



SIGTARP

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

ADVANCING ECONOMIC STABILITY THROUGH TRANSPARENCY, COORDINATED OVERSIGHT AND ROBUST ENFORCEMENT

FOR OFFICIAL USE ONLY UNTIL RELEASED BY THE
HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

STATEMENT OF KEVIN R. PUVALOWSKI

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

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

May 11, 2010

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

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

Background

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

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

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

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

Treasury's Warrant Repurchases

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

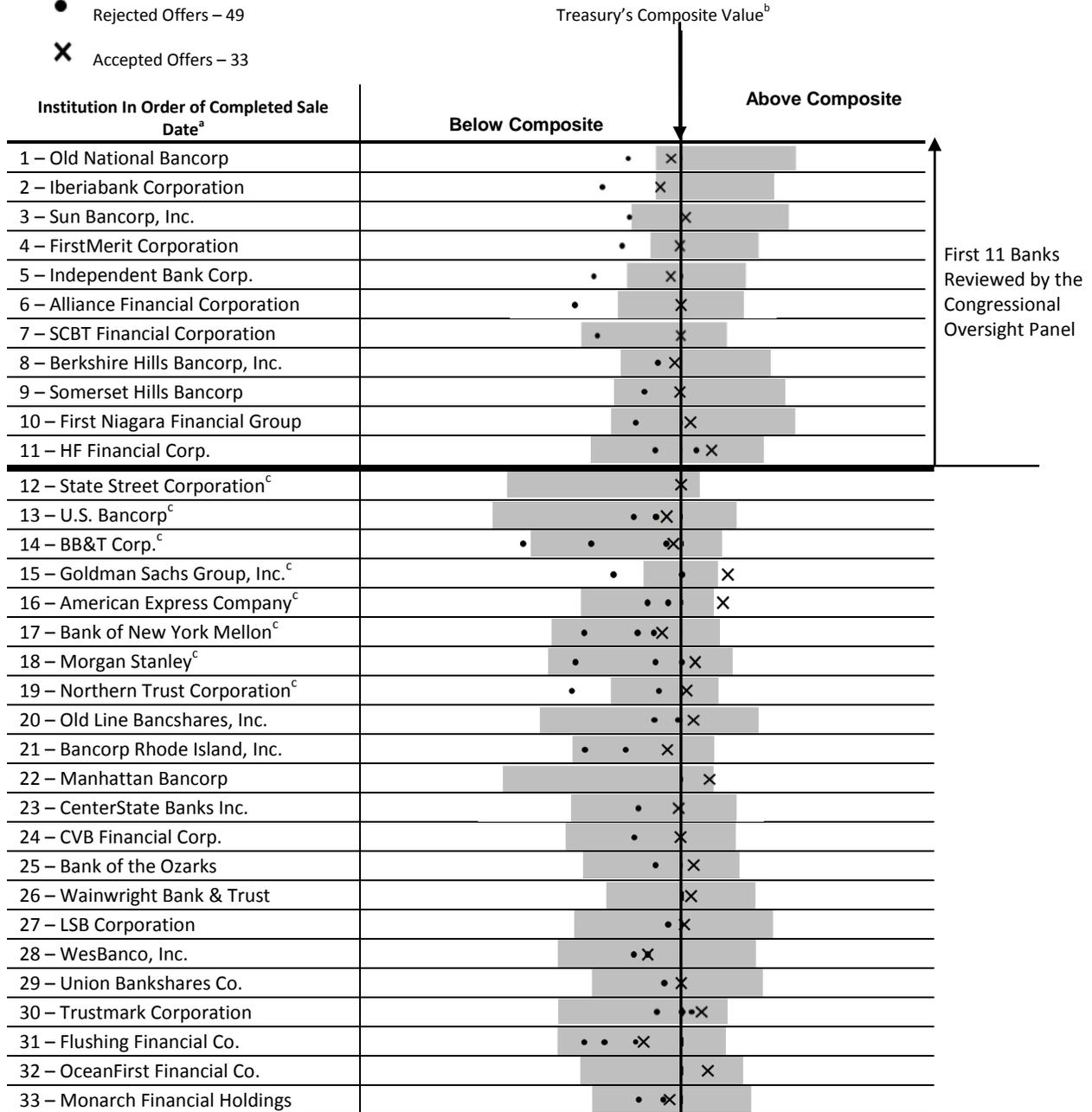
The following chart illustrates the final negotiated price in comparison to Treasury analysts' estimate of value captured in the composite value. Treasury's decisions tend to center around its analyst's determination of composite value.

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

■ Aggregate Price Range – 33

● Rejected Offers – 49

✕ Accepted Offers – 33



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

Source: SIGTARP analysis of Treasury data.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Audit Recommendations and Treasury's Response

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

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

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

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

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

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

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

Via Online: WWW.SIGTARP.GOV
Via Toll Free Phone: 877-SIG-2009
Via Fax: 202-622-4559

Via Mail: Hotline, Office of the SIGTARP
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SIGTARP

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

ADVANCING ECONOMIC STABILITY THROUGH TRANSPARENCY, COORDINATED OVERSIGHT AND ROBUST ENFORCEMENT

ASSESSING TREASURY'S PROCESS TO SELL WARRANTS RECEIVED FROM TARP RECIPIENTS

**SIGTARP-10-006
MAY 10, 2010**



SIGTARP

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

Summary of Report: SIGTARP-10-006

Why SIGTARP Did This Study

The Emergency Economic Stabilization Act of 2008 (“EESA”) mandated that the Department of the Treasury (“Treasury”) receive warrants or debt instruments when it invests in troubled assets under the Troubled Asset Relief Program (“TARP”). For public held institutions, the warrants provide Treasury the right, at its option, to purchase shares of common stock at a predetermined price. As recipient institutions repay their TARP investments, Treasury sells the warrants, either directly to the recipient institution at a negotiated price or via public auction.

Pricing the warrants is not straightforward, however, because there is limited market information concerning warrants of this duration. Treasury thus developed an approach to estimate fair market value in order to assess offers from institutions seeking to repurchase warrants.

This audit seeks to determine (1) the process and procedures Treasury has established to ensure that the Government receives fair market value for the warrants; and (2) the extent to which Treasury follows a consistent and well-documented process in reaching its decision to sell warrants back to recipient institutions.

What SIGTARP Recommends

SIGTARP recommends that Treasury (1) ensure that more detail is captured in Warrant Committee meeting minutes, in particular, about the members’ qualitative considerations regarding why bids are accepted or rejected; (2) document in detail the substance of all communications with recipients concerning warrant repurchases; and (3) develop and follow guidelines and internal controls concerning how negotiations will be pursued, including the degree and nature of information to be shared with repurchasing institutions concerning Treasury’s valuation of the warrants.

In commenting on a draft of this report, Treasury agreed to review their procedures to ensure that there is sufficient consistency in their process, but did not specifically respond to our recommendations; instead, Treasury indicated that it would respond more fully to the report’s findings and provide a detailed description of the actions it intends to take with regard to the concerns raised in the report within 30 days. SIGTARP will provide an update on that response in its next Quarterly Report to Congress.

May 10, 2010

Assessing Treasury’s Process To Sell Warrants Received from TARP Recipients

What SIGTARP Found

Once a publicly traded bank pays back its TARP investment, Treasury undertakes a process for the sale of the bank’s warrants, either directly back to the bank through negotiation or to third parties through an auction. If a bank decides to repurchase its warrants, Treasury assesses the bank’s bid after arriving at a “composite” estimated value for the warrants that references market quotes, financial modeling valuations, and third-party estimates. Treasury’s Warrant Committee recommends whether to accept the offer, and the Assistant Secretary for Financial Stability makes the final decision. If a price cannot be negotiated, the warrants are auctioned publicly.

To its credit, Treasury has generally succeeded in negotiating prices from recipients for the warrants at or above its estimated composite value. Of the 33 warrant public company repurchases analyzed, 20 of the final negotiated prices were at or above Treasury’s composite value, and nine of the final negotiated prices were just under the composite value. The four remaining transactions included the first two completed (during which time Treasury was operating under a governing statute that limited how long Treasury had to negotiate and before Treasury had its valuation methodology worked out) and two for warrants in small institutions that received less than \$100 million in TARP funds (for which valuation is difficult because of less liquidity in the bank’s stock). In total, for all warrant transactions (repurchases and auctions) through March 19, 2010, Treasury received \$5.63 billion in proceeds from warrant sales.

This audit, however, has identified two broad areas in which Treasury’s process for selling warrants directly to financial institutions is lacking in ways that impair transparency and have led to a lack of consistency in the process. The first is that Treasury does not sufficiently document important parts of the negotiation process: the substantive reasons for Warrant Committee decisions are not reflected in Warrant Committee minutes, and negotiations between Treasury and recipient institutions are not documented. This lack of documentation makes it impossible to test whether Treasury is fairly and consistently making decisions that could mean a difference of tens of millions of dollars for taxpayers.

The second significant deficiency is that Treasury does not have established guidelines or internal controls over how the negotiations proceed, and in particular as to how much information is shared with recipient institutions about Treasury’s estimated fair market value and the price it will likely accept for the warrants. Descriptions provided to SIGTARP by several of the banks that engaged in negotiations with Treasury confirmed that Treasury was willing to provide detailed information about its estimates to certain banks, but was unwilling to share similar details with others. Moreover, although Treasury indicated that it generally would not provide an indication of its valuation until the institution’s bid was close, the cases examined in detail in the audit do not bear this out. Indeed, the amount of information provided, the circumstances of when information would be provided, and the results of the negotiation varied widely.

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

Special Inspector General for the Troubled Asset Relief Program



OFFICE OF THE SPECIAL INSPECTOR GENERAL
FOR THE TROUBLED ASSET RELIEF PROGRAM
1801 L STREET, NW
WASHINGTON, D.C. 20220

May 10, 2010

MEMORANDUM FOR: The Honorable Timothy F. Geithner, Secretary of the Treasury

SUBJECT: Assessing Treasury's Process to Sell Warrants That It Received From TARP Recipients (SIGTARP-10-006)

We are providing this audit report for your information and use. It discusses the results of the 46 warrant repurchases completed as of March 19, 2010. As of that date, 33 banks had bought back their warrants through a negotiated process, seven banks allowed their warrants to be auctioned, and six private banks repurchased the preferred shares that Treasury received as the result of the warrants it exercised at the time of the investments. The audit highlights deficiencies in the documentation of and a lack of established guidelines and internal controls over the negotiation process.

The Office of the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP") conducted this audit under the authority of Public Law 110-343, as amended, which also incorporates the duties and responsibilities of inspectors general of the Inspector General Act of 1978, as amended.

We considered comments from the Department of the Treasury when preparing the final report. The comments are addressed in the report, where applicable, and a copy of Treasury's response to the audit is included in the Management Comments appendix of this report.

We appreciate the courtesies extended to the SIGTARP staff. For additional information on this report, please contact Mr. Kurt Hyde, Deputy Special Inspector General for Audit (202-622-4633/kurt.hyde@do.treas.gov).

A handwritten signature in blue ink, appearing to read "Neil M. Barofsky".

