36.2 percent of the non-performing single family loans at Large Banks, also due to either their own mortgage lending or their acquisition of mortgage lenders in recent years. Thus, only four of the Large Banks drive the startling proportion of non-performing single family loans to all non-performing loans when compared to the amount of these loans in the Large Banks' loan portfolios.

[251] The three non-TARP Large Banks are HSBC Bank USA, RBS Citizens, and TD Bank. TD Bank has no loans 90+ days past due as of the first quarter of 2010, although 1.6 percent of its total loans and leases are 30–89 days past due, primarily in the real estate sector. Credit card loans 90+ days past due at HSBC Bank USA account for 83 percent of the total loans 90+ days past due at the three Large non-TARP Banks. The other loans 90+ past due at HSBC Bank USA are construction and development loans and C&I loans, with a negligible amount related to single family loans. Almost half of the loans 90+ days past due at RBS Citizens are single family loans, but they are only 2.4 percent of all loans 90+ days past due at these three banks.

[252] The Panel conducted a t-test for the significance of mean differences between TARP and non-TARP banks across asset sizes for each loan type, with a p value of 5 percent ($p = .05$). Statistical significance is measured through a test of significance, using certain data points, the results of which determine whether a data characteristic is statistically significant. Statistical significance indicates that a data result is unlikely to have occurred by chance, but this does not necessarily mean that the result is therefore meaningful to the overall population or that other sources of error did not influence the results. Also, not finding that a result is statistically significant does not mean that there is no difference between the data points.

iii. Construction and Land Loans

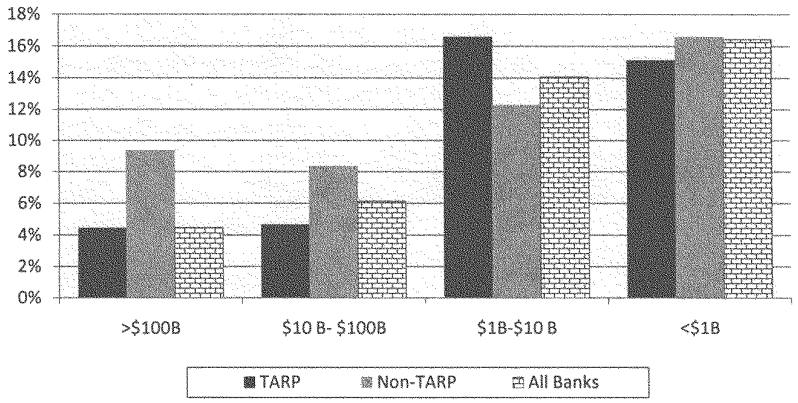
FIGURE 17: CONSTRUCTION AND LAND DEVELOPMENT LOANS AS A PERCENTAGE OF TOTAL LOANS, BY SIZE



Construction and land loans represent a larger percentage of the loan portfolios of Smaller and Smallest Banks than Medium and Large Banks. The concentration of construction loans in Smaller and Smallest Banks is expected because these banks provide a disproportionate amount of credit to local and regional businesses involved in construction. As a result of their exposure to these volatile businesses, Smaller and Smallest Banks were particularly vulnerable to the crash in real estate prices and to the credit freeze. TARP banks hold a greater percentage of construction loans than non-TARP banks, which might have affected banks' decisions on whether to apply to the CPP. These banks might have needed TARP funds to stabilize their balance sheets from these problem loans.[253]

[253] Due to the complicated application process to obtain CPP funds, it is difficult to establish causation between exposures and CPP participants, as some banks voluntarily withdrew their applications as a stigma developed and others were encouraged to do so by regulators.

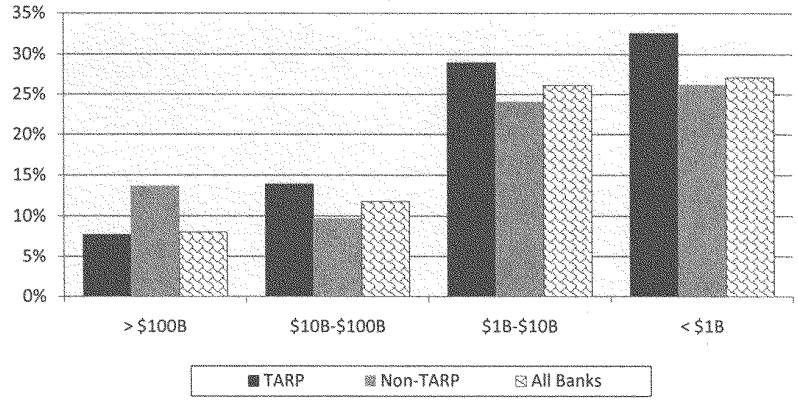
FIGURE 18: CONSTRUCTION AND LAND DEVELOPMENT LOANS 90+ DAYS PAST DUE AS A PERCENTAGE OF ALL LOANS 90+ DAYS PAST DUE, BY SIZE



In all bank asset categories except Smaller Banks, the percentages of non-performing construction and land development loans to all non-performing loans at non-TARP banks are higher than those at TARP banks, although the percentages of these loans to all loans at the TARP banks is higher.

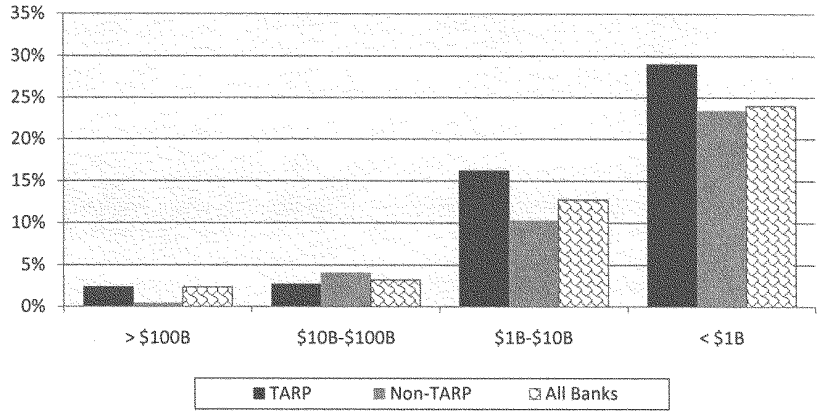
iv. Commercial Real Estate Loans

FIGURE 19: COMMERCIAL REAL ESTATE LOANS AS A PERCENTAGE OF ALL LOANS, BY SIZE



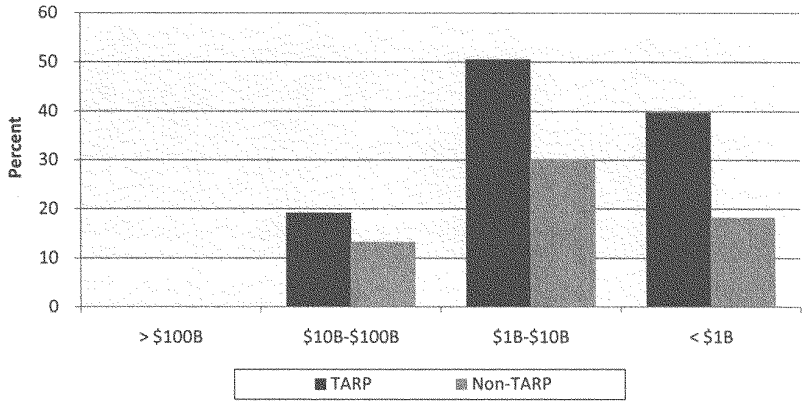
The loan distribution and proportion of commercial real estate (CRE) loans resembles that for construction and development loans, with Smallest Banks being disproportionately represented.

FIGURE 20: COMMERCIAL REAL ESTATE LOANS 90+ DAYS PAST DUE AS A PERCENTAGE OF ALL LOANS 90+ DAYS PAST DUE, BY SIZE



The percentages of non-performing CRE loans to all non-performing loans are much smaller than the percentages of CRE loans to all loans across all bank asset categories and slightly smaller at the Smallest Banks. Roughly one-quarter of all loans and all non-performing loans at the Smallest Banks are comprised of CRE loans.

FIGURE 21: PERCENTAGE OF INSTITUTIONS WITH ''CRE CONCENTRATION'' AS OF Q1 2010 [254]



Smaller and Smallest Banks carry the highest "CRE Concentrations" among all banks.[255] And as noted in Figure 21 above, in the

[254] Data provided by Foresight Analytics.

[255] An institution is "CRE Concentrated" when its total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total capital; or when its total CRE loans represent 300 percent or more of its total capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the past 36 months.

Medium, Smaller, and Smallest Banks asset categories a higher percentage of TARP banks are "CRE Concentrated," compared to the percentages of non-TARP banks. These high percentages in TARP banks could denote potential weaknesses in their loan portfolios and need for TARP funds. As noted in the Panel's February 2010 report, smaller banks took on riskier commercial real estate loans, so the high concentration of both CRE loans to total loan portfolio and non-performing CRE loans in the Smallest and Smaller Banks is to be expected.[256] Whereas the Large Banks had a disproportionately larger percentage of non-performing single family loans, Large Banks have negligible non-performing CRE loans.[257]

For the most part, the distribution of loans across bank asset sizes and between TARP and non-TARP banks reveals few differences. The number of TARP banks across asset categories does not mirror the proportions of all banks across those same categories, due to the fast assimilation of the largest banks into the program. While the regional distribution of all banks shows concentrations in the Southeast and Midwest driven by the number of Large Banks in these regions, smaller banks are chiefly in the Midwest and Southwest. The Southwest is slightly less represented in the TARP, but not significantly enough to be considered an outlier. When comparing TARP and non-TARP banks, the proportion of loan types to all loans is statistically significant at the Smallest Banks. Whereas the proportion of all loan types, except the proportion of single family loans to all loans, is statistically significant at Smaller Banks. As far as problem loans, Large TARP Banks and smaller non-TARP banks have a statistically significant number of single family loans weighing down their portfolios, while construction and land loans are slightly worse at non-TARP banks. The other loan types and asset categories are fairly consistent in the proportion of non-performing loans by type to all non-performing loans compared to the proportion of loans by type to all loans. Thus, while single family loans were potentially a driving factor in Large Banks' need for CPP funds, there is no other clear loan type that caused a similar need in other bank sizes, although their exposure to real estate is also significant.

3. Examination of Capital Conditions

There are a number of measures of bank capital.[258] Tier 1 capital is the highest quality capital and is generally made up of common stockholders' equity, certain forms of preferred stock, and certain trust preferred securities.[259] High-quality capital is liquid capital

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[256] February Oversight Report, *supra* note 103, at 42.

[257] The Smallest Banks also originate the majority of farm loans, because they are primarily located in smaller communities and direct their lending to the local businesses and residents. These banks are often the only source of credit for farmers and rural residents. Panel staff briefing with Paul Merski, senior vice president and chief economist, Independent Community Bankers of America (June 23, 2010). Non-performing farm loans as a percentage of all non-performing loans almost precisely mirrors the proportion of farm loans to all loans, although for the Smallest Banks, the non-performing farm loans are a bit higher proportionally.

[258] For a more complete discussion of bank capital measures, *see* June Oversight Report, *supra* note 76, at 9–10.

[259] Tier 1 (core) capital is the sum of the following capital elements: (1) common stockholders' equity; (2) perpetual preferred stock; (3) senior perpetual preferred stock issued by Treasury under the TARP; (4) certain minority interests in other banks; (5) qualifying trust preferred securities; and (6) a limited amount of other securities. Board of Governors of the Federal Reserve System, *BHC Supervision Manual,* § 4060.3.2.1.1 (Jan. 2008) (online at www.federalreserve.gov/boarddocs/SupManual/bhc/4000p1.pdf). Disputes may arise as to the value of an institution's

that banks hold to absorb losses arising from troubled assets. From a strictly regulatory point of view, TARP funds are included in Tier 1 capital. However, analysts and investors tend to focus more closely on Tier 1 common, which does not count TARP funds and other forms of non-common equity, and tangible common equity, a GAAP measure of capital that also does not count all non-common equity.[260] At this point, the TARP is viewed by the market as an expensive source of funding and lower quality capital.[261]

The Tier 1 risk-based capital ratio and the Tier 1 leverage ratio are two important measures of the quality of a bank's capital reserves. The Tier 1 risk-based capital ratio is calculated by dividing the bank's Tier 1 capital by the risk-weighted value of its assets ("risk-weighted assets").[262] This ratio attempts to measure the bank's capital relative to its risk exposure. The Tier 1 leverage ratio is calculated by dividing the bank's Tier 1 capital by its average total consolidated assets.[263] This ratio provides a measure of the bank's capital relative to its overall assets without adjusting for risk. The Tier 1 capital ratio is a useful tool for comparing a bank's health to that of other banks, and the Tier 1 leverage ratio is an additional measure of capital adequacy. Figure 22 shows the median Tier 1 capital ratio for different bank sizes, for all banks, and for those that received TARP assistance. It shows that the Tier 1 capital ratios on average are higher for banks that did not receive assistance.

Tier 1 capital because parties may disagree on the value of the institution's capital elements. For example, there may be disagreements on the fair value of the institution's trading assets or the estimated fair value of the institution's goodwill and intangible assets.

An amendment to the financial reform bill offered by Senator Susan Collins (R-Maine) provides that trust preferred securities will no longer constitute Tier 1 capital. As passed out of conference, however, the amendment excludes securities issued before May 19, 2010 by depository institution holding companies of less than $15 billion. Dodd-Frank Wall Street Reform and Consumer Protection Act, *supra* note 92, at § 171. As a result, the immediate effect on the capital levels of small banks will be limited, but it will likely further constrain the capital-raising options for small banks in the future. The House of Representatives passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in a 237–192 vote on June 30, 2010, but as of July 13, 2010, the Senate has not taken action yet.

[260] Generally Accepted Accounting Principles (GAAP) is a collection of guidelines and rules used by the accounting industry and set in the United States by the Financial Accounting Standards Board (FASB).

[261] U.S. Large Cap Banks sell-side analyst conversations with Panel staff (June 22, 2010).

[262] Under 12 CFR § 225, at Appendix A § III.C, each asset on the balance sheet is assigned a risk weighting according to its level of risk. Financial institutions adjust the value of their assets according to the assets' risk profiles and aggregate the adjusted values to get the risk-weighted assets. For example, cash is assigned a 0 percent risk weighting because its face value cannot vary. By contrast, a mortgage-backed security would be assigned a higher risk weighting than other, safer assets. Similar adjustments are made for certain portions of an institution's capital elements. Federal Deposit Insurance Corporation, *Director's Corner: San Francisco Region Director's College Computer—Based Training Capital* (June 29, 2005) (online at www.fdic.gov/regulations/resources/directors_college/sfcb/capital/instruction2.html).

[263] Average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the organization's Consolidated Financial Statements, less goodwill. Federal Deposit Insurance Corporation, *6000—Bank Holding Company Act, Appendix D to Part 225—Capital Adequacy Guidelines for Bank Holding Companies: Tier 1 Leverage Measure* (Dec. 3, 2009) (online at fdic.gov/regulations/laws/rules/6000-2200.html) (accessed July 12, 2010).