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

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ASSESSING TREASURY'S PROCESS TO SELL WARRANTS THAT IT RECEIVED FROM TARP RECIPIENTS

SIGTARP REPORT 10-006

MAY 10, 2010

Introduction

To facilitate a return to the taxpayer, the Emergency Economic Stabilization Act of 2008 (“EESA”) mandated, with limited exceptions, that the Department of the Treasury (“Treasury”) receive warrants from assisted financial institutions when it invests in troubled assets under the Troubled Asset Relief Program (“TARP”). For a specified period of time, the warrants provide Treasury the right to purchase, at a previously determined price, shares of common stock for publicly traded institutions, or preferred stock or debt for non-publicly traded institutions. Because warrants rise in value as the financial institution’s underlying stock price rises, warrants give taxpayers an opportunity to benefit from an institution’s potential recovery following the receipt of TARP funds.

Under TARP’s Capital Purchase Program (“CPP”), Treasury invested \$204.9 billion in 707 banks and other financial institutions in exchange for preferred stock and, in some instances, debt securities.¹ In connection with these CPP transactions, Treasury received warrants from 282 publicly traded banks and 402 companies that are private, S-corporations, or mutual holding companies.² For these 402 companies, Treasury received warrants of additional preferred shares or debt instruments, in an amount equal to five percent of the CPP investment, that were immediately exercised when the investments were made, thus effectively providing Treasury more preferred shares or debt than it purchased. For publicly traded institutions, Treasury received warrants of common stock with a 10-year expiration date that give Treasury the right to purchase common stock worth 15 percent of the total amount of Treasury’s CPP investment in the institution.³

Under the CPP Security Purchase Agreement (“SPA CPP”), banks originally were not permitted to repay investments within the first three years unless the company completed a qualified equity offering of at least 25 percent of the CPP investment amount. On February 17, 2009, however, the American Recovery and Reinvestment Act 2009 (“ARRA”) changed the timing of when CPP recipients could pay back its Treasury investment, providing that, “subject to consultation with the appropriate federal banking agency, [Treasury] shall permit a TARP recipient to repay [the

¹ As of December 31, 2009, CPP is closed to new applicants.

² Twenty-two community development financial institutions (“CDFIs”) that received CPP funds were not required to issue warrants to Treasury

³ According to the Annex D of the CPP Securities Purchase Agreement, the warrants received by Treasury do not entitle Treasury to any voting rights with respect to any voting stock prior to the date of exercise. This restriction also applies to any person to whom Treasury transfers the shares or warrants.

CPP investment] without regard to whether the financial institution has replaced such funds from any other source or to any waiting period.” Pursuant to the CPP SPA, publicly traded banks are permitted, once the bank repays the CPP investment, to repurchase their warrants at a price equal to fair market value. On March 31, 2009, the first banks repaid Treasury, and on May 8, 2009, Old National Bancorp became the first CPP recipient to repurchase its warrants from Treasury.

Treasury also holds warrants for common stock in companies in connection with investments made under other TARP programs. Specifically, Treasury has received warrants from American International Group (“AIG”) under the Systemically Significant Failing Institutions (“SSFI”) program, from Citigroup and Bank of America under the Targeted Investment Program (“TIP”), from Citigroup under the Asset Guarantee Program (“AGP”), from General Motors and GMAC under the Automotive Industry Financing Program (“AIFP”), and from each of Public-Private Investment Funds under the Legacy Securities Public-Private Investment Program (“S-PPIP”). Treasury’s disposition process has been the same for warrants acquired under all TARP programs.

As of March 19, 2010, 33 publicly traded banks had bought back their warrants when they repaid the CPP investment. In addition, Treasury auctioned the warrants of seven banks, including the warrants received from Bank of America under both CPP and TIP. Finally, six private banks also repurchased the warrant preferred shares that Treasury exercised at the time of the investment.⁴ As of March 19, 2010, Treasury still held warrants in 242 public institutions.⁵

Audit Objectives

This audit, which was conducted in response to requests by Senator Jack Reed and Representative Maurice Hinchey, seeks to determine:

- the process and procedures Treasury has established to ensure that the Government receives fair market value for the warrants
- the extent to which Treasury follows a consistent and well-documented process in reaching decisions where differing valuations of warrants existed.

This audit complements a Congressional Oversight Panel report released on July 10, 2009, that examined the warrant valuation process. The scope of this audit covers 33 warrant repurchases by CPP recipient banks through March 19, 2010. We also reviewed auctions of seven banks’ warrants that were auctioned through March 12, 2010.

⁴ Treasury gave privately held banks that pay back the CPP investment the right to repurchase the preferred shares or debt that Treasury received when it previously exercised the warrants. Six privately held banks bought back at par value the preferred shares Treasury received when it exercised warrants at the time of the CPP investment. This audit does not address further those repurchased-at-par transactions.

⁵ Since March 19, 2010, and as of April 29, 2010 per OFS Transaction report, six additional banks have repurchased their warrants. Of the 6, three went through the negotiated process, one went through the auction, and two additional privately held banks redeemed their additional preferred shares.

Background

On October 3, 2008, Congress enacted EESA to provide the Secretary of the Treasury with authority and facilities to restore liquidity and stability to the financial system. EESA requires that the Secretary use that authority and those facilities in a manner that, among other things, “maximizes overall return to the taxpayer of the United States.” Under EESA, Treasury is required to obtain warrants in exchange for any Government investment over \$100 million. Although not required by EESA, Treasury also received warrants for institutions that received less than \$100 million, except for community development financial institutions (“CDFIs”).

Treasury received warrants related to investments under CPP, SSFI, TIP,⁶ AGP, AIFP, and S-PPIP. Appendix B provides information on the largest positions in warrants held by Treasury, listed by TARP program, as of March 19, 2010. Appendix C provides a summary of Treasury’s CPP investments, including the number of institutions that provided warrants to Treasury as part of the capital investment.

On October 14, 2008, Treasury announced CPP, a program with the stated goal of strengthening financial markets and increasing lending by making capital investments in healthy, viable U.S. financial institutions. In exchange for its CPP investments, Treasury obtained dividend-paying preferred shares or interest-bearing debt instruments. The preferred shares pay dividends of five percent in the first five years and nine percent afterward. The debt instruments, which were received from participants that are S-corporations, pay interest of 7.7 percent for the first five years and 13.8 percent thereafter.

In addition, Treasury generally⁷ received warrants from CPP participants as a way to generate additional returns for taxpayers. For publicly held institutions, the warrants give Treasury the right to purchase common stock in the institution, in an amount equal in value to 15 percent of the CPP investment,⁸ at a predetermined price called the “strike price,”

Warrants 101 - Example

Assume that Treasury has the right to buy 100 shares of stock in a bank at a price of \$10 per share; this price is called the strike price. During the term of the warrant, Treasury has the option to exercise the warrant and purchase shares from the company at the strike price. If the bank’s stock is currently trading on the New York Stock Exchange at \$12, for example, Treasury could purchase shares from the bank at \$10 and sell them for a profit at the market price to make \$2 per share. When, as in this example, a warrant’s exercise price is lower than the current market price of the stock, the warrants are considered “in the money.” When the strike price is above the stock’s market price, it is “out of the money.” However, even warrants that are “out of the money” have value, based on the possibility that the share price will eventually rise above the strike price. It is not unusual that warrants are “out of the money” at the time they are issued.

⁶ As of December 31, 2009, the Targeted Investment Program was effectively closed as both Citigroup and Bank of America repaid the funding received under this program. Treasury still holds the warrants it received from Citigroup, as of March 31, 2010. On March 29, 2010, Treasury announced that it intended to dispose of approximately 7.7 billion shares of Citigroup; however, the disposition does not affect Treasury’s holdings of Citigroup warrants for its common stock.

⁷ CDFIs, which are financial institutions that provide financial services to under-served communities, were not required to provide warrants to Treasury for investments less than \$50 million.

⁸ The CPP SPA provided that participants could halve the number of shares subject to their warrants by completing, before December 31, 2009, one or more qualified equity offerings with aggregate gross proceeds equivalent to the value of Treasury’s CPP investment. A total of 38 CPP participants did so; of those, nine have repaid their CPP investments and Treasury has sold the corresponding warrants. In addition, under the CPP SPA, Treasury has the

at any time up to 10 years from the date of issuance. Treasury calculated the strike price by averaging the bank's common stock price during the 20-day period prior to the date when the bank was preliminarily approved for CPP funds. For companies that are private, S-corporations, or mutual holding companies, Treasury received the right to purchase, at a nominal price, additional preferred shares (or debt instruments) in an amount equal to five percent of the CPP investment. Treasury immediately exercised those warrants and thus effectively received more preferred shares or debt than it purchased.

The circumstances under which Treasury has been required to dispose of the warrants have changed over time. Under the standard CPP SPA, publicly traded TARP recipients are permitted to repurchase their warrants with proper notice to Treasury (after the bank has redeemed its preferred shares) at the fair market value.⁹ On February 17, 2009, Congress enacted the American Recovery and Reinvestment Act of 2009 ("ARRA"), which required, following the repayment of TARP funding, that Treasury "*shall* liquidate warrants associated with such assistance at the current market price" (emphasis added). Treasury officials interpreted ARRA to mean that the warrants should be liquidated expeditiously once a bank repays the CPP investment. On May 20, 2009, Congress passed the Helping Families Save Their Homes Act of 2009, which amended the ARRA provision requiring Treasury to liquidate its warrants immediately upon TARP repayment. Specifically, Section 403 of the Act provided that Treasury, "at the market price, *may* liquidate warrants associated with such assistance" (emphasis added). According to Treasury officials, this amendment provided Treasury more flexibility, removing any requirement that the Secretary of the Treasury dispose of the warrants at any particular time. For a timeline of the key events and legislative amendments related to Treasury's warrant disposition process, see Appendix D.

On June 26, 2009, Treasury announced guidance for the warrant repurchase process for publicly traded institutions. A copy of this guidance is included in Appendix E. Treasury has stated that it intends to liquidate as quickly as practicable the warrants of institutions that have redeemed their CPP preferred shares. Pursuant to this guidance, if an institution wishes to repurchase warrants from Treasury, it must first take Steps 1 through 4 below; if a repurchase is not accomplished through those steps, Treasury can hold or dispose of the warrants as discussed in Step 5.

- **Step 1 – Notification to Treasury with Determination of Fair Market Value:** Any institution wishing to repurchase its warrants may notify Treasury within 15 days of repayment of TARP funds. According to the CPP SPA, the notification must include the number of warrants to be repurchased and the determination of fair market value from the board of directors. Moreover, the board of directors must be acting in good faith with reliance on an "independent investment banking firm." The independent appraiser must be hired by the TARP recipient. CPP banks may buy back the warrants at any time after the preferred shares have been repurchased.

right to exercise or transfer half of the warrants it holds at any time for such institutions, even if they had not yet redeemed their preferred shares. As of March 19, 2010, Treasury had not done so for any bank.