FIGURE 22: MEDIAN TIER 1 RISK RATIOS, BY SIZE (AS OF Q1 2010)[264]

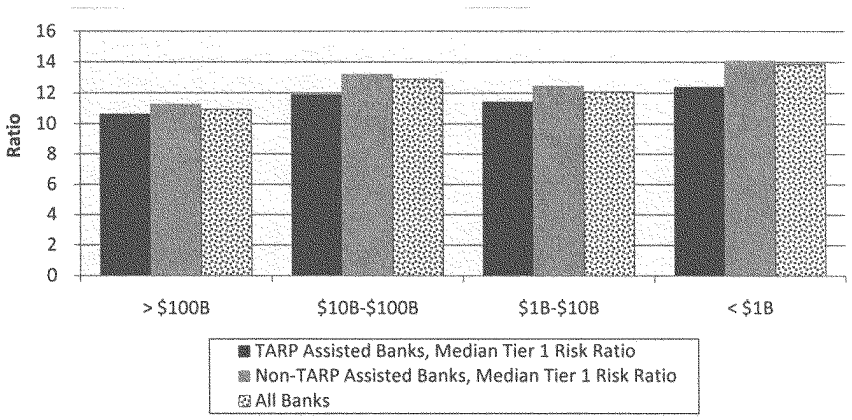
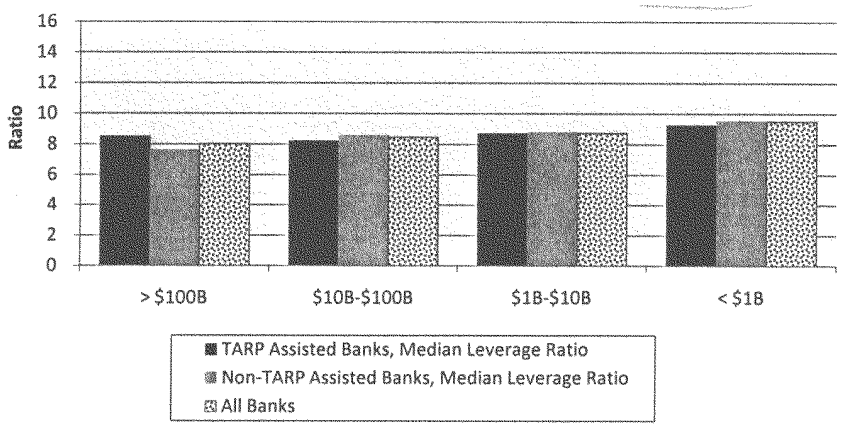


FIGURE 23: MEDIAN TIER 1 LEVERAGE RATIOS, BY SIZE (AS OF Q1 2010)



According to the FDIC's criteria, a "well capitalized" financial institution has a Tier 1 Risk Ratio and Tier 1 Leverage Ratio of at least 6 percent and 5 percent, respectively. An "adequately capitalized" financial institution has a Tier 1 Risk Ratio and Tier 1 Leverage Ratio each of at least 4 percent.[265] The underlying data for these graphs reveal that less than 1 percent of Smaller and Smallest Banks are undercapitalized using the Tier 1 Risk Ratio (5 and 44 banks, respectively). None of the Largest banks are undercapitalized. Over 98 percent of banks in each asset category are "well capitalized:" 82 out of 83 of the Medium Banks, 549 out of 558 of the Smaller Banks, and 7134 out of 7248 of the Smallest

[264] The median ratios are used rather than the average ratios because the data contain extreme values which skew the average. Because the median represents the "middle" of the data, it provides a more accurate reflection of the ratios.

[265] Federal Deposit Insurance Corporation, Capital Groups and Supervisory Groups (July 13, 2007) (online at www.fdic.gov/deposit/insurance/risk/rrps__ovr.html).

banks are well capitalized, with 100 percent—all 20—of Large Banks "well capitalized."[266] According to the Tier 1 Leverage Ratio, less than 2 percent of banks in each asset category are undercapitalized: 1 out of 83 Medium Banks, 9 out of 558 Smaller banks, and 93 out of 7248 Smallest banks. No Large Banks are undercapitalized. More than 97 percent of all banks in each asset category are "well capitalized" using the leverage ratio: 82 out of 83 of the Medium Banks, 541 out of 558 of the Smaller Banks, and 7098 out of 7248 of the Smallest Banks.[267]

FIGURE 24: MEDIAN LOAN GROWTH RATE AT MEDIUM BANKS

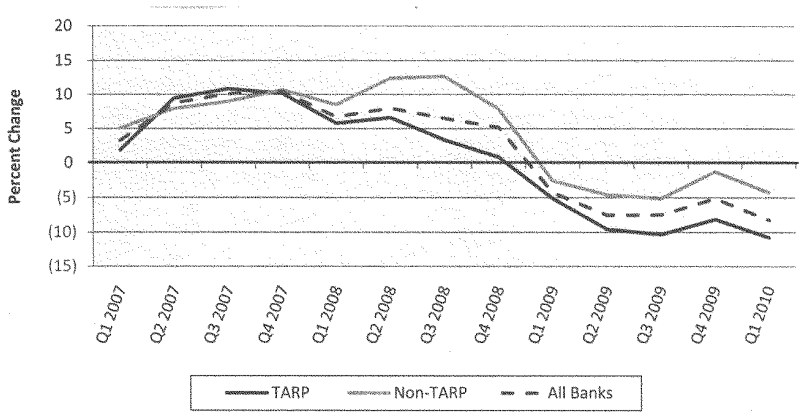
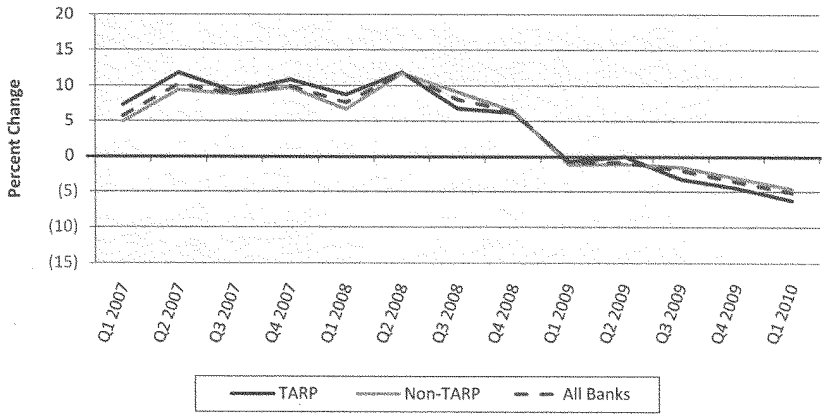


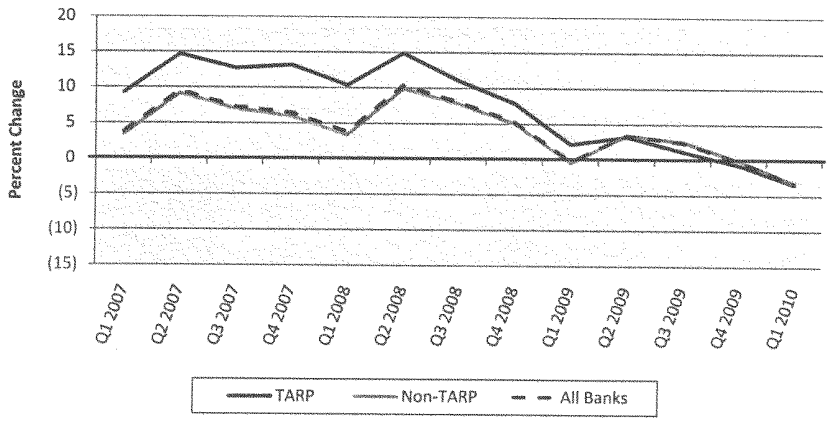
FIGURE 25: MEDIAN LOAN GROWTH RATE AT SMALLER BANKS



[266] It is possible for a bank to be deemed "well capitalized" according to regulatory capital ratio calculation definitions and still appear on the FDIC's Problem List due to being subject to a written agreement or order pursuant to Section 8 of the FDI Act.

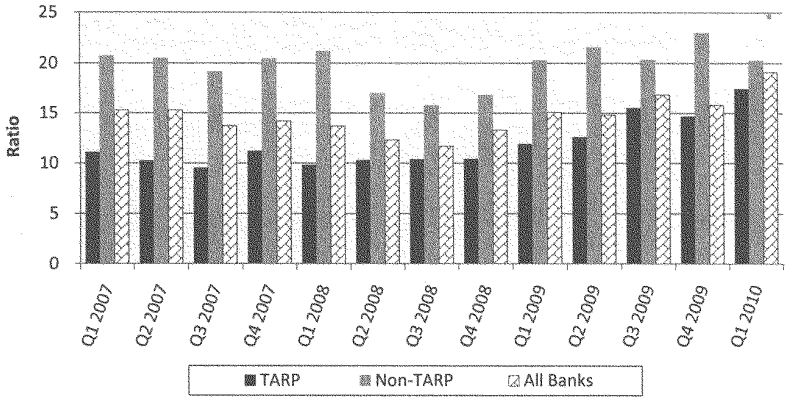
[267] SNL Financial.

FIGURE 26: MEDIAN LOAN GROWTH RATE AT SMALLEST BANKS



As noted in the graphs above, except for a few quarters of slight increases in growth rates, loan growth quarter-over-quarter has decreased since the second quarter of 2008, with both TARP and non-TARP banks' loan growth decreasing in tandem. In fact, TARP banks' decrease in loan growth has been more drastic than that of non-TARP banks, showing that TARP funds are not associated with increased lending. Medium and Smaller Banks' loan growth rates have shown negative percentage changes since the economic crisis, meaning their actual loan growth has decreased, while the growth rates at Smaller Banks remained positive until recent quarters. This suggests that, although at a lesser rate, loan growth at the Smallest Banks was increasing up until the fourth quarter of 2009.

FIGURE 27: MEDIAN LIQUIDITY RATIOS AT MEDIUM BANKS [268]



[268] The Liquidity Ratio is equal to institutions' liquid assets divided by total liabilities. Liquid assets are the sum of institutions' cash, securities, federal funds and repurchases, and trading accounts minus pledged securities. SNL Financial.

FIGURE 28: MEDIAN LIQUIDITY RATIOS AT SMALLER BANKS

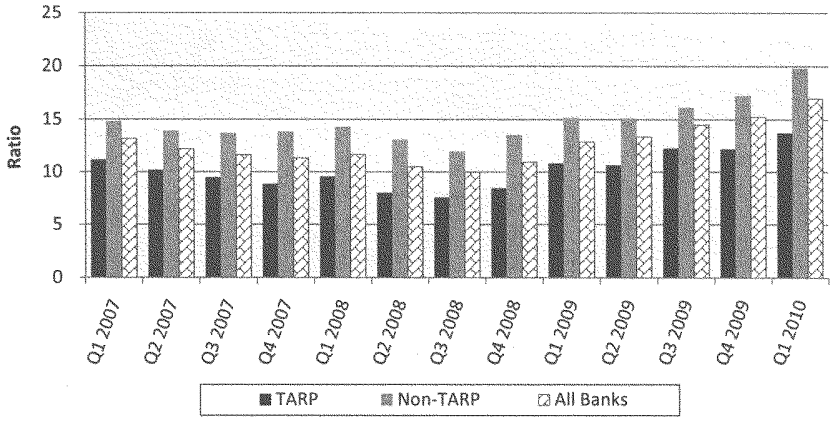
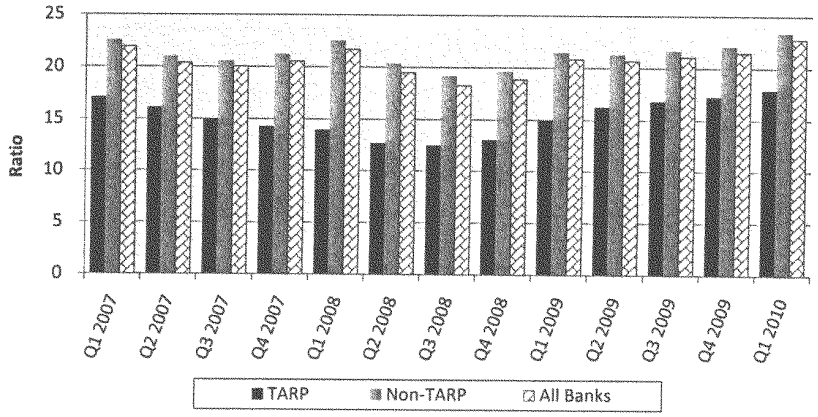


FIGURE 29: MEDIAN LIQUIDITY RATIOS AT SMALLEST BANKS



As noted in the graphs above, the median liquidity ratio for non-TARP banks has been historically higher than that of TARP banks. Though the liquidity ratios for TARP and non-TARP banks dipped at the height of the economic crisis, the ratios for both have returned to or exceeded the level in the first quarter of 2007. These graphs would thus suggest that the liquidity levels of all banks have bounced back from the economic downturn, although the liquidity of TARP banks could be aided by TARP funds received.

FIGURE 30: MEDIAN RETURN ON AVERAGE EQUITY AT MEDIUM BANKS

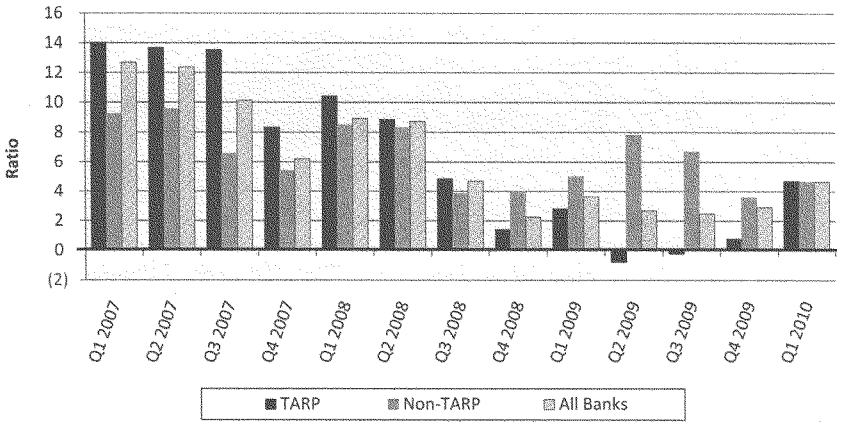


FIGURE 31: MEDIAN RETURN ON AVERAGE EQUITY AT SMALLER BANKS

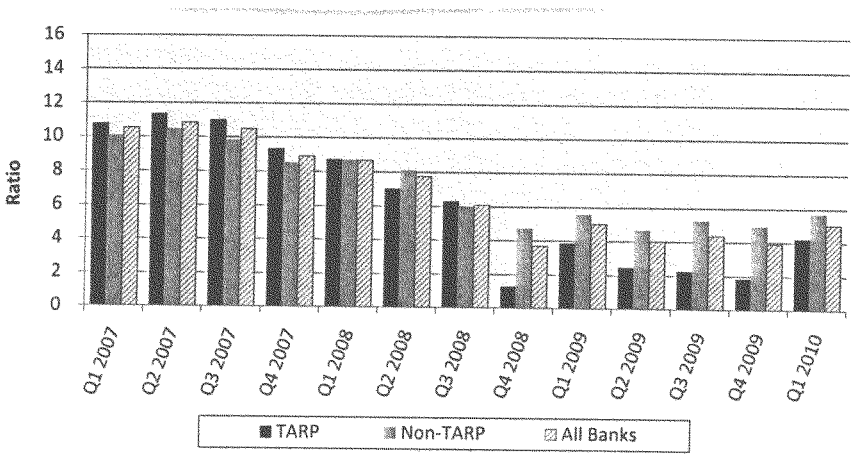
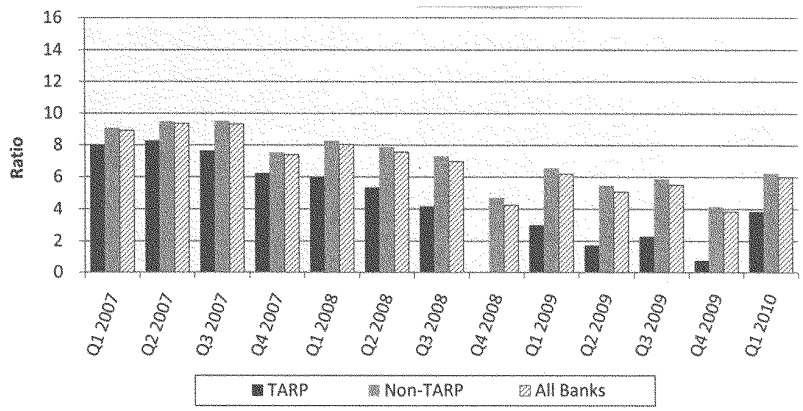


FIGURE 32: MEDIAN RETURN ON AVERAGE EQUITY AT SMALLEST BANKS



The results of the above figures suggest that TARP banks have struggled to regain their return on average equity levels seen before the crisis. While the return on equity across all banks is much lower than it was in 2007, non-TARP banks' returns have exceeded those at TARP banks. The smaller returns on average equity at TARP banks are likely impacted by increased shareholders' equity due to the TARP preferred stock investment, which decreases the return on equity.[269]

The capital measures utilized by regulators suggest that nearly all banks are reasonably well capitalized, with no significant difference between TARP and non-TARP institutions. A closer look at performance metrics utilized by analysts and investors suggests that TARP institutions have suffered greater loan growth losses and are not as well leveraged. The TARP preferred stock investment also hurts those institutions in the way certain metrics are calculated.

4. Bank Failures

The FDIC assesses the health of FDIC-insured financial institutions using the CAMELS composite rating system. The CAMELS composite rating ranges from 1 to 5, with 1 indicating a healthy institution and 5 indicating a weak institution on the brink of failure. Since the beginning of 2007 through the present there have been 254 bank failures, compared to only 41 failures in the prior ten years. From 2007 to 2009, the number of bank failures increased by 137 institutions.[270] The FDIC expects the number of failures to remain high in 2010.[271] Based upon the current rate of failures in 2010, an estimated 179 banks could fail by the end of

[269] Return on average equity is calculated by dividing net income by average shareholders' equity. Federal Deposit Insurance Corporation, *FDIC Quarterly Banking Profile: Glossary* (May 1, 2010) (online at www2.fdic.gov/qbp/Glossary.asp?menuitem=GLOSSARY).

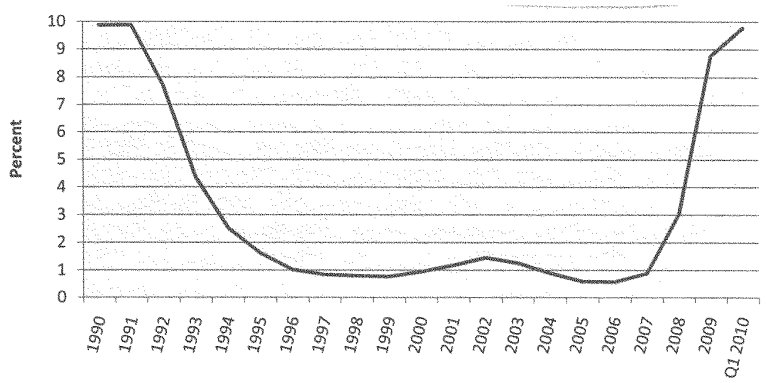
[270] Federal Deposit Insurance Corporation, *Statistics at a Glance: Historical Trends* (Mar. 31, 2010) (online at www.fdic.gov/bank/statistical/stats/2010mar/FDIC.pdf) (hereinafter "Statistics at a Glance: Historical Trends").

[271] House Committee on Financial Services, Written Testimony of Mitchell L. Glassman, director, Division of Resolutions and Receiverships, Federal Deposit Insurance Corporation, *The Condition of Financial Institutions: Examining the Failure and Seizure of an American Bank,* at 1 (Jan. 21, 2010) (online at www.house.gov/apps/list/hearing/financialsvcs__dem/fdic__glassman__statement__final.pdf).

2010, which represents an increase of 28 percent from the number of institutions that failed in 2009.[272] The more recent bank failures were concentrated in the Midwest, Southeast, and West regions.[273] Four CPP-recipient banks have failed during this time: two in California, one in Illinois, and one in New York.[274]

The FDIC places highly vulnerable institutions on the Problem List, which is published quarterly.[275] The FDIC does not disclose the identities or CAMELS ratings of these entities, nor does it disclose the number of CPP recipients on the list.[276] The start of the recession in December 2007 saw a spike in the number of banks placed on the Problem List. From 2007 to 2009, the number of banks placed on the Problem List grew from 76 to 702, an increase of 824 percent. From the end of 2009 to the first quarter of 2010, the number of institutions on the Problem List grew from 702 to 775, an increase of 10 percent.[277] The graph below shows that "problem" institutions currently represent approximately 10 percent of operating financial institutions.[278]

FIGURE 33: PERCENTAGE OF OPERATING FINANCIAL INSTITUTIONS ON FDIC'S PROBLEM LIST[279]



Although the Problem List does not include the failed banks (those banks are removed from the Problem List upon failure), the Problem List has experienced substantial growth since December 2007. According to the FDIC, historically an average of 19 percent of the institutions on the Problem List have failed.[280] The FDIC

[272] SNL Financial. As of July 2, 2010, there have been 86 bank failures in 2010.

[273] The first two concentrations are consistent with the concentration of a large numbers of banks under $100 billion in those regions.

[274] See Section C.5, *supra*, for information on the failures of the CPP recipients.

[275] FDIC Quarterly Banking Profile: First Quarter 2010, *supra* note 176, at 4, 25. The FDIC only publishes the number of "problem" institutions but not the names of the institutions for fear of starting a run on the vulnerable banks.

[276] Because the Treasury Department relies on public information when assessing the financial condition of CPP recipients (see Section D.2, *supra*), Treasury does not know when or if there are CPP institutions on the FDIC's Problem List. Treasury conversation with Panel staff (June 28, 2010).

[277] FDIC Quarterly Banking Profile: First Quarter 2010, *supra* note 176, at 4, 5

[278] Statistics at a Glance: Historical Trends, *supra* note 270.

[279] Statistics at a Glance: Historical Trends, *supra* note 270.

[280] FDIC conversation with Panel staff (June 14, 2010). *See* Federal Deposit Insurance Corporation, *FDIC-Insured Institutions Earned $18 Billion in the First Quarter of 2010* (May 20,

has not specified the percent of "problem" banks that have failed during the current financial crisis; however, assuming that all failed banks appeared on the Problem List, approximately 24 percent of "problem" institutions failed from December 2007 to the present.[281]

2010) (online at www.fdic.gov/news/news/press/2010/pr10117.html). FDIC Chairman Sheila Bair noted that the vast majority of "problem" institutions do not fail.

[281] Statistics at a Glance: Historical Trends, *supra* note 270. From December 2007 to the present, there have been 254 bank failures. Over the same period, 1,080 financial institutions appeared on the Problem List.

Annex II: CPP Missed Dividend Payments

Institution name	FN	Dividend type	Total missed dividend payments*	Amount of missed dividends
1st Federal Bancshares of Arkansas, Inc.		Cumulative	2	$412,500.00
Alliance Financial Services, Inc.		Cumulative	2	503,400.00
Anchor BanCorp Wisconsin, Inc.		Cumulative	5	7,104,166.67
Bankers' Bank of the West Bancorp, Inc.		Cumulative	1	172,207.50
Blue Valley Ban Corp		Cumulative	5	1,359,375.00
BNCCORP, Inc.		Cumulative	2	547,550.00
Bridgeview Bancorp, Inc.		Cumulative	1	517,750.00
Cascade Financial Corporation		Cumulative	3	1,461,375.00
Cecil Bancorp, Inc.		Cumulative	2	289,000.00
Central Pacific Financial Corp.		Cumulative	4	6,750,000.00
Central Virginia Bankshares, Inc.		Cumulative	2	284,625.00
Centrue Financial Corporation		Cumulative	4	1,633,400.00
Citizens Bancorp		Cumulative	4	566,800.00
Citizens Bancshares Co.		Cumulative	2	681,000.00
Citizens Bank & Trust Company		Non-Cumulative	4	130,800.00
Citizens Commerce Bancshares, Inc.		Cumulative	3	257,512.50
Citizens Republic Bancorp, Inc.		Cumulative	2	7,500,000.00
City National Bancshares Corporation		Cumulative	2	235,975.00
Commonwealth Business Bank		Non-Cumulative	5	524,625.00
Community Bank of the Bay		Non-Cumulative	4	72,549.03
Community First Bank		Non-Cumulative	3	80,708.83
Congaree Bancshares, Inc.	FN1	Cumulative	2	134,257.50
Dickinson Financial Corporation II		Cumulative	4	7,959,920.00
Duke Financial Group, Inc. (Peoples Bank of Commerce)		Cumulative	2	503,400.00
Exchange Bank		Cumulative	1	585,875.00
FC Holdings, Inc.		Cumulative	3	860,085.00
Fidelity Federal Bancorp		Cumulative	2	177,374.17
First BanCorp		Cumulative	4	20,000,000.00
First Banks, Inc.		Cumulative	4	16,099,300.00
First Community Bancshares, Inc		Cumulative	1	201,650.00
First Security Group, Inc.		Cumulative	2	825,000.00
First Sound Bank		Non-Cumulative	2	185,000.00
First Southwest Bancorporation, Inc.		Cumulative	2	149,875.00
First Trust Corporation		Cumulative	1	376,884.25
FNB United Corp.		Cumulative	1	643,750.00
FPB Bancorp, Inc.		Cumulative	2	145,000.00
Fresno First Bank		Non-Cumulative	2	33,357.33
Georgia Primary Bank		Non-Cumulative	4	254,787.50
Gold Canyon Bank		Non-Cumulative	1	21,167.50
Goldwater Bank, N.A.	FN2	Non-Cumulative	1	104,940.00
Grand Mountain Bancshares, Inc.		Cumulative	4	161,139.89
Gregg Bancshares, Inc.		Cumulative	1	11,235.00
Hampton Roads Bankshares, Inc.		Cumulative	3	3,013,012.50
Heartland Bancshares, Inc.		Cumulative	2	186,160.00
Heritage Commerce Corp		Cumulative	3	1,500,000.00
Heritage Oaks Bancorp		Cumulative	1	262,500.00
Idaho Bancorp		Cumulative	4	376,050.00
Independent Bank Corporation	FN3	Cumulative	1	2,099,771.39
Integra Bank Corporation		Cumulative	3	3,134,475.00
Intermountain Community Bancorp/Panhandle State Bank		Cumulative	2	675,000.00
Intervest Bancshares Corporation		Cumulative	2	625,000.00
Investors Financial Corporation of Pettis County, Inc. (Excel Bank).		Cumulative	2	167,800.00
Lone Star Bank		Non-Cumulative	5	213,511.50
Madison Financial Corporation		Cumulative	1	45,927.50
Maryland Financial Bank		Non-Cumulative	3	69,487.50
MetroCorp Bancshares, Inc.		Cumulative	1	562,500.00
Midtown Bank & Trust Company	FN4	Non-Cumulative	1	142,295.00
Millennium Bancorp, Inc.	FN5	Cumulative	1	197,835.00
Monarch Community Bancorp, Inc.		Cumulative	2	169,625.00

Institution name	FN	Dividend type	Total missed dividend payments*	Amount of missed dividends
Northern States Financial Corporation		Cumulative	3	645,412.50
Northwest Bancorporation, Inc.		Cumulative	1	143,062.50
Omega Capital Corp.		Cumulative	3	115,117.50
One Georgia Bank		Non-Cumulative	4	305,578.47
OneUnited Bank		Non-Cumulative	5	753,937.50
OSB Financial Services, Inc.		Cumulative	3	383,842.50
Pacific Capital Bancorp		Cumulative	5	11,289,625.00
Pacific City Financial Corporation/ Pacific City Bank		Cumulative	4	882,900.00
Pacific Commerce Bank	FN6	Non-Cumulative	1	87,278.72
Pacific International Bancorp Inc		Cumulative	4	325,000.00
Patapsco Bancorp, Inc.		Cumulative	1	81,750.00
Pathway Bancorp		Cumulative	3	152,317.50
Patterson Bancshares, Inc		Cumulative	4	201,150.00
Peninsula Bank Holding Co.		Cumulative	4	312,500.00
Pierce County Bancorp		Cumulative	3	277,950.00
Plumas Bancorp		Cumulative	1	149,362.50
Popular, Inc.		Cumulative	1	11,687,500.00
Prairie Star Bancshares, Inc.		Cumulative	1	38,150.00
Premier Bank Holding Company		Cumulative	1	129,437.50
Premier Service Bank		Non-Cumulative	4	214,972.22
Premierwest Bancorp		Cumulative	3	1,552,500.00
Presidio Bank		Non-Cumulative	2	276,718.75
Ridgestone Financial Services, Inc.		Cumulative	3	445,537.50
Rising Sun Bancorp		Cumulative	3	244,545.00
Rogers Bancshares, Inc.		Cumulative	3	1,021,875.00
Royal Bancshares of Pennsylvania, Inc.		Cumulative	4	1,520,350.00
Saigon National Bank		Non-Cumulative	6	117,663.22
Santa Clara Valley Bank		Non-Cumulative	1	39,512.50
Seacoast Banking Corporation of Florida/Seacoast National Bank		Cumulative	5	3,125,000.00
Security State Bank Holding-Company (Bank Forward)		Cumulative	2	450,997.00
Sonoma Valley Bancorp		Cumulative	2	235,810.00
South Financial Group, Inc./ Carolina First Bank		Cumulative	2	8,675,000.00
Sterling Financial Corporation/Sterling Savings Bank		Cumulative	4	15,150,000.00
Stonebridge Financial Corp.		Cumulative	1	149,515.00
Syringa Bancorp		Cumulative	3	327,000.00
TCB Holding Company		Cumulative	1	159,832.50
Tennessee Valley Financial Holdings, Inc.		Cumulative	2	81,750.00
The Bank of Currituck		Non-Cumulative	2	109,570.00
The Connecticut Bank and Trust Company		Non-Cumulative	3	178,573.33
The Freeport State Bank		Non-Cumulative	3	12,300.00
TIB Financial Corp		Non-Cumulative	3	1,387,500.00
Timberland Bancorp, Inc.		Cumulative	1	208,012.50
Treaty Oak Bancorp, Inc.		Cumulative	1	44,517.50
U.S. Century Bank		Non-Cumulative	2	1,368,940.00
United American Bank		Non-Cumulative	5	586,102.08
Valley Financial Corporation		Cumulative	1	200,237.50

*As of May 2010. This table does not include missed dividends from four failed CPP institutions or one bank that missed dividends but subsequently redeemed its CPP preferred equity.

FN1: Paid the November 2009 dividend of $44,752.50 on 11/20/09.

FN2: Paid the August 2009 dividend of $34,980 on 8/21/09. Paid the February 2010 dividend of $34,980 on 2/23/10.

FN3: Capitalized their missed dividends totaling $1,800,000 in an exchange dated 4/16/10.

FN4: Paid the August 2009 dividend of $71,147.50 on 8/19/09.

FN5: Paid the February 2010 dividend of $98,917.50 on 2/26/10.

FN6: Paid the May 2009 dividend of $55,317.50 on 6/5/09.

SECTION TWO: ADDITIONAL VIEWS

A. J. Mark McWatters and Professor Kenneth Troske

We concur with the issuance of the July report and offer the additional observations noted below. We appreciate the spirit with which the Panel and the staff approached this complex issue and incorporated suggestions during the drafting process.

The taxpayers still have an investment of over $24 billion of TARP funds in smaller financial institutions through the Capital Purchase Program (CPP), and Treasury should undertake to oversee and protect those investments in a prudent and market-oriented manner.[282] CPP recipients that are experiencing financial distress should enter into workout negotiations with their investors and creditors so as to restructure their equity capital and debt obligations. The asset managers retained by Treasury should actively participate in the negotiations with the objective of implementing a reasonable and market driven restructuring of Treasury's CPP investments. For failing institutions, converting some or all of the CPP preferred stock/subordinated debt into another form of investment and/or reducing the dividend/interest rate on the CPP allocations is preferable to waiting for the FDIC to resolve an institution. We appreciate that some may argue with conviction against the restructuring of CPP allocations where the taxpayers accept any economic loss. Regrettably, since the CPP allocations have been funded—that is, the "money is out the door"—Treasury may have little choice but to accept restructuring plans that assign a portion of the overall loss to the taxpayers. Such an approach, however, may yield a greater return for the taxpayers than an FDIC resolution.

CPP recipients that are not distressed should honor their contractual obligations to the taxpayers in full as they come due. Treasury should not undertake an across-the-board write-off of CPP allocations to small bank recipients. Any write-offs should be negotiated on an as-necessary, case-by-case basis with Treasury's overarching strategy mandating the repayment of all CPP advances together with unpaid and accrued dividends and interest. Any across-the-board effort to forgive part or all of Treasury's investments in small bank CPP recipients will send the wrong message to the markets and create significant moral hazard risks.

More than three years remain for TARP recipients to refinance their 5 percent CPP capital before the contractual rate resets to 9 percent.[283] It is certainly not unusual for well-run smaller financial institutions to obtain private capital at market rates, and Treasury and Federal and state banking supervisors should encourage CPP

[282] In order to accomplish this goal, Treasury should organize a team of attorneys, accountants, and banking experts and proceed to restructure its distressed CPP investments. In accordance with the terms of the documents evidencing the CPP allocations and applicable law, Treasury should also designate directors to serve on the board of each troubled CPP recipient. Treasury may wish to consider retaining the services of retired bank officers, attorneys, and financial services professionals as potential directors. Treasury should consider ways to address potential director concerns about liability, including considering indemnifying the directors or, if that is not possible, purchasing D&O insurance.

[283] Is it not ironic that the financial crisis was caused in part by the reset of "teaser-rate" residential mortgages, yet Treasury adopted the same approach in structuring the CPP program? Is it not surprising that similar difficulties have arisen for CPP recipients as they attempt to refinance their TARP allocations before the teaser rate resets from 5 percent to 9 percent?

recipients promptly to repay their TARP allocations. That some small banks have experienced difficulty in refinancing their CPP obligations may speak more to the under performance of the institutions than to the unavailability of private capital in general. Some may assert there is a dearth of prospective capital for small bank CPP recipients. It is possible, however, that some CPP recipients are not diligently searching for new capital based upon the expectation that Treasury will undertake an across-the-board write-off of its CPP allocations to small banks. Treasury should thoroughly discourage such an expectation so as to deter CPP recipients from undertaking a tepid search for capital.