⁹ Publicly traded companies have an incentive to repurchase and retire warrants because the exercise of warrants of common stock results in the issuance of new shares, which diminishes, or "dilutes," the value of existing shares. Non-public TARP recipients have the right to repurchase the preferred shares and subordinated debt that Treasury took when it immediately exercised the warrants at the time their CPP transactions closed.

- **Step 2 – Treasury Evaluates the Repurchase Offer:** According to the CPP SPA and the guidance announced by Treasury, Treasury has 10 days to evaluate the TARP recipient’s offer of fair market value. Treasury uses three different valuation methodologies to evaluate the CPP recipients’ determination of fair market value of the warrants:

 - *Market Quotes* – The long duration warrants that Treasury holds are not listed on a securities exchange. Accordingly, Treasury uses market prices of securities with similar characteristics to assess the market value of the warrants. Securities with similar characteristics include publicly traded warrants and options of similar institutions. Treasury gathers quotes on the value of the warrants from 3-10 market participants, such as investment banks and asset management firms.
 - *Treasury’s Financial Models* – Treasury conducts valuations based on well-known, common financial models, such as the binomial and Black-Scholes models. The models use various known inputs as well as assumptions about the volatility and dividends of the common stock of the institution to calculate the value of the warrants. To estimate the long-term volatility of the common stock, Treasury uses the implied volatility of any traded short-term options on the stock as well as the long-term historical average of 60-day trailing volatility for the past 10 years of the common stock price. Treasury also uses the implied volatility of publicly traded, long-dated warrants of similar institutions to determine the volatility assumption.
 - *Third-party Valuation* – Treasury uses eight external asset managers that it has hired to manage TARP assets to assess independently the value of each institution’s warrants.
- **Step 3 – Resolution Period:** Should Treasury reject the TARP recipient’s repurchase offer, the chief executive officer of the TARP recipient or a designee and a representative of Treasury meet to discuss Treasury’s objections to the valuation proposed by the TARP recipient and attempt to reach an agreement. As of March 19, 2010, 33 warrant repurchases have occurred as a result of Treasury accepting a bank’s initial offer or as a product of this effort to resolve Treasury’s objections to the price offered by the bank.
- **Step 4 – Appraisal Procedure:** If no price is agreed upon after 10 days, either the institution or Treasury may invoke the “Appraisal Procedure.” This involves Treasury and the TARP recipient each choosing an independent appraiser to agree upon the fair market value of the warrants. If the two appraisers are not able to agree upon a fair market value after 30 days, then a third independent appraiser will be chosen with the consent of the first two appraisers. The third appraiser has 30 days to make a decision, and, subject to limitations—such as if one of the three valuations is significantly different from the other two—a composite valuation of the three appraisals is used to establish the fair market value. Treasury will be bound by this price determination, but Treasury has stated that if the recipient is not satisfied with this price it may withdraw its notification to repurchase the warrants. Under the CPP SPA, the costs of conducting any appraisal procedure “shall be borne by the Company.” As of March 19, 2010, no CPP bank has invoked the appraisal procedure.

- **Step 5 – Alternative Disposition:** If neither the institution nor Treasury invoke the “Appraisal Procedure,” or if the institution decides not to seek to repurchase its warrants, Treasury has various options as to how it manages these investments over the 10-year exercisable period—it may sell them, exercise them, or hold them as it sees fit to otherwise maximize benefit to the taxpayers. On June 26, 2009, Treasury clarified its intentions on selling the warrants that it had received and indicated that it would publicly auction warrants in cases where it could not reach agreement upon a fair market value.

As of March 19, 2010, 46 CPP institutions had completely exited TARP, with Treasury selling its associated warrants holdings either directly to the issuers or via the public auction process. In addition, Treasury auctioned warrants obtained from Bank of America under the TIP. In total, Treasury received \$5.63 billion from the sale of TARP warrants, broken down as follows:

- **Repurchase of Warrants Directly from Treasury** – \$2.92 billion from 33 banks that transacted directly with Treasury to complete the warrant sales through March 19, 2010.
- **Proceeds from Auctions** – \$2.71 billion from the auction of warrants from seven banks.
- **Sale of Preferred Shares** – \$2.6 million from preferred stock repurchases by six privately held banks.

These proceeds provide an additional return to taxpayers from Treasury's investment beyond the dividend and interest payments it received on the related preferred stock or debt instruments. For a list of institutions, both public and private, that have repaid their TARP funds and repurchased their warrants as of March 19, 2010, see Table 1. These institutions are no longer part of TARP.

Table 1: TARP Warrant Repurchases, as of March 19, 2010

Institutions	Redemption Pursuant to a Qualified Equity Offering	Repurchase Date	Amount of Repurchase (\$000)
PUBLIC INSTITUTIONS			
Old National Bancorp		5/8/2009	\$1,200
Iberiabank Corporation	X	5/20/2009	\$1,200
First Merit Corporation		5/27/2009	\$5,025
Independent Bank Corp.		5/27/2009	\$2,200
Sun Bancorp, Inc.		5/27/2009	\$2,100
Alliance Financial Corporation		6/17/2009	\$900
Berkshire Hills Bancorp, Inc.		6/24/2009	\$1,040
First Niagara Financial Group	X	6/24/2009	\$2,700
SCBT Financial Corporation		6/24/2009	\$1,400
Somerset Hills Bancorp		6/24/2009	\$275
HF Financial Corp.		6/30/2009	\$650
State Street Corporation	X	7/8/2009	\$60,000
U.S. Bancorp		7/15/2009	\$139,000
BB&T Corp.		7/22/2009	\$67,010
The Goldman Sachs Group, Inc.		7/22/2009	\$1,100,000
American Express Company		7/29/2009	\$340,000
Bank of New York Mellon Corp		8/5/2009	\$136,000
Morgan Stanley		8/12/2009	\$950,000
Northern Trust Corporation		8/26/2009	\$87,000
Old Line Bancshares, Inc.		9/2/2009	\$225
Bancorp Rhode Island, Inc.		9/30/2009	\$1,400
Manhattan Bancorp		10/14/2009	\$63
CenterState Banks of Florida	X	10/28/2009	\$212
CVB Financial Corp.	X	10/28/2009	\$1,307
Bank of the Ozarks, Inc.		11/24/2009	\$2,650
LSB Corporation		12/16/2009	\$560
Wainwright Bank & Trust Co.		12/16/2009	\$569
Union Bankshares Corporation	X	12/23/2009	\$450
WesBanco, Inc.		12/23/2009	\$950
Trustmark Corporation		12/30/2009	\$10,000
Flushing Financial Corporation	X	12/30/2009	\$900
OceanFirst Financial Corp.	X	2/3/2010	\$431
Monarch Financial Holdings, Inc.	X	2/10/2010	\$260
Capital One Financial Corp ^a		12/3/2009	\$148,731
JP Morgan Chase & Co ^a		12/10/2009	\$950,318
TCF Financial Corporation ^a		12/15/2009	\$9,600
Bank of America Corporation ^a		3/3/2010	\$186,343
Bank of America Corporation ^a		3/3/2010	\$124,229
Bank of America Corporation ^{a,b}		3/3/2010	\$1,255,639
Signature Bank ^a		3/10/2010	\$11,321
Texas Capital Bancshares, Inc. ^a		3/11/2010	\$6,709
Washington Federal, Inc. ^a		3/9/2010	\$15,623
PRIVATE INSTITUTIONS			
Centra Financial Holdings, Inc.		4/15/2009	\$750
First ULB Corp.		4/22/2009	\$245
First Manitowoc Bancorp, Inc.		5/27/2009	\$600
Midwest Regional Bancorp, Inc.		11/10/2009	\$35
1 st United Bancorp, Inc.		11/18/2009	\$500
Midland States Bancorp, Inc.		12/23/2009	\$509
Totals	46 Banks		\$5,628,829

Notes:

a. Treasury sold these banks' warrants through a registered public offering or auction.

b. This represents the sale of Bank of America Corporation's warrants received under the Targeted Investment Program.

Source: TARP Transactions Report, March 19, 2010.

Oversight of Treasury's Warrant Disposition Process

On June 17, 2009, the Government Accountability Office (“GAO”) published a report that discussed Treasury’s initial implementation of the warrant disposition process. According to GAO, at that point, Treasury had provided only limited information about the warrant repurchase process, and GAO recommended that Treasury “ensure that the warrant valuation process maximizes benefits to taxpayers and consider publicly disclosing additional details regarding the warrant repurchase process, such as the initial price offered by the issuing entity and Treasury’s independent valuations, to demonstrate Treasury’s attempts to maximize the benefit received for the warrants on behalf of the taxpayer.” After Treasury published its June 26, 2009, guidance on its warrant valuation process, GAO confirmed in its October 2009 report that this recommendation was partially implemented.

On July 10, 2009, the Congressional Oversight Panel released the results of its technical valuation of Treasury’s warrants. Based on the result of its own financial modeling of the warrants, the Congressional Oversight Panel concluded that “eleven small banks have repurchased their warrants from Treasury for a total amount that the [Congressional Oversight] Panel estimates to be only 66 percent of its best estimate of their value.” The Congressional Oversight Panel later reported in its January 13, 2010 report that “subsequent to the publication of the July report, an additional 25 financial institutions have repurchased their warrants or sold warrants in auction sales, generating total aggregate proceeds to Treasury of \$4.0 billion, which represented more than 92 percent of the [Congressional Oversight] Panel’s best estimate of their values.” The July report recommended that “Treasury should promptly provide written reports to the American taxpayers analyzing in sufficient detail the fair market value determinations for any warrants either repurchased by a TARP recipient from Treasury or sold by Treasury through an auction, and it should disclose the rationale for its choice of an auction or private sale. Most important, Treasury should undertake to negotiate the disposition of the warrants in a manner that is as transparent and fully accountable as possible.”

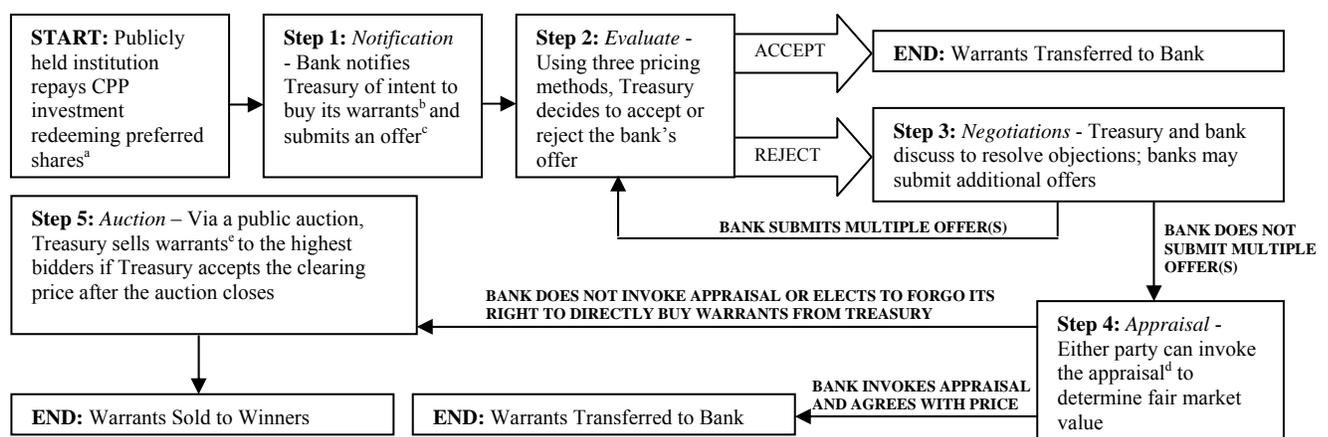
Initially, Treasury described the general process of its warrant repurchases without providing any detail about individual transactions other than the price at which the warrants were sold. This lack of transparency was criticized by SIGTARP, the Congressional Oversight Panel and GAO. On January 20, 2010, Treasury published its Warrant Disposition Report, which included information on Treasury’s warrant sales process and decision-making considerations. The report included valuation estimates, banks’ rejected offers, and accepted prices for 34 completed sales of warrants for public institutions through December 31, 2009. For those institutions that directly repurchased warrants, Treasury reported rejected and accepted offers, Treasury’s price estimates used to assess the submitted offers, and information on some of the assumptions Treasury and third parties used to arrive at its various price estimates. For those institutions whose warrants were sold at auction through December 31, 2009, Treasury described the initial offer it received from the bank and the results of the auctions after the bank elected not to continue direct negotiations with Treasury. For each warrant sale, Treasury showed a graphical representation of the final estimates used by Treasury officials when analyzing a bank’s offer for its warrants. An example of this graphical representation is provided in Appendix F.

Treasury's Process to Sell the Warrants

This section discusses the process Treasury takes to determine the appropriate price for the sale of warrants and describes its process for negotiating the repurchase of warrants from financial institutions.

Once a publicly traded bank pays back its TARP investment, there are steps (as noted previously in this report) that culminate in the sale of the warrants, either directly back to the bank through negotiation (or an appraisal process) or to third parties through an auction. For purposes of illustration, SIGTARP has labeled these as Steps 1 through 5. If the bank elects to offer to repurchase its warrants, the bank starts at Step 1 of the process, as described below. If Treasury rejects the offer, the bank can make a new offer that Treasury will consider. If the bank elects to forgo its opportunity to make an offer or cannot agree with Treasury on a negotiated price for the warrants, Treasury proceeds to Step 5, the auction process. Figure 1 provides a summary of the various steps of Treasury's warrant disposition process.

Figure 1: Treasury's Warrant Disposition Process for Public Institutions



Notes:

- a. For privately held institutions and S-Corporations, Treasury immediately exercises the warrants at the time of the initial CPP transaction and receives additional preferred shares or subordinate debt as a result.
- b. If the institution does not wish to repurchase the warrants, Treasury can sell the warrant to a third party; however, Treasury is required to notify the institution at least 30 days prior to the sale of the warrants in an effort to reissue and register warrants to allow sale to third parties.
- c. The board of directors must certify to Treasury that they acted in good faith to arrive at the fair market value determination.
- d. The determination by the independent appraisers is binding on Treasury if the institution chooses to proceed with the sale.
- e. At any time throughout this process, the institution may revoke its intent to repurchase its warrant, at which point Treasury proceeds to the auction process.

Source: SIGTARP analysis of the Securities Purchase Agreement.

Step 1: Notification to Treasury with Determination of Fair Market Value

If the bank decides to make a repurchase offer, it notifies Treasury of its intent to make an offer and may do so within 15 days of repayment of the TARP investment.¹⁰ The offer must include the number of warrants the institution would like to repurchase, its board of directors' fair market value determination for the warrants, and a certification that the bank was "acting in good faith in reliance on an opinion of a nationally recognized independent investment banking firm." Treasury has 10 days to evaluate the offer.

Step 2: Treasury Evaluates the Repurchase Offer

Treasury's valuation team consists of three to five Treasury analysts and one supervisory analyst. This team prepares Treasury's assessment of offers from banks. Treasury assigns an analyst whose role is to evaluate the offer by using three pricing methods—market quotes, financial modeling outputs, and third-party estimates (third party's modeling outputs)—and determine the warrants' fair market value. These inputs drive Treasury's "composite value," which is the analyst's opinion of the appropriate price for the warrants.

Market Quotes

First, Treasury seeks observable market prices for a bank's 10-year warrants—a difficult task given the scarcity of warrants that have such a long term. If a market price for a specific bank's warrants is unavailable (as has been the case in every instance reviewed by SIGTARP), Treasury surveys the market for parties that are willing to provide voluntary indicative bids. An indicative bid is a price quote provided for informational purposes but not for purposes of executing a trade. Treasury solicits bids from 10 to 15 firms, including investment banks, hedge funds, and asset management firms active in the options markets. Treasury's process requires a minimum of three market quotes.¹¹ According to Treasury, firms receive no confidential information from Treasury and must rely on publicly available information in making their quotes.

Market quotes typically generated the lowest estimates of Treasury's three pricing methods. According to Treasury, indicative market bidders—the firms that provide the price quotations—may tend to price the warrants as much as they are willing to pay for them and not necessarily fair market value. A senior Treasury official told SIGTARP that one of the limitations of this pricing method is that the bidders have no stake in the transaction. SIGTARP found that the market quotes tended to be below the final negotiated price, with only 2 of 33 warrant repurchases analyzed by SIGTARP with market quotes above Treasury's final negotiated price.

¹⁰ Treasury is free to sell the warrants any time up until it receives an offer from the bank, however, Treasury must give the institution 30 days notice before selling the warrants.

¹¹ Treasury continues to solicit market quotes from market participants until a minimum of three prices are obtained.

Financial Modeling Outputs

The analyst also uses two financial models to estimate the fair market value of the warrants. These models—a Black-Scholes model and a binomial model—are generally accepted as standard option valuation tools throughout the financial industry. These models produce a range of potential values based on known inputs such as the maturity date of the warrant (here, 10 years) and the warrant's strike price (established in the CPP contract), and on certain assumptions of future activity, such as the future volatility of the underlying stock price and future dividend payments.

Treasury also uses observable market prices when estimating its model inputs, such as 2-year Long Term Equity Anticipation Securities (also known as LEAPS), which are options with longer terms than other more common options. In addition, since the recently auctioned warrants trade in the secondary market, there are now observable market prices that Treasury uses when determining key inputs to its modeled valuation.

After Treasury computes an estimated value using the financial models, the Treasury analyst may also apply a liquidity discount based on, among other things, the volume of shares traded and the extent to which the security can easily be sold in the market. This discount attempts to quantify the markdown that the market would apply to the value of the warrants because of the difficulty of selling infrequently traded securities (such as long-maturity warrants in small banks) in the market. For large institutions, Treasury does not apply a liquidity discount.¹²

Table 2 on the next page provides definitions of Treasury's key model assumptions, summarizes Treasury's approach to calculating each assumption, and describes Treasury's rationale for its approach on how it estimates each assumption.

The Black-Scholes model calculates the value of an option based on the price movements of the underlying stock. The model is geared for pricing European-style options that cannot be exercised before expiration, whereas American-style options—like CPP warrants—can be exercised at points in time before and up to the warrant's maturity. The Black-Scholes model has some limitations, such as the fact that several of the model's assumptions do not account for changes over time.

The binomial model uses the same analytical approach as the Black-Scholes model; however, its assumptions vary over time as opposed to the assumptions remaining constant. The binomial model accounts for changes in stock prices over time intervals, dividend-paying stocks, and more long-dated warrants. Therefore, the model can calculate the price of an American-style option, determining at each point in the warrant's life where the underlying share price will exceed the strike price (referred to as intrinsic value).

Treasury applied a combined approach of using both Black-Scholes and binomial models. For both models, the price depends on the input assumptions used. Accordingly, warrant valuation varies significantly based on the assumptions that an individual modeler inputs into the models. Because it is difficult to predict the future activity of prices, dividend payments and other events, two modelers who use the same models may arrive at very different prices because of varying assumptions. Differing assumptions about the volatility of the institution's common stock price, for example, can drive significantly different values.

¹² In its July 10, 2009 report, the Congressional Oversight Panel questioned Treasury's decision to include a liquidity discount. The Congressional Oversight Panel's own analysis did not include such a discount because, in its view, Treasury has the option to hold the warrants until expiration and therefore illiquidity is irrelevant.

Table 2: Treasury’s Financial Modeling Assumptions

Definition	Treasury’s Methodology for Calculating the Assumption	Treasury’s Rationale for Using the Assumption
Stock Price		
<p><i>The stock price is the price of a single share of the institution’s common stock, which is the asset Treasury would receive if the warrant is exercised. The higher the stock price, the higher the value of the warrant.</i></p>	<p>Treasury uses a 20-day trailing average of past stock prices to smooth any dramatic short-term fluctuations in the stock’s price movements. To account for the industry practice of using the current stock price, Treasury also considers the current stock price to include any recent shifts that may impact valuation.</p>	<p>According to a Treasury official, then-Assistant Secretary Neel Kashkari decided to use the 20-day trailing average because it is the same method used to calculate the strike price set in the CPP contract.</p>
Volatility		
<p><i>Volatility reflects the unpredictable changes of the underlying stock’s price throughout the life of the warrant. Higher volatility will increase the value of the warrant because, with higher volatility, there is a higher probability that the stock price will exceed the warrant’s strike price.</i></p>	<p>Treasury uses both historical and option-implied volatility to estimate future volatility of a company’s stock price. For historical volatility, Treasury calculates the 60-day trailing average volatility for the last ten years. Some larger, public institutions have options with maturities of up to two years. Using prices of these shorter-maturing options, Treasury forecasts option-implied volatility over ten years. Treasury’s recent auctions created a market for 10-year warrants; accordingly, Treasury incorporates volatility data from these traded warrants.</p>	<p>Treasury uses the 60-day trailing average to smooth out daily price swings. Treasury also considers 6 months to 10 years of past market volatility data to project the stock’s future volatility.</p>
Dividend Payments		
<p><i>Dividends are the payments made to common shareholders for investing in the company. Higher dividend yield will decrease the price of the warrant by eroding the value of the underlying shares.</i></p>	<p>Treasury analyzes the bank’s dividend payment history and reviews the implied or explicit dividend policies issued by the institution. Treasury reviews historical dividends over the last 10 years as an indication of how to estimate future dividend payments.</p>	<p>Treasury assumes that dividends normalize over time and thus uses a constant yield based on historical observations.</p>
Liquidity Discount		
<p><i>A liquidity discount is a discount to account for an investor holding shares that are not easily sold in the secondary market. Higher liquidity discounts will decrease the price of the warrant.</i></p>	<p>Treasury applies liquidity discounts from 0 to 50 percent. A Treasury contractor developed a survey of the CPP banks to establish a range of possible liquidity discounts. Treasury assesses the ranges from the survey and the factors of the institution to determine where the bank falls within that established range relative to its peers. Qualitative factors include stock volatility and average daily trading volume of the underlying stock. Treasury also compares the model price of the bank to liquid option prices.</p>	<p>Treasury’s liquidity discount depends on, among other things, the size of the warrant position, the average trading volume of the underlying stock, and the liquidity of the equity underlying the warrants. For Treasury, the institutions whose shares are widely traded do not receive a discount.</p>

Note: For CPP warrants, the warrant’s maturity date and strike price are established in the CPP contract.