Although we support the restructuring of distressed CPP allocations as a sensible investment strategy, we do not recommend that Treasury allocate additional TARP funds to troubled CPP recipients.[284] We are concerned that such action will again send the wrong message to the markets and create significant moral hazard risks. Little will be gained from propping up underperforming financial institutions other than the creation of more institutions with a Treasury-sanctioned competitive advantage over their unsubsidized peers. Why should the taxpayers underwrite poorly performing CPP recipients when most financial institutions are competently managed and capable of returning an appropriate risk-adjusted rate of return to their investors? What public policy goals support the long-term subsidization of the financial sector by the taxpayers? If the TARP was enacted to negate the risk of a systemic collapse, it is not clear why so many smaller institutions received TARP allocations unless the failure of such institutions in the aggregate would have caused a systemic collapse of the financial system. The failure of some—if not many—of these institutions, however, would not appear to present any systemic risk to the financial system. Some may argue that small banks face extinction and should be protected as an endangered species. To the contrary, there appears little reason to conclude that investors will not organize new financial institutions to replace those that fail or are incapable of providing their investors with an appropriate risk-adjusted return.

Many of the presently troubled small bank CPP recipients may have profited from their overindulgence in commercial real estate, among other ill-advised ventures, only to be bailed out by the taxpayers through the CPP when the going got really rough. By authorizing the allocation of additional TARP funds to these institutions, Treasury will promote less-than-prudent management policies and encourage financial institutions to adopt needlessly risky investment strategies with the expectation—if not a sense of entitlement—that they will be bailed out when the markets turn. As seasoned managers know, the markets always turn.

Some of the troubled small bank CPP recipients were no doubt mismanaged and they should be permitted to fail if a workout proves unrealistic. The removal of these institutions from the marketplace will inject a much needed dose of discipline and clear the field for more competently run institutions to prosper. In a market

[284] Troubled CPP recipients should look to the private markets for additional equity and debt capital and not to the TARP.

economy, failure must remain a well respected option and competitive advantage must arise from innovative and prescient management and not from a government subsidized thumb on the scales.

Finally, Treasury should begin to explicitly recognize the long-run effect that the CPP program has on the level of competition and efficiency in the financial sector. While it is true that in a competitive market large firms are often more efficient and stable than small firms, increases in concentration in a sector that comes about through government subsidies of some firms at the expense of others usually result in less efficient firms that are dependent on continued government support for their survival. As we show in this report, the CPP program has the potential to increase concentration in the banking sector, thus creating more and larger too-big-to-fail firms, setting the stage for future problems in the financial sector. In order to enhance the stability of the financial sector we need to return to a world where the market determines which firms grow and which firms decline.

SECTION THREE: TARP UPDATES SINCE LAST REPORT

A. TARP Repayments

In June 2010, five institutions have fully redeemed Treasury's investments under the CPP. Treasury received $1.1 billion in repayments from Lincoln National Corporation, Boston Private Financial Holdings, Inc., FPB Financial Corp., First Southern Bancorp Inc., and Lakeland Financial Corp. Boston Private Financial Holdings, Inc. and FPB Financial Corp. repaid $104 million and $2.2 million, respectively, which represents the remaining balance from earlier partial repayments. A total of 20 banks have fully repaid $13.8 billion in preferred equity CPP investments in 2010.

B. CPP Warrant Dispositions

As part of its investment in senior preferred stock of certain banks under the CPP, Treasury received warrants to purchase shares of common stock or other securities in those institutions. On June 16, 2010, SVB Financial Group repurchased its warrants from Treasury for $6.8 million in total proceeds. In addition, an auction was held on June 9, 2010, for 2,615,557 warrants to purchase Sterling Bancshares, Inc. common stock. The price per share was $1.15, and Treasury received approximately $2.9 million in aggregate net proceeds from the secondary public offering. The Panel's best valuation estimates at repurchase date for SVB Financial and Sterling warrants were $7.9 million and $5.3 million, respectively.

C. Sales of Citigroup Common Stock

On June 30, 2010, Treasury completed the sale of another 1.1 billion shares of Citigroup common stock at $4.03 per share. This is in addition to the 1.5 billion shares that were sold on May 26, 2010. To date, Treasury has earned approximately $10.5 billion in total gross proceeds from both sales, with a net profit of $2 billion. Treasury obtained this stock in June 2009 when it agreed to exchange its $25 billion investment in Citigroup for 7.7 billion shares of the company's common stock at a price of $3.25 per share.

D. Automotive Industry Financing Program

On June 10, 2010, Treasury announced that it provided General Motors Company (GM) "guidance on its role in the exploration of a possible initial public offering (IPO)" for GM common stock. The IPO would allow Treasury to dispose of the GM common equity it currently holds. Treasury acquired 60.8 percent of the company's common shares in 2009 as part of the company's restructuring under the TARP. The IPO is expected to include the sale of shares held by Treasury, GM, and other shareholders who are willing to participate. The date of the offering and overall amount of primary and secondary shares to be offered are still to be determined.

E. HFA Hardest Hit Fund

On June 23, 2010, the administration approved the use of $1.5 billion in "Hardest Hit Fund" foreclosure-prevention funding by

Housing Finance Agencies (HFAs) in Arizona, California, Florida, Michigan, and Nevada. Last February, President Obama announced the Housing Finance Agency Innovation Fund for the Hardest Hit Housing Markets (HFA Hardest Hit Fund) for the five states most affected by the decline in housing prices. After submitting a proposal to Treasury detailing their objectives, requested amount, and use of funds, the state HFAs will receive the following amounts from the HFA Hardest Hit Fund: Arizona ($125.1 million), California ($699.6 million), Florida ($418 million), Michigan ($154.5 million), and Nevada ($102.8 million). Program objectives include reducing principal and interest rates for homeowners with negative equity, mortgage assistance through subsidies for the unemployed or under-employed, reduction or settlement of second liens, payment for arrearages, and facilitation of short sales and/or deeds-in-lieu to avoid foreclosure.

F. Metrics

Each month, the Panel's report highlights a number of metrics that the Panel and others, including Treasury, the Government Accountability Office (GAO), Special Inspector General for the Troubled Asset Relief Program (SIGTARP), and the Financial Stability Oversight Board, consider useful in assessing the effectiveness of the Administration's efforts to restore financial stability and accomplish the goals of EESA. This section discusses changes that have occurred in several indicators since the release of the Panel's June report.

• **Financial Indices.** Since its post-crisis trough in April 2010, the St. Louis Federal Reserve Financial Stress Index has increased over ninefold.[285] Such an increase indicates that recently more stress is being felt across the financial spectrum. The index has, however, decreased over three standard deviations from the starting date of EESA in October 2008.

Volatility has increased of late. The Chicago Board Options Exchange Volatility Index (VIX) has nearly doubled since its post-crisis low on April 12, 2010, although current levels are short of mid-May's heights.

[285] Federal Reserve Bank of St. Louis, Series STLFSI: Business/Fiscal: *Other Economic Indicators* (Instrument: St. Louis Financial Stress Index (STLFSI), Frequency: Weekly) (online at research.stlouisfed.org/fred2/categories/98) (hereinafter "Series STLFSI: Business/Fiscal: Other Economic Indicators") (accessed July 6, 2010). The index includes 18 weekly data series, beginning in December 1993 to the present. The series are: effective federal funds rate, 2-year Treasury, 10-year Treasury, 30-year-Treasury, Baa-rated corporate, Merrill Lynch High Yield Corporate Master II Index, Merrill Lynch Asset-Backed Master BBB-rated, 10-year Treasury minus 3-month Treasury, Corporate Baa-rated bond minus 10-year Treasury, Merrill Lynch High Yield Corporate Master II Index minus 10-year Treasury, 3-month LIBOR-OIS spread, 3-month TED spread, 3-month commercial paper minus 3-month Treasury, the J.P. Morgan Emerging Markets Bond Index Plus, Chicago Board Options Exchange Market Volatility Index, Merrill Lynch Bond Market Volatility Index (1-month), 10-year nominal Treasury yield minus 10-year Treasury Inflation Protected Security yield, and Vanguard Financials Exchange-Traded Fund (equities). The index is constructed using principal components analysis after the data series are de-meaned and divided by their respective standard deviations to make them comparable units. The standard deviation of the index is set to 1. For more details on the construction of this index, see Federal Reserve Bank of St. Louis, *National Economic Trends Appendix: The St. Louis Fed's Financial Stress Index* (Jan. 2010) (online at research.stlouisfed.org/publications/net/NETJan2010Appendix.pdf).

FIGURE 34: ST. LOUIS FEDERAL RESERVE FINANCIAL STRESS INDEX [286]

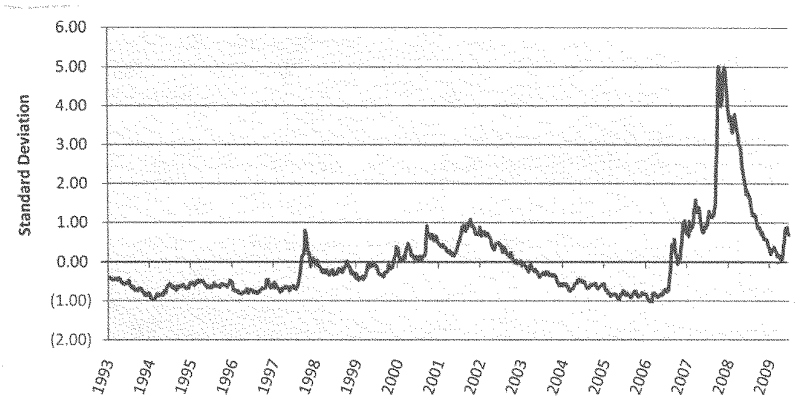
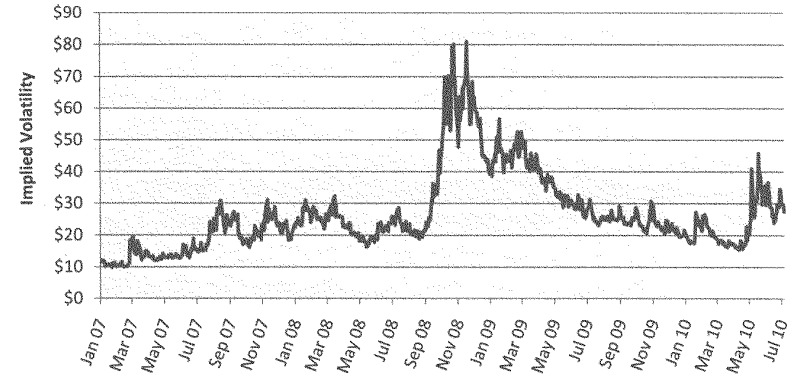


FIGURE 35: CHICAGO BOARD OPTIONS EXCHANGE VOLATILITY INDEX [287]



• **Interest Rate Spreads.** Since the Panel's June report, interest rate spreads have stayed fairly constant, suggesting the previously noted slowdown in economic growth has leveled off. The conventional mortgage spread, which measures the 30-year mortgage rate over 10-year Treasury bond yields, decreased by less than 1 percent in June to date. The 30-year mortgage interest rates have also decreased very slightly.[288] The TED Spread, which serves as an indicator for perceived risk in the financial markets, eased its upward trend, growing less than 10 percent in June to date as opposed to nearly doubling over the month of May.

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[286] Series STLFSI: Business/Fiscal: Other Economic Indicators, *supra* note 285.

[287] Data accessed through Bloomberg data service on July 2, 2010.

[288] Board of Governors of the *Federal Reserve System, Federal Reserve Statistical Release H.15: Selected Interest Rates: Historical Data* (Instrument: Conventional Mortgages, Frequency: Weekly) (online at www.federalreserve.gov/releases/h15/data/Weekly__Thursday__/H15__MORTG__NA.txt) (accessed June 24, 2010).

The LIBOR–OIS spread reflects the health of the banking system. While it increased over 150 percent in the month of May, it has also slowed its rise, increasing less than 10 percent in June to date.[289] Increases in the LIBOR rates and TED Spread suggest more hesitation among banks to lend to other counterparties.[290]

The interest rate spread for AA asset-backed commercial paper, which is considered mid-investment grade, has increased by nearly 15 percent since the Panel's June report. The interest rate spread on A2/P2 commercial paper, a lower grade investment than AA asset-backed commercial paper, increased by nearly 30 percent during June to date. The widening commercial paper spreads in June could be affected by recent problems in the Euro zone. Money market mutual funds are divesting from Greece, Spain, and Portugal. European CP due in a month has been trading on average at more than double the rate of 30-day U.S. AA-rated Financial Commercial Paper.[291]

FIGURE 36: INTEREST RATE SPREADS

Indicator	Current spread (as of 6/24/2010)	Percent change since last report (6/2/2010)
Conventional mortgage rate spread [292]	1.52	2.70
TED Spread (basis points)	40.83	8.15
Overnight AA asset-backed commercial paper interest rate spread [293]	0.13	14.29
Overnight A2/P2 nonfinancial commercial paper interest rate spread [294]	0.25	28.57

[292] Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release H.15: Selected Interest Rates: Historical Data* (Instrument: Conventional Mortgages, Frequency: Weekly) (online at www.federalreserve.gov/releases/h15/data/Weekly_Thursday_/H15_MORTG_NA.txt) (accessed June 24, 2010); Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release H.15: Selected Interest Rates: Historical Data* (Instrument: U.S. Government Securities/Treasury Constant Maturities/Nominal 10–Year, Frequency: Weekly) (online at www.federalreserve.gov/releases/h15/data/Weekly_Friday_/H15_TCMNOM_Y10.txt) (accessed June 25, 2010).

[293] Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release: Commercial Paper Rates and Outstandings: Data Download Program* (Instrument: AA Asset-Backed Discount Rate, Frequency: Daily) (online at www.federalreserve.gov/DataDownload/Choose.aspx?rel=CP) (accessed June 25, 2010); Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release: Commercial Paper Rates and Outstandings: Data Download Program* (Instrument: AA Nonfinancial Discount Rate, Frequency: Daily) (online at www.federalreserve.gov/DataDownload/Choose.aspx?rel=CP) (accessed June 25, 2010). In order to provide a more complete comparison, this metric utilizes the average of the interest rate spread for the last five days of the month.

[294] Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release: Commercial Paper Rates and Outstandings: Data Download Program* (Instrument: A2/P2 Nonfinancial Discount Rate, Frequency: Daily) (online at www.federalreserve.gov/DataDownload/Choose.aspx?rel=CP) (accessed June 25, 2010). In order to provide a more complete comparison, this metric utilizes the average of the interest rate spread for the last five days of the month.

• **LIBOR Rates.** As of June 24, 2010, the 3-month and 1-month London Interbank Offer Rates (LIBOR), the prices at which banks lend and borrow from each other, are 0.537 and 0.347, respectively. Beginning on March 1, 2010, the 3-month LIBOR has more than doubled to date, although it has increased by less than 1 percent since the Panel's June report. The 1-month LIBOR has also increased significantly in the past three months, albeit decreasing about 1 percent since June 2, 2010. Since March 1, the 1-month LIBOR rate rose by half again. These heightened levels indicate

[289] Data accessed through Bloomberg data service on June 24, 2010.

[290] Federal Reserve Bank of Minneapolis, *Measuring Perceived Risk—The TED Spread* (Dec. 2008) (online at www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4120).

[291] The Bank of England, *Statistical Interactive Database: Euro-Commercial Paper Rates* (Instrument: 1 month—euro, Frequency: Daily) (online at www.bankofengland.co.uk/mfsd/iadb/NewIntermed.asp) (accessed July 1, 2010). Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release: Commercial Paper Rates and Outstandings: Data Download Program* (Instrument: AA Financial Discount Rate, Frequency: Daily) (online at www.federalreserve.gov/DataDownload/Choose.aspx?rel=CP) (accessed June 25, 2010).

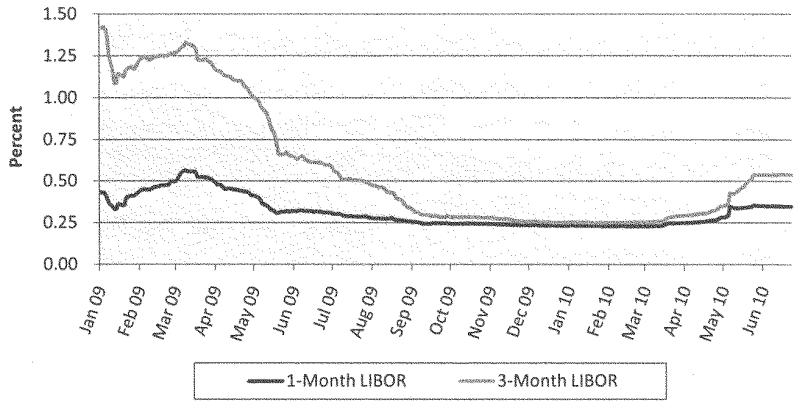
continuing concern among banks about lending and borrowing from one another.[295]

FIGURE 37: 3-MONTH AND 1-MONTH LIBOR RATES (AS OF JUNE 24, 2010)

Indicator	Current rates (as of 6/24/2010)	Percent Change from data available at time of last Report (6/2/2010)
3-Month LIBOR [296]	.537	(1.05)
1-Month LIBOR [297]	.347	(0.06)

[296] Data accessed through Bloomberg data service on June 25, 2010.
[297] Data accessed through Bloomberg data service on June 25, 2010.