Source: This table was compiled from multiple sources, including Congressional Oversight Panel July 10, 2009 Report; Treasury June 26, 2009 Announcement on Warrant Valuation and Disposition; “TARP Warrants Valuation Methods” written by Robert A. Jarrow dated September 22, 2009; OFS Iberiabank Warrant Valuation Models and Methodology; and SIGTARP interviews of OFS staff.

Third-party Estimates

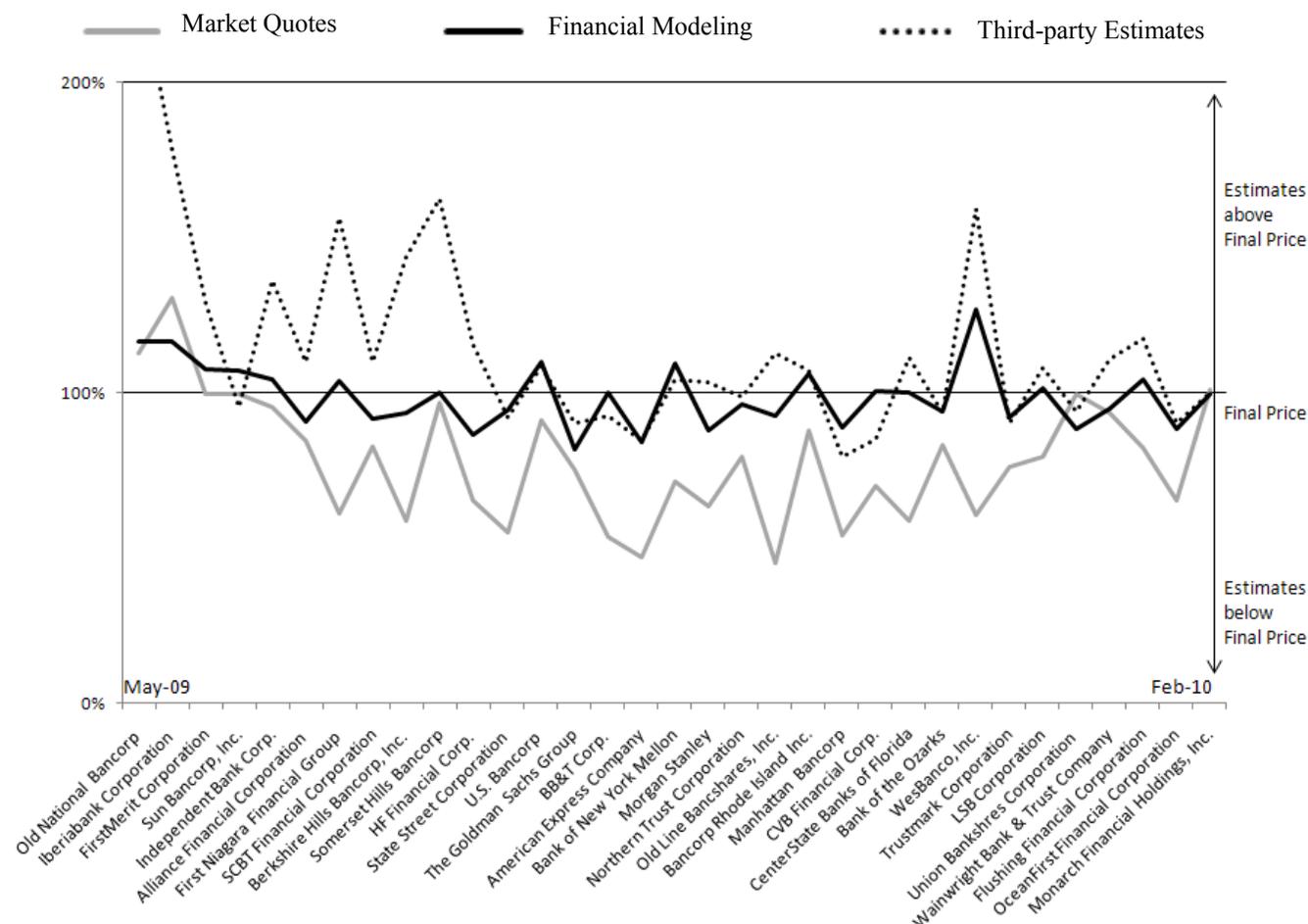
To provide an independent price assessment, Treasury employs one of eight asset managers to run its own proprietary valuation models to arrive at an independent price to use for Treasury's analysis. According to Treasury, each of these eight firms is assigned a group of banks for purposes of warrant valuation. When banks are starting the process to buy back their warrants, Treasury contacts one of the eight firms to obtain a third-party valuation.

Prior to April 2009 and for the first two warrant sales, Treasury relied on financial modeling consultants to provide the third-party estimates, which according to Treasury, "may not have had market expertise necessary to make reasonable assumptions for key inputs such as volatility and dividend yield." Treasury hired three of the eight current asset managers in April 2009 following an evaluation of about 200 companies that submitted proposals to a publicly announced solicitation in November 2008. Treasury hired the remaining five asset management firms in December 2009. According to Treasury, it expanded the asset manager selection to hire more diverse firms in addition to the three firms already retained.

For the first 11 warrants analyzed, SIGTARP found that the third-party estimates generally tended to be the highest of the three pricing methods. After the first 11 banks, third-party estimates more closely aligned with Treasury's financial modeling estimates. Treasury's largest asset manager—AllianceBernstein—told SIGTARP that it has refined the inputs for its valuation based on the results of the auctions and completed warrants repurchase transactions.

In an analysis of 33 warrants repurchases through March 19, 2010, SIGTARP found that Treasury's model estimate tended to be in the middle of the three pricing methods and was generally the one closest to the final negotiated price. Figure 2 provides a graphical depiction of how final prices have compared to estimates from the three different valuations—market quotes, financial modeling, and third-party estimates—for 33 warrant repurchases.

Figure 2: Fair Market Value Estimates as Percentages of Final Warrant Prices



Source: SIGTARP analysis of OFS warrant files.

Assessment of the Bank’s Determination of Fair Market Value

After Treasury collects estimated price ranges from the three pricing methods, the Treasury analyst graphs the estimates from these ranges and plots the bank’s offer to assess where within the ranges the offer falls.¹³ An example of how Treasury plots these ranges and the bank’s offer is provided in Appendix F. From these three price ranges, the Treasury analyst determines a composite value (also referred to in Treasury documents as an estimate of fair market value). The analyst presents the analysis to the Warrant Committee. The Warrant Committee then votes to recommend that the Assistant Secretary accept or reject the institution’s offer.

¹³ Prior to June 2009, the written fair market value assessment and graph also included what Treasury refers to as a “fundamental analysis,” which is an analysis of value based on the fundamental facts about a company such as sales, earnings, and dividend prospects. In June 2009, the fundamental analysis was removed by Assistant Secretary Allison because it was not industry standard for valuation. Treasury analysts told SIGTARP that, prior to its removal, they considered the fundamental analysis as a check to the other valuation estimates and that the analysis was “not really important” and “not a material input” to Treasury’s determination of fair market value.

Treasury officials describe the composite value as what, after analysis, the analyst believes the warrants are worth. Treasury does not have formal guidance or written policies on how the analyst determines the composite value, and, according to Treasury's CPP staff, this determination of fair market value is largely done on a case-by-case basis, depending on the analyst's subjective weighing of the three price estimates and the following factors:

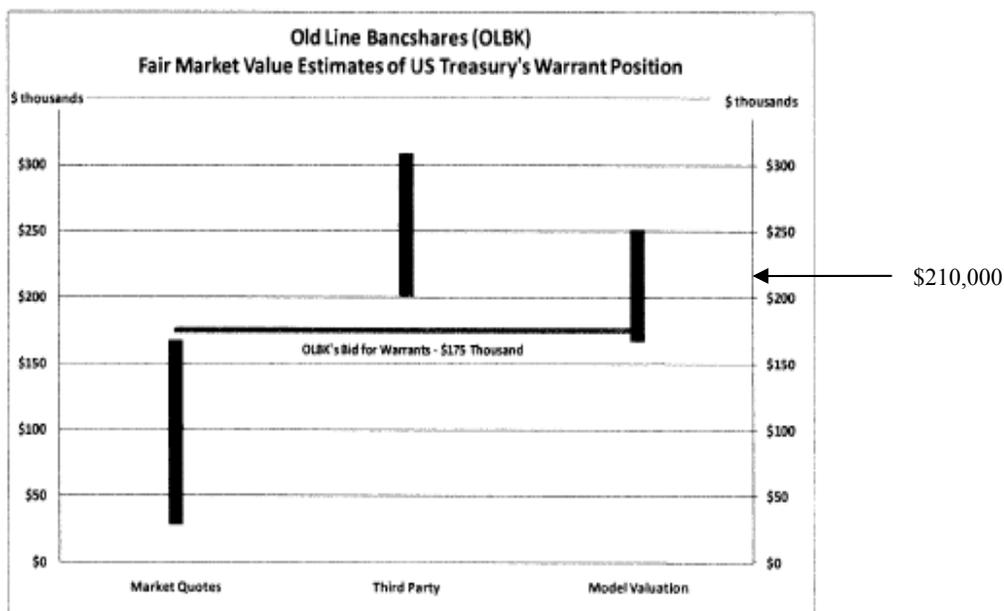
- Existence of outliers within the pricing methodologies
- Spreads of the ranges of the three fair market value estimates
- Market volatility of the underlying stock price
- Size of the institutions for purposes of measuring liquidity of the underlying stock

Treasury's CPP staff stated that it is difficult to have procedures to determine how to set the composite value because each offer differs. The CPP team told SIGTARP that, basically, the preparer compares the three valuation metrics and decides where the most agreement between the three price ranges regardless of whether the point incorporates prices from all three ranges. Where the composite value line is drawn within these three ranges is a judgment call, and thus the composite value may depend on which analyst works on a particular warrant.¹⁴

When SIGTARP requested the rationale for the composite price calculation, the CPP staff demonstrated the approach for Old Line Bancshares. Using the bar charts in Figure 3, the staff pointed to where the CPP team thought the three estimates converged, which in Treasury's opinion was around \$200,000 or \$210,000. Old Line Bancshares' warrants were sold back to the bank at \$225,000.

¹⁴ This has particular importance in light of the fact that the analyst's recommendation has, thus far, been followed by the Warrant Committee in every case and by the Assistant Secretary in all but one case.

Figure 3: Excerpt from Analyst’s Fair Market Value Determination, August 7, 2009



Note: SIGTARP added \$210,000 in the margin for demonstrative purposes.

Source: OFS warrant files.

The Treasury analyst next prepares a recommendation on the banks’ offer that includes a detailed written fair market value assessment. The documentation of the assessment provides summary details of Treasury’s warrant position in the bank, the details of the bank’s submitted offer, the analyst’s graphical representation of the three fair market value ranges, the submitted offer, the composite value, and an explanation of how each of the three price ranges were derived. For an example of the analyst’s documentation of a fair market value determination, see Appendix G.