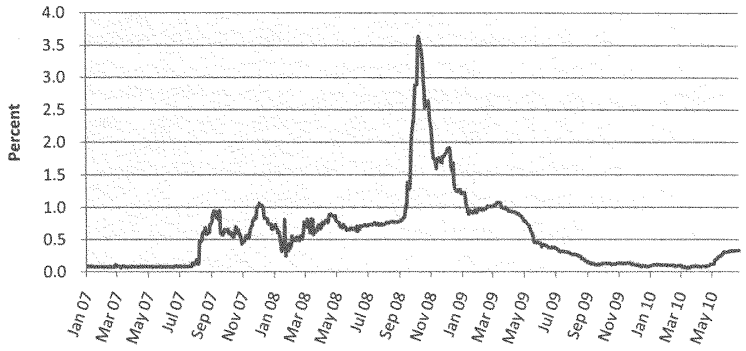
FIGURE 38: 3-MONTH AND 1-MONTH LIBOR [298]



• **LIBOR-OIS Spread.** The LIBOR-OIS Spread serves as an indicator of the health of the banking system. It is the difference between LIBOR and the overnight indexed swap rate. It has been gradually rising since late April and has nearly tripled since early May. While the spread is nowhere near the landmark values seen during the peak of the financial crisis, recent LIBOR-OIS spread values are over three times the historic norm of approximately 11 basis points, from December 2001 to June 2007.

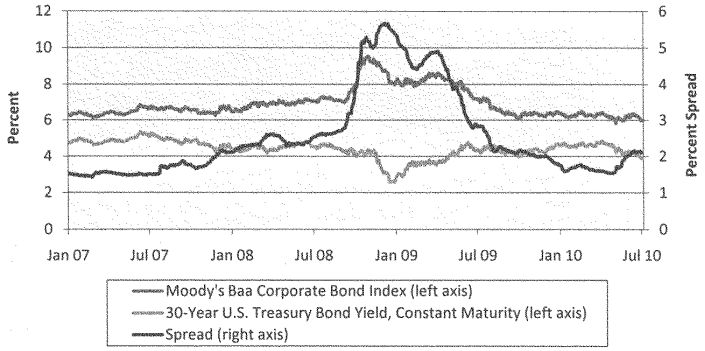
[295] Data accessed through Bloomberg data service on June 25, 2010.
[298] Data accessed through Bloomberg data service on June 25, 2010.

FIGURE 39: LIBOR-OIS SPREAD [299]



• **Corporate Bond Spread.** The spread between Moody's Baa Corporate Bond Yield Index and 30-year constant maturity U.S. Treasury Bond yields has been steadily increasing since late April. Since early May, this spread has increased by over a third. This indicates the difference in perceived risk between corporate and government bonds, and an increasing spread could indicate either that corporate bonds are viewed as becoming relatively more risky, or that U.S. government debt is being viewed as relatively less risky (or both).

FIGURE 40: MOODY'S BAA CORPORATE BOND INDEX AND 30-YEAR U.S. TREASURY YIELD [300]



• **Housing Indicators.** Foreclosure actions, which consist of default notices, scheduled auctions, and bank repossessions, dropped 3 percent in May to 322,920. This metric is over 15 percent above the foreclosure action level at the time of the EESA enactment.[301]

[299] Data accessed through Bloomberg data service on June 25, 2010.

[300] The Federal Reserve Bank of St. Louis, *Series DGS30: Selected Interest Rates* (Instrument: 30-Year Treasury Constant Maturity Rate, Frequency: Daily) (online at research.stlouisfed.org/fred2/) (accessed June 28, 2010). Corporate Baa rate data accessed through Bloomberg data service on June 25, 2010.

[301] RealtyTrac, *Foreclosure Activity Increases 5 Percent In October* (Nov. 13, 2008) (online at www.realtytrac.com/contentmanagement/pressrelease.aspx?channelid=9&itemid=5420).

Both the Case-Shiller Composite 20-City Composite as well as the FHFA Housing Price Index decreased slightly in March 2010. The Case-Shiller and FHFA indices are 7 percent and 6 percent, respectively, below their levels of October 2008.[302] Sales of new homes collapsed in May to 300,000, the lowest level since 1963.[303] Market consensus is that this is due in part to the April 30th expiration of federal tax credits for new-home buyers.[304]

FIGURE 41: HOUSING INDICATORS

Indicator	Most recent monthly data	Percent change from data available at time of last Report	Percent change since October 2008
Monthly foreclosure actions [305]	322,920	(3.3)	15.5
S&P/Case-Shiller Composite 20 Index [306]	145.1	(.05)	(6.7)
FHFA Housing Price Index [307]	194.7	0.9	(3.7)

[305] RealtyTrac, *Foreclosure Activity Press Releases* (online at www.realtytrac.com/ContentManagement/PressRelease.aspx) (accessed June 28, 2010). Most recent data available for May 2010.

[306] Standard & Poor's, *S&P/Case-Shiller Home Price Indices* (Instrument: Seasonally Adjusted Composite 20 Index) (online at www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff--p-us----) (accessed July 12, 2010). Most recent data available for March 2010.

[307] U.S. and Census Division Monthly Purchase Only Index, *supra* note 302. Most recent data available for April 2010.

Additionally, Case-Shiller futures [308] prices indicate a market expectation that home-price values will stay constant or decrease through the end of 2010. These futures are cash-settled to a weighted composite index of U.S. housing prices, as well as to specific markets in 10 major U.S. cities, and are used both to hedge by businesses whose profits and losses are related to any area of the housing industry and to balance portfolios by businesses seeking exposure to an uncorrelated asset class. As such, futures prices are a composite indicator of market information known to date and can be used to indicate market expectations for home prices.

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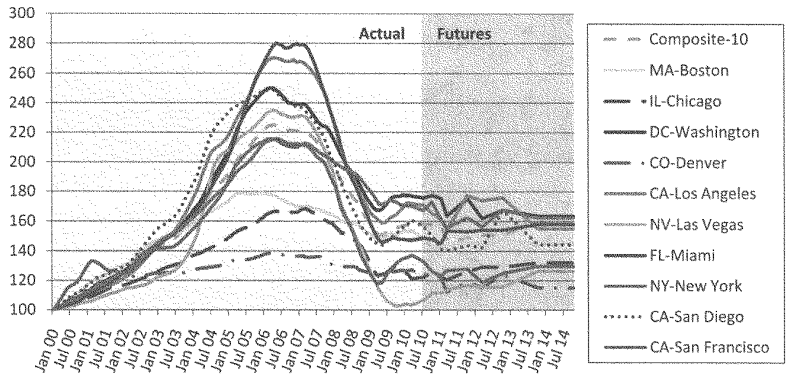
[302] Most recent data available for April 2010. Standard and Poor's, *S&P/Case-Shiller Home Price Indices* (Instrument: Case-Shiller 20-City Composite Seasonally Adjusted, Frequency: Monthly) (online at www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff--p-us----) (accessed June 28, 2010). Federal Housing Finance Agency, *U.S. and Census Division Monthly Purchase Only Index* (Instrument: USA, Seasonally Adjusted) (online at www.fhfa.gov/Default.aspx?Page=87) (hereinafter "U.S. and Census Division Monthly Purchase Only Index") (accessed July 12, 2010). S&P has cautioned that the seasonal adjustment is potentially being distorted by irregular factors. These distortions could include distressed sales and the various government programs. S&P Indices: Index Analysis, S&P Indices, *S&P/Case-Shiller Home Price Indices and Seasonal Adjustment* (Apr. 2010) (online at www.standardandpoors.com/servlet/BlobServer?blobheadername3=MDT-Type&blobcol=urldata&blobtable=MungoBlobs&blobheadervalue2=inline%3B+filename%3DCaseShiller__Seasonal Adjustment2%2C0.pdf&blobheadername2=Content-Disposition&blobheadervalue1=application%2Fpdf&blobkey= id&blobheadername1=content-type&blobwhere=1243679046081&blobheadervalue3=UTF-8).

[303] U.S. Census Bureau and U.S. Department of Housing and Urban Development, *New Residential Sales in May 2010* (June 23, 2010) (online at www.census.gov/const/newressales.pdf); U.S. Census Bureau, *Houses Sold by Region* (online at www.census.gov/ftp/pub/const/sold__cust.xls) (accessed June 25, 2010).

[304] Mortgage Bankers Association, *June 2010 Mortgage Finance Commentary* (June 11, 2010) (online at www.mbaa.org/NewsandMedia/PressCenter/73095.htm) ("Early data from MBA's Weekly Application Survey continue to suggest a fairly sharp pullback in home sales following the expiration of the homebuyer tax credit.").

[308] Data accessed through Bloomberg data service on June 28, 2010. The Case-Shiller Futures contract is traded on the CME and is settled to the Case-Shiller Index two months after the previous calendar quarter. For example, the February contract will be settled against the spot value of the S&P Case-Shiller Home Price Index values representing the fourth calendar quarter of the previous year, which is released in March. Note that utility of futures as forecasts diminishes the further out one looks.

FIGURE 42: CASE-SHILLER HOME PRICE INDEX AND FUTURES VALUES [309]



G. Financial Update

Each month, the Panel summarizes the resources that the federal government has committed to economic stabilization. The following financial update provides: (1) an updated accounting of the TARP, including a tally of dividend income, repayments, and warrant dispositions that the program has received as of May 31, 2010; and (2) an updated accounting of the full federal resource commitment as of June 23, 2010.

1. The TARP

a. Costs: Expenditures and Commitments

Treasury has committed or is currently committed to spend $520.3 billion of TARP funds through an array of programs used to purchase preferred shares in financial institutions, provide loans to small businesses and automotive companies, and leverage Federal Reserve loans for facilities designed to restart secondary securitization markets.[310] Of this total, $196.61 billion is currently outstanding under the $698.7 billion limit for TARP expenditures set by EESA, leaving $497.69 billion available for fulfillment of anticipated funding levels of existing programs and for funding new programs and initiatives.[311] The $196.61 billion includes purchases

[309] All data normalized to 100 at January 2000. Futures data accessed through Bloomberg data service on June 28, 2010. Futures values data presented here are from June 28, 2010. Standard and Poor's, *S&P/Case-Shiller Home Price Indices* (Instrument: Case-Shiller U.S. Home Price Values, Seasonally Adjusted, Frequency: Monthly) (online at www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff--p-us----) (accessed June 28, 2010).

[310] EESA, as amended by the Helping Families Save Their Homes Act of 2009, limits Treasury to $698.7 billion in purchasing authority outstanding at any one time as calculated by the sum of the purchase prices of all troubled assets held by Treasury. 12 U.S.C. § 5225(a), (b); Helping Families Save Their Homes Act of 2009, Pub. L. No. 111–22 § 402(f) (reducing by $1.23 billion the authority for the TARP originally set under EESA at $700 billion).

[311] On June 30, 2010, the House & Senate Conference Committee agreed to reduce the amount authorized under the TARP from $700 billion to $475 billion as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The revision to the TARP also prohibits allocating available funds to new programs and initiatives. See Dodd-Frank Wall Street Reform and Consumer Protection Act, *supra* note 92, at 770. The House of Representatives passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in a 237–192 vote on June 30, 2010,

of preferred and common shares, warrants and/or debt obligations under the CPP, AIGIP/SSFI Program, PPIP, and AIFP.[312] Additionally, Treasury has spent $247.5 million under the Home Affordable Modification Program (HAMP). Originally, $50 billion of TARP funds were designated for foreclosure mitigation, primarily under HAMP; however, $2.1 billion was redirected to the HFA Hardest Hit Fund, a fund created by the Administration to assist states that have experienced the largest declines in home prices as a result of the foreclosure crisis.

b. Income: Dividends, Interest Payments, CPP Repayments, and Warrant Sales

As of June 30, 2010, a total of 76 institutions have completely repurchased their CPP preferred shares. During the month of June, Treasury received $1.1 billion in total repayments from five institutions, including FPB Financial Corp. and Boston Private Financial Holdings, Inc., which redeemed the $104 million balance on their CPP investments. The largest repayment this month was $950 million from Lincoln National Corporation.

Of these institutions that have fully repaid Treasury, 37 have repurchased their warrants for common shares that Treasury received in conjunction with its preferred stock investments; Treasury sold the warrants for common shares for 14 other institutions at auction.[313] Warrants for common shares of First Financial Bancorp and Sterling Bancshares, Inc. were sold at auction on June 2 and June 9, 2010, respectively, for $6.1 million in total proceeds. On June 16, 2010, First Southern Bancorp repurchased its warrants for preferred stock from Treasury for $545,000.

In addition, Treasury receives dividend payments on the preferred shares that it holds, usually 5 percent per annum for the first five years and 9 percent per annum thereafter.[314] To date, Treasury has received approximately $22.4 billion in net income from warrant repurchases, dividends, interest payments, and other considerations deriving from TARP investments,[315] and another $1.2 billion in participation fees from its Guarantee Program for Money Market Funds.[316]

c. TARP Accounting

FIGURE 43: TARP ACCOUNTING (AS OF JUNE 30, 2010) [i]

[Dollars in billions]

TARP Initiative	Anticipated funding	Actual funding	Total repayments/ reduced exposure	Funding outstanding	Losses	Funding available
Capital Purchase Program (CPP) [ii]	$204.90	$204.90	$137.45	[iii] $67.45	[iv] $2.33	$0

but as of July 13, 2010, the Senate has not taken action yet. With the official passage of the bill still pending, the Panel will continue to report the total funding authorized through the TARP under EESA to be $698.7 billion.

[312] Treasury Transactions Report for the Period Ending June 30, 2010, *supra* note 2.

[313] *Id.*

[314] Securities Purchase Agreement: Standard Terms, *supra* note 75, at 7.

[315] Treasury Cumulative Dividends and Interest Report, *supra* note 51.

[316] U.S. Department of the Treasury, *Treasury Announces Expiration of Guarantee Program for Money Market Funds* (Sept. 18, 2009) (online at www.treasury.gov/press/releases/tg293.htm).

FIGURE 43: TARP ACCOUNTING (AS OF JUNE 30, 2010) [i]—Continued

[Dollars in billions]

TARP Initiative	Anticipated funding	Actual funding	Total repayments/ reduced exposure	Funding outstanding	Losses	Funding available
Targeted Investment Program (TIP) [v]	40.00	40.00	40.00	0	–	0
AIG Investment Program (AIGIP)/ Systemically Significant Failing Institutions Program (SSFI)	69.80	[vi] 49.10	0	49.10	–	20.70
Automobile Industry Financing Program (AIFP)	81.30	81.30	[vii] 10.80	67.10	[viii] 3.50	0
Asset Guarantee Program (AGP) [ix]	5.00	5.00	[x] 5.00	0	–	0
Capital Assistance Program (CAP) [xi]	–	–	–	–	–	–
Term Asset-Backed Securities Lending Facility (TALF)	20.00	[xii] 0.10	0	0.10	–	19.90
Public-Private Investment Program (PPIP) [xiii]	30.00	12.00	0	11.00	–	18.00
Auto Supplier Support Program (ASSP) [xiv]	[xv] 3.50	3.50	3.50	0	–	0
Unlocking SBA Lending	[xvi] 15.00	[xvii] 0.11	0	0.11	–	14.89
Home Affordable Modification Program (HAMP)	[xviii] 47.90	[xix] 0.25	0	0.25	–	47.65
Hardest Hit Funds (HHF) Program	[xx] 2.10	[xxi] 1.50	0	1.50	–	0.60
Community Development Capital Initiative (CDCI)	[xxii] 0.78	0	0	0	–	0.78
Total Committed	520.28	397.76	–	196.61	–	122.52
Total Uncommitted	178.42	–	196.75	–	–	[xxiii] 375.17
Total	**$698.70**	**$397.76**	**$196.75**	**$196.61**	**$5.83**	**$497.69**

[i] U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[ii] As of December 31, 2009, the CPP was closed. U.S. Department of the Treasury, *FAQ on Capital Purchase Program Deadline* (online at www.financialstability.gov/docs/FAQ%20on%20Capital%20Purchase%20Program%20Deadline.pdf).