Warrant Committee Makes a Recommendation to the Assistant Secretary

Although the Assistant Secretary for Financial Stability ultimately decides whether to accept or reject an offer, Treasury established a CPP Warrant Committee (“Warrant Committee”)¹⁵ to recommend whether an offer should be accepted or rejected. When the Warrant Committee convenes, the Treasury analyst who performed the analysis and set the composite value (a qualitative judgment) presents his fair market value assessment to the Warrant Committee members. Warrant Committee members told SIGTARP that the composite value is not necessarily determinative. The committee members also rely on the quantitative analysis represented by the three evaluation metrics in deciding whether to accept or reject a financial institution’s determination of fair market value. Each member of the Warrant Committee and the Assistant Secretary weigh the three valuation ranges as they deem appropriate. In addition, they consider the analyst’s presentation and recommendation as well as the following factors in determining whether to accept or reject an offer:

¹⁵ The Warrant Committee consists of the CPP Director, Deputy Director, Head of CPP Asset Management, and a representative from the Office of the Chief Investment Officer.

- Comparison of the offer to Treasury’s valuation metrics
- significant movements of the current stock price
- deviations of the current stock price from the 20-day trailing average of the stock price
- trading volume of the underlying stock
- size of the institution
- potential auction costs
- potential investor interest in the warrants

For example, according to Treasury, if a bank’s offer is only slightly below Treasury’s composite value, and the value of the warrant position is low enough that the costs of auctioning the warrants will make material difference in the actual return to taxpayers, it does not make sense for Treasury to reject and go to auction when the costs associated with the auction, which are approximately the greater of \$150,000 or 1.5 percent of the auction’s proceeds, outweigh the difference between the offer and Treasury’s estimate of fair market value. Treasury also told SIGTARP that the Warrant Committee considers whether the current stock price of the bank has been rising significantly over the course of Treasury’s valuation period. For example, at the time of the decision to accept Goldman Sachs’ offer of \$1.1 billion, the bank’s common share price was \$159.80 compared to the 20-day average price of \$148.16. According to Treasury, “this difference was taken under consideration in Treasury’s analysis of the company’s determination of fair market value.” Treasury accepted Goldman Sachs’ offer of \$1.1 billion.

SIGTARP found, based on documentation provided by Treasury, that the Warrant Committee unanimously voted in agreement with the analysts’ recommendation for every one of the offers assessed for 33 completed sales through March 19, 2010.

After the Warrant Committee votes¹⁶ on the recommendation to accept or reject an offer, it is submitted to the Assistant Secretary for consideration, along with the Warrant Committee minutes and the analyst’s fair market value assessment. The Assistant Secretary told SIGTARP that, in addition to the composite value, he considers all three fair market value ranges when contemplating an offer. According to the Assistant Secretary, he has not overruled the Warrant Committee recommendation in any case. However, as discussed more fully below, SIGTARP found in one case (Morgan Stanley) that after the Warrant Committee approved the firm’s bid of \$900 million, the Assistant Secretary told Morgan Stanley that Treasury was not prepared to accept its bid for that amount. Morgan Stanley bid \$950 million, which was accepted.

A review of the Warrant Committee minutes for 33 warrants repurchases through March 19, 2010, found that Treasury did not document the qualitative factors considered by the Warrant Committee members when making determinations whether to accept or reject a bank’s offer. Most of the meeting minutes from Warrant Committee sessions were limited and included only the name of the institution, the institution’s offer amount, the name of the analyst who presented Treasury’s analysis of fair market value, the analyst’s recommendation on whether to accept or reject the offer, whether the offer was at or close to the analyst’s composite value or fair market

¹⁶ The Warrant Committee requires three members for a quorum.

value range, and the final vote of the Warrant Committee members. Figure 4 provides an example of Warrant Committee Meeting minutes that was typical of the amount of detail provided for the banks in our audit.

Figure 4: Example of Treasury’s Warrant Committee Meeting Minutes

CPP Warrant Committee Minutes
June 17, 2009
11:45 A.M.
1801 L Street
Minutes by [REDACTED]

CPP Warrant Committee Members in Attendance:

[REDACTED] (via telephone)
[REDACTED]

Staff Members in Attendance:

[REDACTED]

Meeting Notes

1. UST 200 – Berkshire Hills Bancorp
 - a. [REDACTED] presented, and recommended that UST accept the revised offer of \$1,040m which is close to Treasury’s determination. This recommendation was accepted 4-0.
2. UST 269 – Somerset Hills Bancorp
 - a. [REDACTED] presented, and recommended that UST accept the revised offer of \$275k which is at Treasury’s range. This recommendation was accepted 4-0.

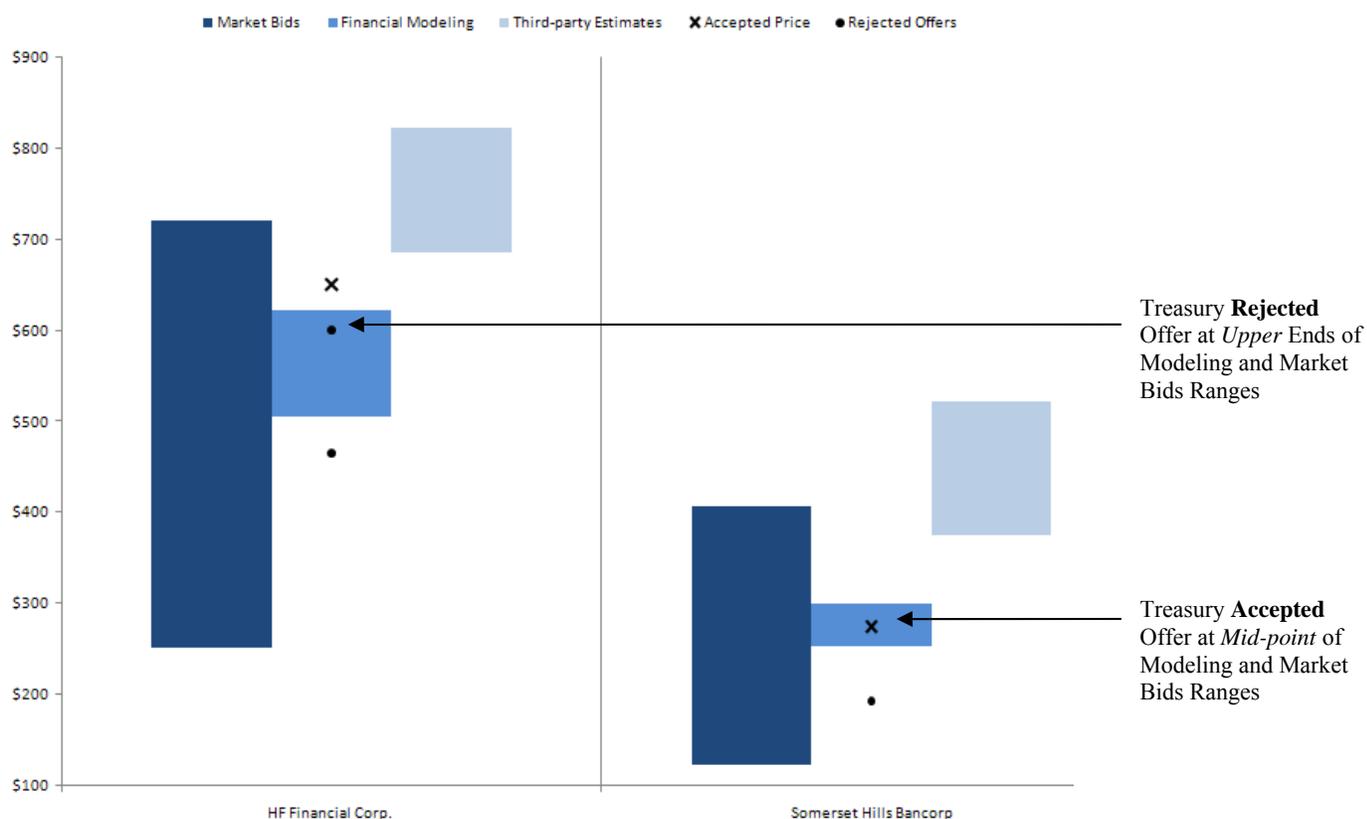
Source: SIGTARP analysis of OFS warrant files.

The minutes often focus on how close the offer is to Treasury’s determination or range and do not document the factors the Warrant Committee members reportedly considered when recommending whether to accept or reject an offer.¹⁷ As a result of the lack of detailed documentation of the Warrant Committee’s considerations, SIGTARP could not determine the extent to which the Warrant Committee made decisions consistently or objectively across institutions, and it is difficult to determine from the documentation why Treasury accepted prices for some institutions but rejected similar bids from others.

For example, Figure 5 provides a comparison of two banks’ rejected and accepted offers within Treasury’s ranges of fair market value estimates. In one, Treasury accepted Somerset Hills’ second offer, which was above the mid-point for the market quote range and at the mid-point of Treasury’s financial modeling range. However, Treasury rejected HF Financial Corp.’s second bid, which was above both of these ranges. In both examples, the Warrant Committee followed the analyst’s recommendation.

¹⁷ This level of documentation contrasts with the details provided in minutes of meetings of the Investment Committee, which is a similar decision-making committee that makes recommendations to the Assistant Secretary regarding the investment of TARP funds. In Investment Committee meeting minutes, Treasury documents details of each company and records the considerations discussed by the various Committee members that factored into the final recommendation.

Figure 5: Comparison of Two Banks' Rejected and Accepted Offers within Treasury's Ranges of FMV Estimates (\$000s)



Source: SIGTARP analysis of OFS warrant files.

A review of the Warrant Committee minutes for these banks did not reveal any rationale for the apparent difference in treatment between these two institutions. These are the notes from the Warrant Committee minutes for the second offers from these two banks:

- **Somerset Hills Bancorp** – June 17, 2009: [Analyst A] presented, and recommended that UST accept the revised offer of \$275[000] which is at Treasury's range. This recommendation was accepted 4-0.
- **HF Financial** – June 29, 2009: [Analyst A] presented HF's revised offer of \$600,000. He recommended that UST ask for a final offer of \$650,000 and conditionally accept that offer, if made by HF. This recommendation was accepted 3-0.

A member of the Warrant Committee told SIGTARP that he agreed with the analyst's decision to reject HF Financial's second bid of \$600,000 because Treasury's financial modeling valuation should have been higher than what was depicted in the charts (as shown in Figure 5). He added that the Treasury analyst ran the financial model and then applied a 50 percent liquidity discount to the price. However, the third-party estimates and the bank's offer used a 30 percent liquidity discount, which he believed was more appropriate. Adjusting the liquidity discount (without re-running the model) from 50 percent to 30 percent increased the modeling estimate of fair market value from \$550,000 to more than \$600,000. Accordingly, the Warrant Committee did not accept

HF Financial's second bid. The same Warrant Committee member said it was his recollection that, for Somerset Hills's second bid, Treasury was already using a 30 percent liquidity discount, and, therefore, he agreed with the analyst that they should accept the bank's offer. Furthermore, Treasury stated that the value of the warrant position was very small (under 400,000) and that the fixed costs of running the auction and legal fees (a minimum of \$150,000) would significantly reduce the real return to the taxpayer. Upon additional research, SIGTARP found Treasury actually applied a 40 percent liquidity discount to its model price for Somerset Hills. Although the Treasury analyst documented the liquidity discounts used in both cases, the Warrant Committee minutes did not reflect that the liquidity discount was a decision-making factor that led to the rejection of HF Financial's second bid, and thus SIGTARP cannot definitively verify the Warrant Committee member's *ex post facto* justification.

Step 3: Negotiation Period

If the Assistant Secretary rejects the initial offer, Treasury typically sends a rejection letter to the bank. The letter includes information for the bank to contact a Treasury analyst to start the process of resolving differences. The bank decides whether it wants to continue discussions if Treasury rejects its offer. If the bank decides to submit a subsequent offer, Treasury will assess the offer the same way it assessed the first offer. A Treasury analyst may collect additional market quotes or rerun the modeling component if there has been significant time between the first offer and the subsequent offer or if the Assistant Secretary requests it. The Warrant Committee reconvenes to review the new offer and determines whether it is acceptable. Final acceptance remains with the Assistant Secretary. Of the 33 warrant repurchases SIGTARP reviewed, Treasury accepted 4 initial bids, 15 second bids, 9 third bids, 4 fourth bids, and 1 fifth bid.

With respect to Treasury's approach before holding conversations with an institution after the rejection of an initial offer, the CPP staff told SIGTARP that the valuation team analysts meet in advance of the discussion and agree on their strategy and approach on what will be discussed with the institution. Treasury stated that the amount of information it discloses to each institution is a result of where the bank is within these stages of the negotiation, although none of this information is reflected in formal guidelines:

- *Discovery Phase:* Treasury stated that the first discussions revolve around process. In this phase, Treasury communicates how the values were derived from three different methods of market quotes, model valuation, and third-party estimates. A Treasury official stated that "you can tell from the beginning who understands the process and who doesn't." According to Treasury, some banks do not understand or are confused by the contractual element of TARP and the warrants repurchase process. With such banks, Treasury has to educate them on the process. Treasury told SIGTARP that it does not tell banks where their offer falls within the three price ranges and what they can do to get it accepted. From time to time, Treasury might share more information on assumptions to get the institution moving in the right direction, but only if Treasury senses that the institution has come to an understanding regarding Treasury's three-pronged valuation methodology. According to Treasury, it does not provide counteroffers at this stage. One Treasury official stated that at this stage what is discussed is "approach, not numbers."

- *Post-Discovery Phase:* On subsequent calls, Treasury informed SIGTARP that it might engage in a more detailed discussion once the offer is somewhat closer to Treasury’s determination of fair market value. Treasury commented that it discusses reactions to extenuating circumstances during these calls with the banks. For example, Treasury stated that, if a bank is tremendously off from the composite value, it lets the bank go back to the “drawing board” to figure out what the value is. In such cases, Treasury indicated that it would not provide as much detail regarding the inputs and outputs of the valuation because the institution is too far off. Once the bank is within a closer range, however, Treasury stated that it may provide valuation input enhancements to the bank that might eliminate the differences between Treasury’s value and the bank’s price. According to Treasury, it does not want to disadvantage the smaller banks, as they might not be equipped or staffed to arrive at as sophisticated a valuation as the bigger banks. However, Treasury commented that the level of information they provide is not based on whether the bank is big or small. According to Treasury the negotiating analysts provide more detailed information depending on how close an institution is to Treasury’s fair market value estimate. According to Treasury, it does not make sense to give detailed information, including specific prices, to those that are far off.
- *Post-Warrant Committee:* Once Treasury officials receive feedback from the Warrant Committee, they might provide to the bank a fair market value with which the Warrant Committee would be comfortable. Treasury makes it clear that these suggestions are not a commitment to accept that price.
- *Assistant Secretary Conversations:* The Assistant Secretary told SIGTARP that sometimes when he is deciding whether to accept or reject an offer, financial institutions call him to “feel” him out. The Assistant Secretary told SIGTARP that he does not negotiate on these calls, but rather just listens to the pitch made by the banks and conveys Treasury’s position.¹⁸ The Assistant Secretary indicated that Treasury’s policy was not to provide specific numbers to institutions, on the theory that the banks could bid more than Treasury’s composite value.

None of the conversations between Treasury officials and the banks are documented by Treasury. Without such documentation, SIGTARP could not further determine the extent to which institutions were treated consistently and objectively during these discussions. Descriptions provided to SIGTARP by eight of the banks that engaged in negotiations confirmed that Treasury was willing to provide detailed information about its estimates to certain banks, but unwilling to share similar details with others. Unfortunately, because Treasury does not document these negotiations with financial institutions and because there are no established guidelines or criteria for the level of information shared with each institution, it is impossible to determine the justification for the differences in the quality of information shared with these banks. The following examples illustrate the varying levels of detail provided to different banks:

¹⁸ However, as discussed in more detail below, according to a senior official of Morgan Stanley, the Assistant Secretary called him to communicate that Treasury was not going to accept Morgan Stanley’s offer of \$900 million. The official told SIGTARP that a \$950 million figure was discussed during that call; although the official could not recall who suggested that figure, contemporaneous documentation indicates that the official understood from that call that Treasury was prepared to accept \$950 million.

- **Old National Bancorp:** On April 15, 2009, Old National Bancorp (“Old National”) submitted its first bid of \$558,862, which Treasury subsequently rejected. Old National officials told SIGTARP that, during the subsequent negotiation process, Treasury’s negotiating analyst stated that Treasury estimated a fair market value of around \$1.3 million. Bank officials noted that the conversations with the analyst made it somewhat apparent that Treasury would not accept offers much below the \$1.3 million range. Although Treasury’s negotiating analyst did not say that Treasury would accept an offer of \$1.3 million, the bank left the conversation with the impression that an offer at that amount would likely have been accepted. Treasury did not provide the inputs; it was up to the bank to find inputs to get to that number. The bank submitted a second bid of \$1.2 million, which Treasury accepted. This price was 11 percent below Treasury’s determination of fair market value of \$1.35 million.
- **Sun Bancorp:** On April 21, 2009, Sun Bancorp (“Sun”) submitted its initial bid of \$1,049,496, which Treasury rejected. According to Sun officials, in subsequent telephone conversations, Treasury officials explained the valuation process and stated that their valuation range was around \$3 million, a number arrived at by valuing the warrants at \$4 million and applying a 25 percent liquidity discount. On May 19, 2009, Sun submitted a second bid of \$2.1 million (a figure that was slightly higher than Treasury’s composite value of \$2.0 million), which was accepted.
- **SCBT Financial:** On June 3, 2009, SCBT Financial (“SCBT”) submitted an initial bid of \$694,060, which Treasury rejected. According to SCBT officials, in subsequent telephone conversations, Treasury told SCBT that the liquidity discount applied by the bank was too large and suggested that a smaller discount be applied. SCBT’s second bid of \$1.4 million, which matched Treasury’s composite value, was accepted.
- **Somerset Hills Bancorp:** On June 4, 2009, Somerset Hills submitted an offer to Treasury for \$192,752, which Treasury rejected. According to Somerset Hill’s senior leadership, the bank’s board of directors established a ceiling amount the bank could offer to Treasury without revisiting the board for approval. The first offer was on the lower end of the bank’s range and under the ceiling. The bank told SIGTARP that, during the first phone call, Treasury shared its valuation approach and general process. For the second call, the bank executives stated that they clearly understood what Treasury’s valuation range was. Treasury did not give the inputs to the model, but provided bank officials a dollar range approximate.¹⁹ They compared Treasury’s range to the range approved by the board of directors and commented that the ranges were very similar (within 10 percent of each other). The officials said that Treasury made clear that it couldn’t accept anything over the phone; however, the officials had a clear sense of what the range was. With the new information, the bank submitted a second offer of \$275,000, which was accepted by Treasury. Treasury’s composite value was \$275,000.
- **American Express:** On July 1, 2009, American Express submitted its first bid of \$230 million, which Treasury rejected. American Express officials told SIGTARP that they were surprised at Treasury’s “no counter offer” approach. The company called the first subsequent conversation a “discovery conversation,” and noted that Treasury did not share the actual values of its pricing methods and was not very forthcoming on why there

¹⁹ Somerset Hills’ executives could not recall the exact dollar amount provided by Treasury during the negotiation.

were differences. Treasury shared that it was using the market quotes, financial modeling, and third-party estimates, but it was not willing to articulate how the three played out in its final valuation. Treasury did not share inputs or assumptions, methodologies, “not even a number to go by.” Treasury suggested for American Express’ second offer that the bank use the current stock price in its valuation because the stock price had risen so dramatically over the past 20-day period. American Express presented a second offer of \$260 million, which again was rejected. At that point, Treasury simply provided an indication that the bank was getting closer. Finally, on July 28, 2009, the company offered to pay \$340 million. Treasury accepted the offer, which was more than 21 percent above Treasury’s composite value of \$280 million.

- **Morgan Stanley:** On June 30, 2009, Morgan Stanley submitted its first bid of \$500 million, which Treasury rejected. Morgan Stanley told SIGTARP that the first discussion thereafter centered on the construct and methodology of how Treasury was thinking of value. Treasury did not provide any numbers, guidance about their inputs, or a firm view about price—even though Treasury indicated that it would provide more guidance if the bank got closer to Treasury’s price. On July 15, 2009, Morgan Stanley submitted its second bid of \$500 million, which they viewed as being \$80 million better than their original estimate of FMV because of the decline in their stock price from \$29.10 to \$27.88. Treasury rejected that offer as well. On July 31, 2009, Morgan Stanley raised its bid to \$800 million, which Treasury again rejected. On August 4, 2009, Morgan Stanley submitted a revised offer of \$900 million, which was approved by the Warrant Committee that day. After the Warrant Committee approved the \$900 million bid, the Assistant Secretary asked the CPP team for the volatility and internal rate of return at \$900 million, to which the team replied on that day. According to Treasury, Morgan Stanley’s chief financial officer called the Assistant Secretary to inquire about the status of the \$900 million bid. According to the Assistant Secretary, he told Morgan Stanley that he was requesting more information from the Warrant Committee and that Morgan Stanley needed to “sharpen their pencils” and get back to Treasury.