[iii] Treasury has classified the investments it made in two institutions, CIT Group ($2.3 billion) and Pacific Coast National Bancorp ($4.1 million), as losses on the Transactions Report. Therefore Treasury's net current CPP investment is $65.1 billion due to the $2.3 billion in losses thus far. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010,* at 4, 6 (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[iv] This figure represents the TARP losses associated with CIT Group ($2.3 billion) and Pacific Coast National Bancorp ($4.1 million). This number does not include UCBH Holdings or Midwest Bank Holdings, Inc. UCBH Holdings, Inc. received $299 million in TARP funds and is currently in bankruptcy proceedings. As of May 26, 2010, the banking subsidiary of the TARP recipient Midwest Bank Holdings, Inc. ($89.4 million) was in receivership. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010,* at 15 (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[v] Both Bank of America and Citigroup repaid the $20 billion in assistance each institution received under the TIP on December 9 and December 23, 2009, respectively. Therefore the Panel accounts for these funds as repaid and uncommitted. *See* U.S. Department of the Treasury, *Treasury Receives $45 Billion in Repayments from Wells Fargo and Citigroup* (Dec. 23, 2009) (online at www.treas.gov/press/releases/20091229716198713.htm); U.S. Department of the Treasury, Treasury Receives $45 Billion Payment from Bank of America (Dec. 9, 2009) (online at www.financialstability.gov/latest/pr__12092009c.html).

[vi] AIG has completely utilized the $40 billion made available on November 25, 2008 and drawn-down $7.54 billion of the $29.8 billion made available on April 17, 2009. This figure also reflects $1.6 billion in accumulated but unpaid dividends owed by AIG to Treasury due to the restructuring of Treasury's investment from cumulative preferred shares to non-cumulative shares. American International Group, Inc., *Form 10–K for the Fiscal Year Ending December 31, 2009,* at 45 (Feb. 26, 2010) (online at www.sec.gov/Archives/edgar/data/5272/000104746910001465/a2196553z10-k.htm); U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010,* at 20 (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf); information provided by Treasury staff in response to Panel request.

[vii] On May 14, 2010, Treasury accepted a $1.9 billion settlement payment from Chrysler Holding to satisfy Chrysler Holdco's existing debt. In addition, Chrysler LLC, ''Old Chrysler,'' repaid $30.5 million of its debt obligations to Treasury on May 10, 2010 from proceeds earned from collateral sales. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010,* at 17–18 (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[viii] The $1.9 billion settlement payment represents a $1.6 billion loss on Treasury's Chrysler Holding Investment. This amount is in addition to losses connected to the $1.9 billion loss from the $4.1 billion debtor-in-possession credit facility, or Chrysler DIP Loan. U.S. Department of the Treasury, *Chrysler Financial Parent Company Repays $1.9 Billion in Settlement of Original Chrysler Loan* (May 17, 2010) (online at www.financialstability.gov/latest/pr_05172010c.html); U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[ix] Treasury, the Federal Reserve, and the Federal Deposit Insurance Corporation terminated the asset guarantee with Citigroup on December 23, 2009. The agreement was terminated with no losses to Treasury's $5 billion second-loss portion of the guarantee. Citigroup did not repay any funds directly, but instead terminated Treasury's outstanding exposure on its $5 billion second-loss position. As a result, the $5 billion is now counted as uncommitted. U.S. Department of the Treasury, *Treasury Receives $45 Billion in Repayments from Wells Fargo and Citigroup* (Dec. 22, 2009) (online at www.treas.gov/press/releases/20091229716198713.htm).

[x] Although this $5 billion is no longer exposed as part of the AGP and is accounted for as available, Treasury did not receive a repayment in the same sense as with other investments. Treasury did receive other income as consideration for the guarantee, which is not a repayment and is accounted for in Figure 43.

[xi] On November 9, 2009, Treasury announced the closing of this program and that only one institution, GMAC, was in need of further capital from Treasury. GMAC subsequently received an additional $3.8 billion in capital through the AIFP on December 30, 2009. U.S. Department of the Treasury, *Treasury Announcement Regarding the Capital Assistance Program* (Nov. 9, 2009) (online at www.financialstability.gov/latest/tg_11092009.html); U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010,* at 17–18 (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[xii] Treasury has committed $20 billion in TARP funds to a loan funded through TALF LLC, a special purpose vehicle created by the Federal Reserve Bank of New York. The loan is incrementally funded and as of May 26, 2010, Treasury provided $104 million to TALF LLC. This total includes accrued payable interest. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010,* at 20 (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf); Federal Reserve Bank of New York, *Factors Affecting Reserve Balances* (H.4.1) (May 27, 2010) (online at www.federalreserve.gov/releases/h41/). As of June 30, 2010, the TALF program is closed. Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility New Issue: Terms and Conditions* (online at www.newyorkfed.org/markets/talf_terms.html) (accessed July 6, 2010).

[xiii] On April 20, 2010, Treasury released its second quarterly report on the Legacy Securities Public-Private Investment Partnership. As of March 31, 2010, the total value of assets held by the PPIP managers was $10 billion. Of this total, 88 percent was non-agency Residential Mortgage-Backed Securities and the remaining 12 percent was Commercial Mortgage-Backed Securities. U.S. Department of the Treasury, T3Legacy Securities Public-Private Investment Program, Program Update—Quarter Ended March 31, 2010 (Apr. 20, 2010) (online at www.financialstability.gov/docs/External%20Report%20-%2003-10%20Final.pdf). Information on PPIP disbursements and funds outstanding are from Treasury Secretary Geithner's written testimony for a hearing with the Congressional Oversight Panel on June 22, 2010. Congressional Oversight Panel, Written Testimony of Timothy F. Geithner, secretary, U.S. Department of the Treasury, *COP Hearing with Treasury Secretary Timothy Geithner,* at 6 (Jun. 22, 2010) (online at cop.senate.gov/documents/testimony-062210-geithner.pdf).

[xiv] On April 5, 2010 and April 7, 2010, Treasury's commitment to lend to the GM SPV and the Chrysler SPV respectively under the ASSP ended. In total, Treasury received $413 million in repayments from loans provided by this program ($290 million from the GM SPV and $123 million from the Chrysler SPV). Further, Treasury received $101 million in proceeds from additional notes associated with this program. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010,* at 18 (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[xv] On July 8, 2009, Treasury lowered the total commitment amount for the program from $5 billion to $3.5 billion. This action reduced GM's portion from $3.5 billion to $2.5 billion and Chrysler's portion from $1.5 billion to $1 billion. GM Supplier Receivables LLC, the special purpose vehicle (SPV) created to administer this program for GM suppliers has made $290 million in partial repayments and Chrysler Receivables SPV LLC, the SPV created to administer the program for Chrysler suppliers, has made $123 million in partial repayments. These were partial repayments of drawn-down funds and did not lessen Treasury's $3.5 billion in total exposure under the ASSP. Total proceeds from these Additional Notes total $101.1 million. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010,* at 18 (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[xvi] U.S. Department of the Treasury, *Fact Sheet: Unlocking Credit for Small Businesses* (Oct. 19, 2009) (online at www.financialstability.gov/roadtostability/unlockingCreditforSmallBusinesses.html) (''*Jumpstart Credit Markets For Small Businesses By Purchasing Up to $15 Billion in Securities*'').

[xvii] Treasury settled on the purchase of three floating rate Small Business Administration 7(a) securities on March 24, 2010, one on April 30, 2010, three on June 30, 2010, two on July 30, 2010, and two on August 30, 2010. Treasury anticipates a settlement on one floating rate SBA 7a security on May 28, 2010. As of June 23, 2010, the total amount of TARP funds invested in these securities was $184.09 million. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010,* at 35 (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[xviii] On February 19, 2010, President Obama announced the Housing Finance Agency Innovation Fund for the Hardest Hit Housing Markets (HFA Hardest Hit Fund). The proposal commits $1.5 billion of the $50 billion in TARP funds allocated to HAMP to assist the five states with the highest home price declines stemming from the foreclosure crisis: Nevada, California, Florida, Arizona, and Michigan. The White House, *President Obama Announces Help for Hardest Hit Housing Markets* (Feb. 19, 2010) (online at www.whitehouse.gov/the-press-office/president-obama-announces-help-hardest-hit-housing-markets). On March 29, 2010, Treasury announced $600 million in funding for a second HFA Hardest Hit Fund which includes North Carolina, Ohio, Oregon, Rhode Island, and South Carolina. U.S. Department of the Treasury, *Administration Announces Second Round of Assistance for Hardest-Hit Housing Markets* (Mar. 29, 2010) (online at www.financialstability.gov/latest/pr_03292010.html). For further discussion of the newly announced HAMP programs and the effect these initiatives may have on the $50 billion in committed TARP funds, see Section D.1 of the Panel's April report. Congressional Oversight Panel, *April Oversight Report: Evaluating Progress on TARP Foreclosure Mitigation Programs,* at 30 (Apr. 14, 2010) (online at cop.senate.gov/documents/cop-041410-report.pdf).

[xix] In response to a Panel inquiry, Treasury disclosed that, as of June 30, 2010, $247.5 million in funds had been disbursed under HAMP. As of June 30, 2010, the total of all the caps set on payments to each mortgage servicer was $39.8 billion. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[xx] This figure represents the amount announced by the Administration and the Treasury for funding of the HFA Hardest Hit Fund. *See* footnote 594 of the Panel's April Oversight Report for details about proposed funding for the two HFA Hardest Hit Funds. Congressional Oversight Panel, *April Oversight Report: Evaluating Progress on TARP Foreclosure Mitigation Programs,* at 211 (Apr. 14, 2010) (online at cop.senate.gov/documents/cop-041410-report.pdf).

[xxi] On June 23, 2010, the Administration approved the use of $1.5 billion for Hardest Hit Fund foreclosure-prevention funding. This amount will be invested in housing finance agencies (HFAs) in Nevada, California, Florida, Arizona, and Michigan. Each investment will be incrementally funded up to each state's proposed investment amount. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf). Each HFA was required to submit a proposal detailing requested investment amount and individual programs designed to prevent foreclosure. For details on each HFA's programs and copies of their proposals, *see* U.S. Department of the Treasury, *Making Home Affordable: Hardest Hit Fund* (June 22, 2010) (online at www.financialstability.gov/roadtostability/hardesthitfund.html).

[xxii] On February 3, 2010, the Administration announced an initiative under the TARP to provide low-cost financing for Community Development Financial Institutions (CDFIs). Under this program, CDFIs are eligible for capital investments at a two percent dividend rate as compared to the five percent dividend rate under the CPP. In response to a Panel request, Treasury stated that it projects the CDFI program to utilize $780.2 million.

[xxiii] This figure is the sum of the uncommitted funds remaining under the $698.7 billion cap ($178.42 billion) and the repayments ($196.75 billion).

FIGURE 44: TARP PROFIT AND LOSS

[Dollars in millions]

TARP Initiative	Dividends [xxiv] (as of 5/31/10)	Interest [xxv] (as of 5/31/10)	Warrant repurchases [xxvi] (as of 6/30/10)	Other proceeds (as of 5/31/10)	Losses [xxvii] (as of 6/30/10)	Total
Total	$15,700	$749	$7,045	$4,692	($5,822)	$22,364
CPP	9,317	38	5,774	[xxviii] 2,015	(2,334)	14,810
TIP	3,004	–	1,256	–		4,260
AIFP	[xxix] 3,013	675	15	–	(3,488)	215
ASSP	–	15	–	[xxx] 101		116
AGP	366	–	0	[xxxi] 2,234		2,600
PPIP	–	21	–	[xxxii] 66		87
Bank of America Guarantee	–	–	–	[xxxiii] 276		276

[xxiv] U.S. Department of the Treasury, *Cumulative Dividends and Interest Report as of May 31, 2010* (June 11, 2010) (online at financialstability.gov/docs/dividends-interest-reports/May%202010%20Dividends%20and%20Interest%20Report.pdf).

[xxv] *Id.*

[xxvi] U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[xxvii] Treasury classified the investments it made in two institutions, CIT Group ($2.3 billion) and Pacific Coast National Bancorp ($4.1 million), as losses on the Transactions Report. A third institution, UCBH Holdings, Inc., received $299 million in TARP funds and is currently in bankruptcy proceedings. Finally, as of May 26, 2010, the banking subsidiary of the TARP recipient Midwest Banc Holdings, Inc. ($89.4 million) was in receivership. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[xxviii] This figure represents net proceeds to Treasury from the sale of Citigroup common stock to date. The net proceeds account for Treasury's exchange in June 2009 of $25 billion in Citigroup preferred shares for 7.7 billion shares of the company's common stock at $3.25 per share. On May 26, 2010, Treasury completed the sale of 1.5 billion shares of Citigroup common stock at an average weighted price of $4.12 per share. On June 30, 2010, Treasury announced the sale of 1,108,971,857 additional shares of Citigroup stock at an average weighted price of $3.90 per share. As of June 30, 2010, Treasury has received $10.5 billion in gross proceeds from these sales. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[xxix] This figure includes $815 million in dividends from GMAC preferred stock, trust preferred securities, and mandatory convertible preferred shares. The dividend total also includes a $748.6 million senior unsecured note from Treasury's investment in General Motors. Information provided by Treasury.

[xxx] This represents the total proceeds from additional notes. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending May 26, 2010* (May 28, 2010) (online at www.financialstability.gov/docs/transaction-reports/5-28-10%20Transactions%20Report%20as%20of%205-26-10.pdf).

[xxxi] As a fee for taking a second-loss position up to $5 billion on a $301 billion pool of ring-fenced Citigroup assets as part of the AGP, Treasury received $4.03 billion in Citigroup preferred stock and warrants; Treasury exchanged these preferred stocks for trust preferred securities in June 2009. Following the early termination of the guarantee, Treasury cancelled $1.8 billion of the trust preferred securities, leaving Treasury with a $2.23 billion investment in Citigroup trust preferred securities in exchange for the guarantee. At the end of Citigroup's participation in the FDIC's TLGP, the FDIC may transfer $800 million of $3.02 billion in Citigroup Trust Preferred Securities it received in consideration for its role in the AGP to the Treasury. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[xxxii] As of May 31, 2010, Treasury has earned $45 million in membership interest distributions from the PPIP. Additionally Treasury has earned $20.6 million in total proceeds following the termination of the TCW fund. U.S. Department of the Treasury, *Cumulative Dividends and Interest Report as of May 31, 2010 (June 11, 2010)* (online at financialstability.gov/docs/dividends-interest-reports/May%202010%20Dividends%20and%20Interest%20Report.pdf); U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[xxxiii] Although Treasury, the Federal Reserve, and the FDIC negotiated with Bank of America regarding a similar guarantee, the parties never reached an agreement. In September 2009, Bank of America agreed to pay each of the prospective guarantors a fee as though the guarantee had been in place during the negotiations. This agreement resulted in payments of $276 million to Treasury, $57 million to the Federal Reserve, and $92 million to the FDIC. U.S. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Bank of America Corporation, *Termination Agreement,* at 1–2 (Sept. 21, 2009) (online at www.financialstability.gov/docs/AGP/BofA%20-%20Termination%20Agreement%20-%20executed.pdf).

d. Rate of Return

As of July 7, 2010, the average internal rate of return for all financial institutions that participated in the CPP and fully repaid the U.S. government (including preferred shares, dividends, and

warrants) was 9.9 percent. The internal rate of return is the annualized effective compounded return rate that can be earned on invested capital.

e. Warrant Disposition

FIGURE 45: WARRANT REPURCHASES/AUCTIONS FOR FINANCIAL INSTITUTIONS WHO HAVE FULLY REPAID CPP FUNDS AS OF JULY 7, 2010

Institution	Investment date	Warrant repurchase date	Warrant repurchase/ sale amount	Panel's best valuation estimate at repurchase date	Price/ estimate ratio	IRR (percent)
Old National Bancorp	12/12/2008	5/8/2009	$1,200,000	$2,150,000	0.558	9.3
Iberiabank Corporation	12/5/2008	5/20/2009	1,200,000	2,010,000	0.597	9.4
Firstmerit Corporation	1/9/2009	5/27/2009	5,025,000	4,260,000	1.180	20.3
Sun Bancorp, Inc.	1/9/2009	5/27/2009	2,100,000	5,580,000	0.376	15.3
Independent Bank Corp.	1/9/2009	5/27/2009	2,200,000	3,870,000	0.568	15.6
Alliance Financial Corporation	12/19/2008	6/17/2009	900,000	1,580,000	0.570	13.8
First Niagara Financial Group	11/21/2008	6/24/2009	2,700,000	3,050,000	0.885	8.0
Berkshire Hills Bancorp, Inc.	12/19/2008	6/24/2009	1,040,000	1,620,000	0.642	11.3
Somerset Hills Bancorp	1/16/2009	6/24/2009	275,000	580,000	0.474	16.6
SCBT Financial Corporation	1/16/2009	6/24/2009	1,400,000	2,290,000	0.611	11.7
HF Financial Corp	11/21/2008	6/30/2009	650,000	1,240,000	0.524	10.1
State Street	10/28/2008	7/8/2009	60,000,000	54,200,000	1.107	9.9
U.S. Bancorp	11/14/2008	7/15/2009	139,000,000	135,100,000	1.029	8.7
The Goldman Sachs Group, Inc.	10/28/2008	7/22/2009	1,100,000,000	1,128,400,000	0.975	22.8
BB&T Corp.	11/14/2008	7/22/2009	67,010,402	68,200,000	0.983	8.7
American Express Company	1/9/2009	7/29/2009	340,000,000	391,200,000	0.869	29.5
Bank of New York Mellon Corp	10/28/2008	8/5/2009	136,000,000	155,700,000	0.873	12.3
Morgan Stanley	10/28/2008	8/12/2009	950,000,000	1,039,800,000	0.914	20.2
Northern Trust Corporation	11/14/2008	8/26/2009	87,000,000	89,800,000	0.969	14.5
Old Line Bancshares Inc.	12/5/2008	9/2/2009	225,000	500,000	0.450	10.4
Bancorp Rhode Island, Inc.	12/19/2008	9/30/2009	1,400,000	1,400,000	1.000	12.6
Centerstate Banks of Florida Inc.	11/21/2008	10/28/2009	212,000	220,000	0.964	5.9
Manhattan Bancorp	12/5/2008	10/14/2009	63,364	140,000	0.453	9.8
Bank of the Ozarks	12/12/2008	11/24/2009	2,650,000	3,500,000	0.757	9.0
Capital One Financial	11/14/2008	12/3/2009	148,731,030	232,000,000	0.641	12.0
JPMorgan Chase & Co.	10/28/2008	12/10/2009	950,318,243	1,006,587,697	0.944	10.9
TCF Financial Corp	1/16/2009	12/16/2009	9,599,964	11,825,830	0.812	11.0
LSB Corporation	12/12/2008	12/16/2009	560,000	535,202	1.046	9.0
Wainwright Bank & Trust Company	12/19/2008	12/16/2009	568,700	1,071,494	0.531	7.8
Wesbanco Bank, Inc.	12/5/2008	12/23/2009	950,000	2,387,617	0.398	6.7
Union First Market Bankshares Corporation (Union Bankshares Corporation)	12/19/2008	12/23/2009	450,000	1,130,418	0.398	5.8
Trustmark Corporation	11/21/2008	12/30/2009	10,000,000	11,573,699	0.864	9.4
Flushing Financial Corporation	12/19/2008	12/30/2009	900,000	2,861,919	0.314	6.5
OceanFirst Financial Corporation	1/16/2009	2/3/2010	430,797	279,359	1.542	6.2
Monarch Financial Holdings, Inc.	12/19/2008	2/10/2010	260,000	623,434	0.417	6.7
Bank of America	[317] 10/28/2008 [318] 1/9/2009 [319] 1/14/2009	3/3/2010	1,566,210,714	1,006,416,684	1.533	6.5
Washington Federal Inc./ Washington Federal Savings & Loan Association	11/14/2008	3/9/2010	15,623,222	10,166,404	1.537	18.6

FIGURE 45: WARRANT REPURCHASES/AUCTIONS FOR FINANCIAL INSTITUTIONS WHO HAVE FULLY REPAID CPP FUNDS AS OF JULY 7, 2010—Continued

Institution	Investment date	Warrant repurchase date	Warrant repurchase/ sale amount	Panel's best valuation estimate at repurchase date	Price/ estimate ratio	IRR (percent)
Signature Bank	12/12/2008	3/10/2010	11,320,751	11,458,577	0.988	32.4
Texas Capital Bancshares, Inc.	1/16/2009	3/11/2010	6,709,061	8,316,604	0.807	30.1
Umpqua Holdings Corp.	11/14/2008	3/31/2010	4,500,000	5,162,400	0.872	6.6
City National Corp.	11/21/2008	4/7/2010	18,500,000	24,376,448	0.759	8.5
First Litchfield Financial Corporation	12/12/2008	4/7/2010	1,488,046	1,863,158	0.799	15.9
PNC Financial Services Group Inc.	12/31/2008	4/29/2010	324,195,686	346,800,388	0.935	8.7
Comerica Inc	11/14/2008	5/4/2010	183,673,472	276,426,071	0.664	10.8
Valley National Bancorp	11/14/2008	5/18/2010	5,571,592	5,955,884	0.935	8.3
Wells Fargo Bank	10/28/2008	5/20/2010	849,014,998	1,064,247,725	0.798	7.8
First Financial Bancorp	12/23/2008	6/2/2010	3,116,284	3,051,431	1.021	8.2
Sterling Bancshares, Inc./ Sterling Bank	12/12/2008	6/9/2010	3,007,891	5,287,665	0.569	10.8
SVB Financial Group	12/12/2008	6/16/2010	6,820,000	7,884,633	0.865	7.7
Total			**$7,024,771,217**	**$7,144,680,741**	**0.983**	**9.90**

[317] Investment date for Bank of America in the CPP.
[318] Investment date for Merrill Lynch in the CPP.
[319] Investment date for Bank of America in TIP.

FIGURE 46: VALUATION OF CURRENT HOLDINGS OF WARRANTS AS OF JULY 7, 2010

[Dollars in millions]

Stress Test financial institutions with warrants outstanding	Warrant valuation		
	Low estimate	High estimate	Best estimate
Citigroup, Inc.	$14.12	$1,055.10	$182.50
SunTrust Banks, Inc.	12.84	330.47	157.33
Regions Financial Corporation	7.35	195.69	95.83
Fifth Third Bancorp	96.25	389.48	213.65
Hartford Financial Services Group, Inc.	378.15	724.40	520.45
KeyCorp	19.38	166.31	91.92
AIG	202.12	1,657.63	996.91
All Other Banks	898.09	2,122.20	1,531.06
Total	**$1,628.29**	**$6,641.28**	**$3,789.66**

2. Federal Financial Stability Efforts

a. Federal Reserve and FDIC Programs

In addition to the direct expenditures Treasury has undertaken through the TARP, the federal government has engaged in a much broader program directed at stabilizing the U.S. financial system. Many of these initiatives explicitly augment funds allocated by Treasury under specific TARP initiatives, such as FDIC and Federal Reserve asset guarantees for Citigroup, or operate in tandem with Treasury programs, such as the interaction between PPIP and TALF. Other programs, like the Federal Reserve's extension of credit through its Section 13(3) facilities and SPVs and the FDIC's Temporary Liquidity Guarantee Program, operate independently of the TARP.

Since the Panel's last report, the Federal Reserve ended the TALF program, which received a $20 billion debt obligation from Treasury. As of June 30, 2010, the program ended loan issues collateralized by newly issued commercial mortgage-backed securities. The SPV also ceased all loan issues collateralized by other types of TALF-eligible legacy and new issue Asset-Backed Securities on March 31, 2010.[320] By the program's end, investors had requested $73.3 billion in TALF loans, $13.2 billion for CMBS-related operations and $60.1 for non-CMBS operations. Of the total requested, $71.1 billion of the loans were settled at the closing of the March 2010 facility.[321]

b. Total Financial Stability Resources

Beginning in its April 2009 report, the Panel broadly classified the resources that the federal government has devoted to stabilizing the economy through myriad new programs and initiatives as outlays, loans, or guarantees. Although the Panel calculates the total value of these resources at approximately $3 trillion, this would translate into the ultimate "cost" of the stabilization effort only if: (1) assets do not appreciate; (2) no dividends are received, no warrants are exercised, and no TARP funds are repaid; (3) all loans default and are written off; and (4) all guarantees are exercised and subsequently written off.

With respect to the FDIC and Federal Reserve programs, the risk of loss varies significantly across the programs considered here, as do the mechanisms providing protection for the taxpayer against such risk. As discussed in the Panel's November report, the FDIC assesses a premium of up to 100 basis points on TLGP debt guarantees.[322] In contrast, the Federal Reserve's liquidity programs are generally available only to borrowers with good credit, and the loans are over-collateralized and with recourse to other assets of the borrower. If the assets securing a Federal Reserve loan realize a decline in value greater than the "haircut," the Federal Reserve is able to demand more collateral from the borrower. Similarly, should a borrower default on a recourse loan, the Federal Reserve can turn to the borrower's other assets to make the Federal Reserve whole. In this way, the risk to the taxpayer on recourse loans only materializes if the borrower enters bankruptcy. The only loan currently "underwater"—where the outstanding principal loan amount exceeds the current market value of the collateral—is the loan to Maiden Lane LLC, which was formed to purchase certain Bear Stearns assets.

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[320] Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility New Issue: Terms and Conditions* (online at www.newyorkfed.org/markets/talf_terms.html) (accessed July 6, 2010).

[321] Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: CMBS* (online at www.newyorkfed.org/markets/cmbs_operations.html) (accessed July 6, 2010); Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: non-CMBS* (online at www.newyorkfed.org/markets/talf_operations.html) (accessed July 6, 2010).

[322] Congressional Oversight Panel, *November Oversight Report: Guarantees and Contingent Payments in TARP and Related Programs,* at 36 (Nov. 11, 2009) (online at cop.senate.gov/documents/cop-110609-report.pdf).

FIGURE 47: FEDERAL GOVERNMENT FINANCIAL STABILITY EFFORT (AS OF JUNE 23, 2010) [xxxiv]

[Dollars in billions]

Program	Treasury (TARP)	Federal Reserve	FDIC	Total
Total	**$698.7**	**$1,637.1**	**$703.4**	**$3,039.2**
Outlays [xxxv]	271.2	1,319.7	188.4	1,779.3
Loans	32.4	317.4	0	349.8
Guarantees [xxxvi]	20	0	515	535
Uncommitted TARP Funds	375.1	0	0	375.1
AIG [xxxvii]	**69.8**	**89.5**	**0**	**159.3**
Outlays	[xxxviii] 69.8	[xxxix] 25.4	0	95.2
Loans	0	[x1] 64.1	0	64.1
Guarantees	0	0	0	0
Citigroup	**25**	**0**	**0**	**25**
Outlays	[xli] 25	0	0	25
Loans	0	0	0	0
Guarantees	0	0	0	0
Capital Purchase Program (Other)	**42.4**	**0**	**0**	**42.4**
Outlays	[xlii] 42.4	0	0	42.4
Loans	0	0	0	0
Guarantees	0	0	0	0
Capital Assistance Program	**N/A**	**0**	**0**	[xliii] **N/A**
TALF	**20**	**180**	**0**	**200**
Outlays	0	0	0	0
Loans	0	[xlv] 180	0	180
Guarantees	[xliv] 20	0	0	20
PPIP (Loans) [xlvi]	**0**	**0**	**0**	**0**
Outlays	0	0	0	0
Loans	0	0	0	0
Guarantees	0	0	0	0
PPIP (Securities)	[xlvii] **30**	**0**	**0**	**30**
Outlays	10	0	0	10
Loans	20	0	0	20
Guarantees	0	0	0	0
Home Affordable Modification Program	**50**	**0**	**0**	**50**
Outlays	[xlviii] 50	0	0	50
Loans	0	0	0	0
Guarantees	0	0	0	0
Automotive Industry Financing Program	[xlix] **67.1**	**0**	**0**	**67.1**
Outlays	59.0	0	0	59.0
Loans	8.1	0	0	8.1
Guarantees	0	0	0	0
Auto Supplier Support Program	**3.5**	**0**	**0**	**3.5**
Outlays	0	0	0	0
Loans	[l] 3.5	0	0	3.5
Guarantees	0	0	0	0
Unlocking SBA Lending	[li] **15**	**0**	**0**	**15**
Outlays	15	0	0	15
Loans	0	0	0	0
Guarantees	0	0	0	0
Community Development Capital Initiative	[lii] **0.78**	**0**	**0**	**0.78**
Outlays	0	0	0	0
Loans	0.78	0	0	0.78
Guarantees	0	0	0	0
Temporary Liquidity Guarantee Program	**0**	**0**	**515**	**515**
Outlays	0	0	0	0
Loans	0	0	0	0
Guarantees	0	0	[liii] 515	515
Deposit Insurance Fund	**0**	**0**	**188.4**	**188.4**
Outlays	0	0	[liv] 188.4	188.4
Loans	0	0	0	0
Guarantees	0	0	0	0

FIGURE 47: FEDERAL GOVERNMENT FINANCIAL STABILITY EFFORT (AS OF JUNE 23, 2010) [xxxiv]—Continued

[Dollars in billions]

Program	Treasury (TARP)	Federal Reserve	FDIC	Total
Other Federal Reserve Credit Expansion	**0**	**1,367.6**	**0**	**1,367.6**
Outlays	0	[lv] 1,294.3	0	1,294.3
Loans	0	[lvi] 73.3	0	73.3
Guarantees	0	0	0	0
Uncommitted TARP Funds	**375.1**	**0**	**0**	**375.1**

[xxxiv] All data in this exhibit is as of June 23, 2010, except for information regarding the FDIC's Temporary Liquidity Guarantee Program (TLGP). This data is as of May 31, 2010.

[xxxv] The term ''outlays'' is used here to describe the use of Treasury funds under the TARP, which are broadly classifiable as purchases of debt or equity securities (e.g., debentures, preferred stock, exercised warrants, etc.). The outlays figures are based on: (1) Treasury's actual reported expenditures; and (2) Treasury's anticipated funding levels as estimated by a variety of sources, including Treasury pronouncements and GAO estimates. Anticipated funding levels are set at Treasury's discretion, have changed from initial announcements, and are subject to further change. Outlays used here represent investment and asset purchases and commitments to make investments and asset purchases and are not the same as budget outlays, which under section 123 of EESA are recorded on a ''credit reform'' basis.

[xxxvi] Although many of the guarantees may never be exercised or exercised only partially, the guarantee figures included here represent the federal government's greatest possible financial exposure.

[xxxvii] AIG received an $85 billion credit facility (reduced to $60 billion in November 2008 to $35 billion in December 2009, and then to $34 billion in May 2010) from the Federal Reserve Bank of New York. A Treasury trust received Series C preferred convertible stock in exchange for the facility and $0.5 million. The Series C shares amount to 79.9 percent ownership of common stock, minus the percentage common shares acquired through warrants. In November 2008, Treasury received a warrant to purchase shares amounting to 2 percent ownership of AIG common stock in connection with its Series D stock purchase (exchanged for Series E noncumulative preferred shares on 4/17/2009). Treasury also received a warrant to purchase 3,000 Series F common shares in May 2009. Warrants for Series D and Series F shares represent 2 percent equity ownership, and would convert Series C shares into 77.9 percent of common stock. However, in May 2009, AIG carried out a 20:1 reverse stock split, which allows warrants held by Treasury to become convertible into 0.1 percent common equity. Therefore, the total benefit to the Treasury would be a 79.8 percent voting majority in AIG in connection with its ownership of Series C convertible shares. U.S. Government Accountability Office, *Troubled Asset Relief Program: Status of Government Assistance Provided to AIG* (Sept. 2009) (GAO–09–975) (online at www.gao.gov/new.items/d09975.pdf). Additional information was also provided by Treasury in response to Panel inquiry.

[xxxviii] This number includes investments under the AIGIP/SSFI Program: a $40 billion investment made on November 25, 2008, and a $30 billion investment committed on April 17, 2009 (less a reduction of $165 million representing bonuses paid to AIG Financial Products employees). As of July 13, 2010, AIG had utilized $47.5 billion of the available $69.8 billion under the AIGIP/SSFI and owed $1.6 billion in unpaid dividends. This information was provided by Treasury in response to a Panel inquiry.

[xxxix] As part of the restructuring of the U.S. government's investment in AIG announced on March 2, 2009, the amount available to AIG through the Revolving Credit Facility was reduced by $25 billion in exchange for preferred equity interests in two special purpose vehicles, AIA Aurora LLC and ALICO Holdings LLC. These SPVs were established to hold the common stock of two AIG subsidiaries: American International Assurance Company Ltd. (AIA) and American Life Insurance Company (ALICO). As of June 23, 2010, the book value of the Federal Reserve Bank of New York's holdings in AIA Aurora LLC and ALICO Holdings LLC was $16.27 billion and $9.15 billion in preferred equity respectively. Hence, the book value of these securities is $25.416 billion, which is reflected in the corresponding table. Federal Reserve Bank of New York, *Factors Affecting Reserve Balances (H.4.1)* (June 24, 2010) (online at www.federalreserve.gov/releases/h41/).

[xl] This number represents the full $34 billion that is available to AIG through its revolving credit facility with the Federal Reserve Bank of New York (FRBNY) ($25.1 billion had been drawn down as of June 23, 2010) and the outstanding principal of the loans extended to the Maiden Lane II and III SPVs to buy AIG assets (as of May 26, 2010, $14.3 billion and $15.8 billion, respectively). The amounts outstanding under the ML2 and ML3 facilities do not reflect the accrued interest payable to FRBNY. Income from the purchased assets is used to pay down the loans to the SPVs, reducing the taxpayers' exposure to losses over time. Federal Reserve Bank of New York, *Factors Affecting Reserve Balances (H.4.1)* (June 24, 2010) (online at www.federalreserve.gov/releases/h41/); Board of Governors of the Federal Reserve System, *Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet,* at 17 (Oct. 2009) (online at www.federalreserve.gov/monetarypolicy/ files/monthlyclbsreport200910.pdf). On December 1, 2009, AIG entered into an agreement with FRBNY to reduce the debt AIG owes FRBNY by $25 billion. In exchange, FRBNY received preferred equity interests in two AIG subsidiaries. This also reduced the debt ceiling on the loan facility from $60 billion to $35 billion. American International Group, Inc., *AIG Closes Two Transactions That Reduce Debt AIG Owes Federal Reserve Bank of New York by $25 billion* (Dec. 1, 2009) (online at phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MjE4ODI8Q2hpbGRJRD0tMXxUeXBlPTM=&t=1). The maximum available amount from the credit facility was reduced from $34.1 billion to $34 billion on May 6, 2010, as a result of the sale of HighStar Port Partners, L.P. Board of Governors of the Federal Reserve System, *Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet,* at 17 (May 2010) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport201005.pdf).

[xli] May 26, 2010, Treasury completed sales of 1.5 billion shares of Citigroup common stock for $6.1 billion in gross proceeds and $1.3 billion in net proceeds. On June 30, 2010, Treasury completed another sale of 1,108,971,857 billion shares of Citigroup stock. To date, a total of 2.6 billion shares has been sold for a total of $10.5 billion in gross proceeds and $2 billion in net proceeds. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf); U.S. Department of the Treasury, *Treasury Announces the Completion of Its Current Trading Plan to Sell Citigroup Common Stock* (July 1, 2010) (online at www.financialstability.gov/latest/pr__07012010.html).

[xlii] This figure represents the $204.9 billion Treasury disbursed under the CPP, minus the $25 billion investment in Citigroup identified above, and the $137.5 billion in repayments that are reflected as available TARP funds. This figure does not account for future repayments of CPP investments, dividend payments from CPP investments, or losses under the program. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[xliii] On November 9, 2009, Treasury announced the closing of the CAP and that only one institution, GMAC, was in need of further capital from Treasury. GMAC, however, received further funding through the AIFP. Therefore, the Panel considers CAP unused and closed. U.S. Department of the Treasury, *Treasury Announcement Regarding the Capital Assistance Program* (Nov. 9, 2009) (online at www.financialstability.gov/latest/tg__11092009.html).

[xliv] This figure represents a $20 billion allocation to the TALF SPV on March 3, 2009. However, as of June 23, 2010, TALF LLC had drawn only $104 million of the available $20 billion. Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (May 27, 2010) (online at www.federalreserve.gov/Releases/H41/Current/); U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending May 26, 2010* (May 28, 2010) (online at www.financialstability.gov/docs/transaction-reports/5-28-10%20Transactions%20Report%20as%20of%205-26-10.pdf). On June 30, 2010, the Federal Reserve ceased issuing loans collateralized by newly issued CMBS. As of this date, investors had requested a total of $73.3 billion in TALF loans ($13.2 billion in CMBS and $60.1 billion in non-CMBS) and $71 billion in TALF loans had been settled ($12 billion in CMBS and $59 billion in non-CMBS). Earlier, it ended its issues of loans collateralized by other TALF-eligible newly issued and legacy ABS on March 31, 2010. Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility New Issue: Terms and Conditions* (online at www.newyorkfed.org/markets/talf_terms.html) (accessed July 6, 2010); *Term Asset-Backed Securities Loan Facility: CMBS* (online at www.newyorkfed.org/markets/cmbs_operations.html) (accessed July 6, 2010); Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: non-CMBS* (online at www.newyorkfed.org/markets/talf_operations.html) (accessed July 6, 2010).

[xlv] This number is derived from the unofficial 1:10 ratio of the value of Treasury loan guarantees to the value of Federal Reserve loans under the TALF. U.S. Department of the Treasury, *Fact Sheet: Financial Stability Plan* (Feb. 10, 2009) (online at www.financialstability.gov/docs/fact-sheet.pdf) (describing the initial $20 billion Treasury contribution tied to $200 billion in Federal Reserve loans and announcing potential expansion to a $100 billion Treasury contribution tied to $1 trillion in Federal Reserve loans). Because Treasury is responsible for reimbursing the Federal Reserve Board for $20 billion of losses on its $200 billion in loans, the Federal Reserve Board's maximum potential exposure under the TALF is $180 billion.

[xlvi] It is unlikely that resources will be expended under the PPIP Legacy Loans Program in its original design as a joint Treasury-FDIC program to purchase troubled assets from solvent banks. *See also* Federal Deposit Insurance Corporation, *FDIC Statement on the Status of the Legacy Loans Program* (June 3, 2009) (online at www.fdic.gov/news/news/press/2009/pr09084.html); Federal Deposit Insurance Corporation, *Legacy Loans Program—Test of Funding Mechanism* (July 31, 2009) (online at www.fdic.gov/news/news/press/2009/pr09131.html). The sales described in these statements do not involve any Treasury participation, and FDIC activity is accounted for here as a component of the FDIC's Deposit Insurance Fund outlays.

[xlvii] As of June 30, 2010, Treasury reported commitments of $19.9 billion in loans and $9.9 billion in membership interest associated with the program. On January 4, 2010, Treasury and one of the nine fund managers, TCW Senior Management Securities Fund, L.P., entered into a ''Winding-Up and Liquidation Agreement.'' U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[xlviii] Of the $50 billion in announced TARP funding for this program, $39.8 billion has been allocated as of June 29, 2010. However, as of June 30, 2010, only $247.5 million in non-GSE payments have been disbursed under HAMP. The total anticipated funding for HAMP was reduced to $47.9 billion when $2.1 billion was redirected to the HFA Hardest Hit Funds Program under the Housing Financing Agency Innovation Fund for the Hardest Hit Housing Markets. Disbursement information and amount of anticipated HAMP funding reduction provided by Treasury in response to Panel inquiry; U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf); U.S. Department of the Treasury, *Obama Administration Approves Plans for Use of $1.5 Billion in 'Hardest Hit Fund' Foreclosure-Prevention Funding* (online at www.financialstability.gov/latest/pr_06232010.html).

[xlix] A substantial portion of the total $81.3 billion in loans extended under the AIFP have since been converted to common equity and preferred shares in restructured companies. $8.1 billion has been retained as first lien debt (with $1 billion committed to old GM, and $7.1 billion to Chrysler). This figure ($67.1 billion) represents Treasury's current obligation under the AIFP after repayments. U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[l] U.S. Department of the Treasury, *Troubled Asset Relief Program Transactions Report for Period Ending June 30, 2010* (July 1, 2010) (online at www.financialstability.gov/docs/transaction-reports/7-1-10%20Transactions%20Report%20as%20of%206-30-10.pdf).

[li] U.S. Department of the Treasury, *Fact Sheet: Unlocking Credit for Small Businesses* (Oct. 19, 2009) (online at www.financialstability.gov/roadtostability/unlockingCreditforSmallBusinesses.html) (*''Jumpstart Credit Markets For Small Businesses By Purchasing Up to $15 Billion in Securities''*).

[lii] This information was provided by Treasury staff in response to Panel inquiry.

[liii] This figure represents the current maximum aggregate debt guarantees that could be made under the program, which is a function of the number and size of individual financial institutions participating. $305.4 billion of debt subject to the guarantee is currently outstanding, which represents approximately 59.2 percent of the current cap. Federal Deposit Insurance Corporation, *Monthly Reports on Debt Issuance Under the Temporary Liquidity Guarantee Program: Debt Issuance Under Guarantee Program* (May 31, 2010) (online at www.fdic.gov/regulations/resources/TLGP/total_issuance05-10.html). The FDIC has collected $10.4 billion in fees and surcharges from this program since its inception in the fourth quarter of 2008. Federal Deposit Insurance Corporation, *Monthly Reports Related to the Temporary Liquidity Guarantee Program* (May 31, 2010) (online at www.fdic.gov/regulations/resources/tlgp/fees.html).

[liv] This figure represents the FDIC's provision for losses to its deposit insurance fund attributable to bank failures in the third and fourth quarters of 2008, the first, second, third, and fourth quarters of 2009, and the first quarter of 2010. Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Fourth Quarter 2008)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_4qtr_08/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Third Quarter 2008)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_3rdqtr_08/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (First Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_1stqtr_09/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Second Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_2ndqtr_09/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Third Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_3rdqtr_09/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (Fourth Quarter 2009)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_4thqtr_09/income.html); Federal Deposit Insurance Corporation, *Chief Financial Officer's (CFO) Report to the Board: DIF Income Statement (First Quarter 2010)* (online at www.fdic.gov/about/strategic/corporate/cfo_report_1stqtr_10/income.html). This figure includes the FDIC's estimates of its future losses under loss-sharing agreements that it has entered into with banks acquiring assets of insolvent banks during these five quarters. Under a loss-sharing agreement, as a condition of an acquiring bank's agreement to purchase the assets of an insolvent bank, the FDIC typically agrees to cover 80 percent of an acquiring bank's future losses on an initial portion of these assets and 95 percent of losses of another portion of assets. *See, e.g.,* Federal Deposit Insurance Corporation, *Purchase and Assumption Agreement Among FDIC, Receiver of Guaranty Bank, Austin, Texas, FDIC and Compass Bank,* at 65–66 (Aug. 21, 2009) (online at www.fdic.gov/bank/individual/failed/guaranty-tx_p_and_a_w_addendum.pdf). In information provided to Panel staff, the FDIC disclosed that there were approximately $132 billion in assets covered under loss-sharing agreements as of December 18, 2009. Furthermore, the FDIC estimates the total cost of a payout under these agreements to be $59.3 billion. Since there is a published loss estimate for these agreements, the Panel continues to reflect them as outlays rather than as guarantees.

[lv] Outlays are comprised of the Federal Reserve Mortgage Related Facilities. The Federal Reserve balance sheet accounts for these facilities under Federal agency debt securities and mortgage-backed securities held by the Federal Reserve. Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (online at www.federalreserve.gov/datadownload/Choose.aspx?rel=H41) (accessed July 13, 2010). Although the Federal Reserve does not employ the outlays, loans, and guarantees classification, its accounting clearly separates its mortgage-related purchasing programs from its liquidity programs. *See* Board of Governors of the Federal Reserve, *Credit and Liquidity Programs and the Balance Sheet November 2009,* at 2 (Nov. 2009) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200911.pdf).

On September 7, 2008, Treasury announced the GSE Mortgage Backed Securities Purchase Program (Treasury MBS Purchase Program). The Housing and Economic Recovery Act of 2008 provided Treasury the authority to purchase Government Sponsored Enterprise (GSE) MBS. Under this program, Treasury purchased approximately $214.4 billion in GSE MBS before the program ended on December 31, 2009. As of May 2010, there was $174.7 billion still outstanding under this program. U.S. Department of the Treasury, *MBS Purchase Program: Portfolio by Month* (online at www.financialstability.gov/docs/May%202010%20Portfolio%20by%20month.pdf) (accessed July 9, 2010). Treasury has received $46.0 billion in principal repayments and $11.1 billion in interest payments from these securities. U.S. Department of the Treasury, *MBS Purchase Program Principal and Interest* (online at www.financialstability.gov/docs/May%202010%20MBS%20Principal%20and%20Interest%20Monthly%20Breakout.pdf) (accessed July 9, 2010).

[lvi] Federal Reserve Liquidity Facilities classified in this table as loans include: Primary credit, Secondary credit, Central bank liquidity swaps, Primary dealer and other broker-dealer credit, Asset-Backed Commercial Paper, Money Market Mutual Fund Liquidity Facility, Net portfolio holdings of Commercial Paper Funding Facility LLC, Seasonal credit, Term auction credit, Term Asset-Backed Securities Loan Facility, and loans outstanding to Bear Stearns (Maiden Lane I LLC). Board of Governors of the Federal Reserve System, *Factors Affecting Reserve Balances (H.4.1)* (online at www.federalreserve.gov/datadownload/Choose.aspx?rel=H41) (accessed July 9, 2010).

SECTION FOUR: OVERSIGHT ACTIVITIES

The Congressional Oversight Panel was established as part of the Emergency Economic Stabilization Act (EESA) and formed on November 26, 2008. Since then, the Panel has produced 20 oversight reports, as well as a special report on regulatory reform, issued on January 29, 2009, and a special report on farm credit, issued on July 21, 2009. Since the release of the Panel's June oversight report, which examined government assistance to American International Group, the following developments pertaining to the Panel's oversight of the TARP took place:

- The Panel held a hearing in Washington, DC on June 22, 2010, with Treasury Secretary Timothy Geithner, his fourth appearance before the Panel since its inception. The Panel received a general update from the Secretary on the current status and future direction of the TARP, and raised a number of questions on a wide-range of TARP-related topics including questions related to small banks and small business lending, Treasury's continued foreclosure mitigation efforts, and banks' continued exposure to a troubled commercial real estate market. A video recording of the hearing, Secretary Geithner's written testimony, and Panel Members' opening statements all can be found online at cop.senate.gov/hearings.

Upcoming Reports and Hearings

The Panel will release its next oversight report in August. While the Panel's previous reports have been focused almost exclusively on efforts here in the United States, the August report will examine the international aspects of the government's response to the financial crisis.

SECTION FIVE: ABOUT THE CONGRESSIONAL OVERSIGHT PANEL

In response to the escalating financial crisis, on October 3, 2008, Congress provided Treasury with the authority to spend $700 billion to stabilize the U.S. economy, preserve home ownership, and promote economic growth. Congress created the Office of Financial Stability (OFS) within Treasury to implement the TARP. At the same time, Congress created the Congressional Oversight Panel to "review the current state of financial markets and the regulatory system." The Panel is empowered to hold hearings, review official data, and write reports on actions taken by Treasury and financial institutions and their effect on the economy. Through regular reports, the Panel must oversee Treasury's actions, assess the impact of spending to stabilize the economy, evaluate market transparency, ensure effective foreclosure mitigation efforts, and guarantee that Treasury's actions are in the best interests of the American people. In addition, Congress instructed the Panel to produce a special report on regulatory reform that analyzes "the current state of the regulatory system and its effectiveness at overseeing the participants in the financial system and protecting consumers." The Panel issued this report in January 2009. Congress subsequently expanded the Panel's mandate by directing it to produce a special report on the availability of credit in the agricultural sector. The report was issued on July 21, 2009.

On November 14, 2008, Senate Majority Leader Harry Reid and the Speaker of the House Nancy Pelosi appointed Richard H. Neiman, Superintendent of Banks for the State of New York, Damon Silvers, Director of Policy and Special Counsel of the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), and Elizabeth Warren, Leo Gottlieb Professor of Law at Harvard Law School, to the Panel. With the appointment on November 19, 2008, of Congressman Jeb Hensarling to the Panel by House Minority Leader John Boehner, the Panel had a quorum and met for the first time on November 26, 2008, electing Professor Warren as its chair. On December 16, 2008, Senate Minority Leader Mitch McConnell named Senator John E. Sununu to the Panel. Effective August 10, 2009, Senator Sununu resigned from the Panel, and on August 20, 2009, Senator McConnell announced the appointment of Paul Atkins, former Commissioner of the U.S. Securities and Exchange Commission, to fill the vacant seat. Effective December 9, 2009, Congressman Jeb Hensarling resigned from the Panel and House Minority Leader John Boehner announced the appointment of J. Mark McWatters to fill the vacant seat. Senate Minority Leader Mitch McConnell appointed Kenneth Troske, Sturgill Professor of Economics at the University of Kentucky, to fill the vacancy created by the resignation of Paul Atkins on May 21, 2010.