According to Morgan Stanley, however, it was the Assistant Secretary who contacted Morgan Stanley’s chief financial officer to inform the bank that Treasury was not going to accept the \$900 million bid. Based on a follow up discussion, the Assistant Secretary stated to SIGTARP that it was conceivable that he had initiated the call to Morgan Stanley, but he could not remember. According to the chief financial officer, the Assistant Secretary communicated that Morgan Stanley would have to bid more to avert the auction process, the timing of which was uncertain at the time of Morgan Stanley’s bid. He could not recall who suggested a \$950 million figure, but a contemporaneous document appears to indicate at the very least that he understood from that call that Morgan Stanley would have to bid \$950 million to avoid public auction.²⁰ The chief financial officer did recall that the Assistant Secretary made very clear that he wanted a significantly higher price, and that the \$900 million bid was unacceptable. The chief financial officer, after gaining approval from the board of directors, called the Assistant Secretary back to inform him that Morgan Stanley was prepared to bid the previously discussed \$950 million. After these discussions (which were not documented by

²⁰ In an e-mail from the day of the call, the chief financial officer wrote “Allison rang me 950 or go to auction. JJM,s [sic] decision, but frankly I would go to auction.”

Treasury), Morgan Stanley repurchased its warrants for \$950 million, which was nearly six percent higher than Treasury's composite value of \$900 million.

- **Sterling Bank:** On June 5, 2009, Sterling Bank ("Sterling") submitted an initial bid of [REDACTED]²¹ to Treasury, which Treasury rejected. According to Sterling officials, in subsequent conversations, Treasury provided data that included value ranges for each of its methodologies (*i.e.*, market prices, third-party valuations, modeling and fundamental analysis) that resulted in a range of [REDACTED] to [REDACTED]. The bank told SIGTARP that Treasury suggested a bid of [REDACTED] and later indicated a willingness to accept even less, [REDACTED]. Sterling decided not to bid further, however, and Sterling's warrants will be sold at auction. Treasury's composite value was [REDACTED].
- **JP Morgan Chase:** On June 17, 2009, JP Morgan Chase ("JP Morgan") submitted a bid for its warrants of \$825 million, which Treasury rejected. According to JP Morgan officials, in subsequent conversations, although Treasury provided general information on its valuation methodologies, Treasury provided very little input on how far JP Morgan's bid fell short and did not provide any benchmark figure. JP Morgan officials told SIGTARP that JP Morgan asked Treasury whether it would be willing to provide further guidance or clarification if it submitted a second bid that proved to be too low, to which Treasury responded that it was unlikely to provide additional information. JP Morgan told SIGTARP that it thought that the negotiation amounted to a game of "throwing darts in the dark," and that, having made what it believed was a full and fair offer, it was very difficult to negotiate a higher purchase price without any feedback from Treasury. Accordingly, JP Morgan decided to go to auction rather than submit a second bid. JP Morgan's warrants were sold at auction on December 10, 2009, for \$950,318,243. Treasury's composite value was \$1.0 billion.

Step 4: Appraisal Process

The CPP contract provides that if Treasury and the bank cannot agree on fair market value either may invoke an appraisal procedure, which is similar to arbitration. This process has not yet been used. Treasury and the institution would each choose an independent appraiser to calculate the value of the warrants. If they came to different determinations, the two appraisers would then see if they could agree upon a price for the warrants. If they are unable to agree after 30 days, then the first two appraisers select a third independent appraiser, and the average of the three appraisals is then determined. This price is binding upon Treasury if the institution agrees with the determination and wishes to proceed with the sale. If not, the process can be terminated by the financial institution.

A Treasury official stated that, although the appraisal process is an option, he did not think that any institution will use it because the bank would have to bear the costs of appraisers. One bank told SIGTARP that it did not invoke the appraisal procedure because it was too expensive, there

²¹ Treasury has not yet auctioned Sterling Bank's warrants. To maximize taxpayer return at the auction, Treasury asked SIGTARP to redact the details of its negotiations with Sterling until after the auction is completed. SIGTARP will release an un-redacted version of this report upon completion of the Sterling auction.

is uncertainty because no other institution had gone through the process, the appraisal did not seem easy, and the length of the process added uncertainty. If the appraisal procedure is invoked, Treasury has 30 days to hire an appraiser. Treasury stated it will likely use one of its three asset managers as its selected appraiser.

Step 5: Treasury Sells the Warrants at Public Auction

In those instances in which a bank does not make a repurchase offer to Treasury or does make such an offer but cannot agree with Treasury on a negotiated price for its warrants, Treasury will seek to sell the warrants at auction. On June 26, 2009, Treasury announced its intention to use public auctions; on November 19, 2009, Treasury announced that it planned to auction warrants through registered public offerings using a modified Dutch auction. Each warrant offered in an auction gives the buyer the right to purchase one share of the bank's common stock at the strike price on the warrant. The modified Dutch auction allows investors to submit bids to the auction agent (Deutsche Bank), at specified increments above a minimum price per warrant that Treasury sets for each auction. The repaying institutions also have the option to bid in the auction, although institutions bidding on their own warrants have to submit their bid 30 minutes prior to the deadline for all other bidders. Deutsche Bank receives bids from the bidders and determines the final price of the warrants. It then allocates the warrants to the winning bidders. Treasury has the right to reject the results of the auction. For Treasury's auction process as described in the prospectus supplement of one of Treasury's warrant auctions, see Appendix H.

Warrants 101 – Dutch Auctions

For Treasury's warrant auctions (which have multiple bidders bidding for different quantities of the asset), the accepted price is set at the lowest bid of the group of high bidders whose collective bids fulfill the amount offered by Treasury. In an example, three investors place bids to own a portion of 100 shares offered by the issuer.

- Bidder A wants 50 shares at \$4/share
- Bidder B wants 50 shares at \$3/share
- Bidder C wants 50 shares at \$2/share

The seller selects Bidder A and B as the two highest bidders, and their collective bids consume the 100 shares offered. The winning price is \$3, which is what both bidders pay per share. Bidder C's bid is not filled.

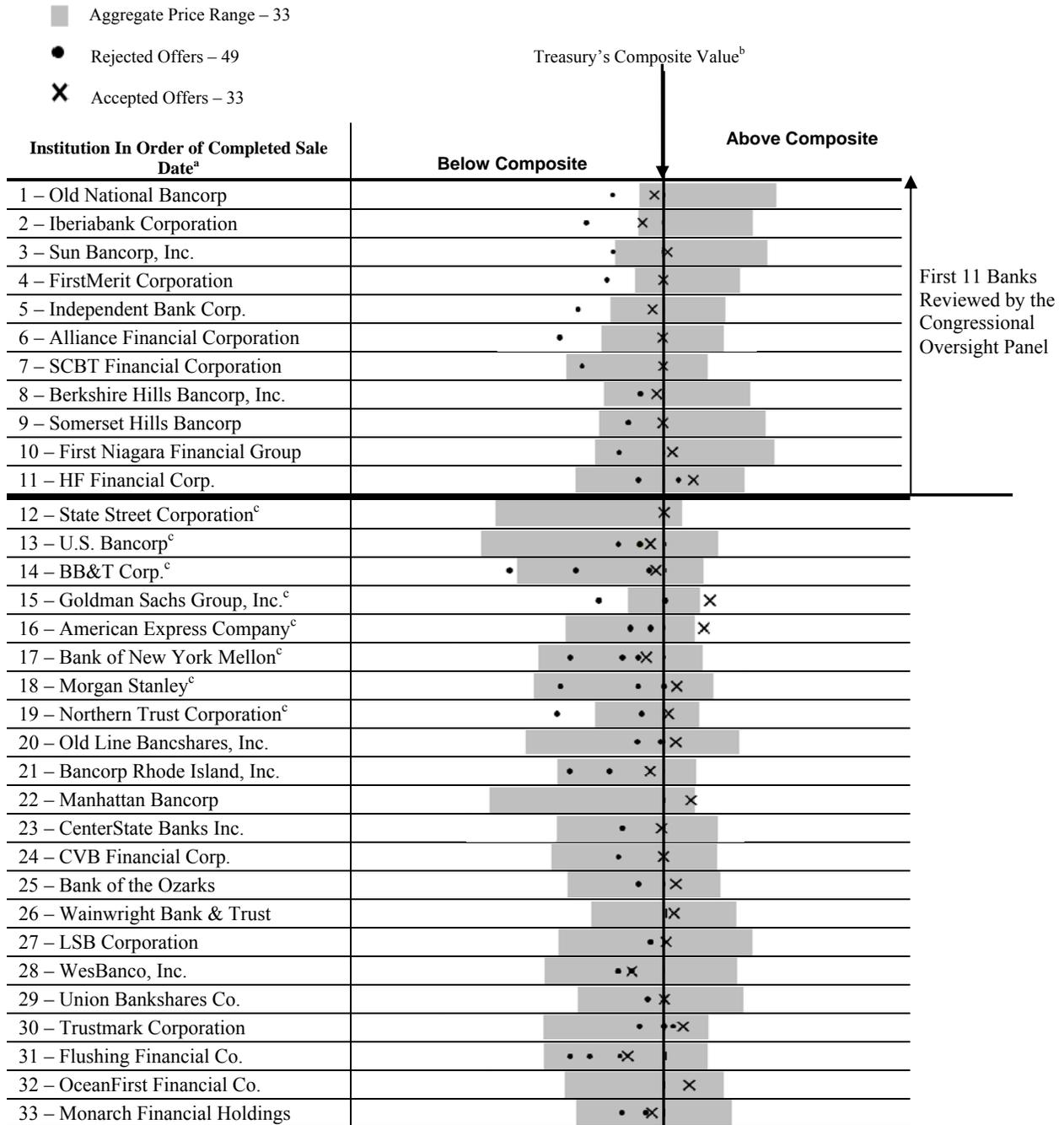
Bank-By-Bank Results of Treasury's CPP and TIP Warrant Sales Process

This section discusses the results of Treasury's implementation of its process to determine Fair Market Value. It also provides information about Treasury's implementation of the auction process.

SIGTARP analyzed the 33 warrants repurchase transactions through March 19, 2010, and collected preliminary observations on Treasury's seven auctions of warrants. As noted earlier, this analysis complements the prior work of the Congressional Oversight Panel.

Figure 6 illustrates the final negotiated price in comparison to Treasury analysts' estimate of value captured in the composite value. Treasury's decisions tend to center around its analyst's determination of composite value. In fact, of the 33 warrant repurchases through March 19, 2010, 20 of the final negotiated prices were at or above Treasury's composite value, and 9 of the final negotiated prices were just under the composite value (generally between 90-99 percent of composite value). The four remaining transactions, included the first two completed (during which time Treasury was operating under a governing statute that limited how long Treasury had to negotiate and before Treasury had its valuation methodology worked out) and two for warrants in small institutions that received less than \$100 million in TARP funds (for which valuation is difficult because of less liquidity in the bank's stock).

Figure 6: Comparison of Treasury’s Acceptance of Offers and Composite Value for Completed Warrant Transactions through March 19, 2010



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

Source: SIGTARP analysis of Treasury data.

After examining 33 completed warrants repurchase transactions—both pre- and post- the Congressional Oversight Panel report—SIGTARP found that a number of factors differentiated the first 11 sales from subsequent sales.

- *Treasury did not apply a liquidity discount for banks that received more than \$1 billion in TARP:* Treasury did not apply a liquidity discount for large institutions. For eight banks that received more than \$1 billion in TARP (whose sales account for 99 percent of direct warrant repurchases), Treasury received 94 percent of the Panel’s estimates. The Panel does not apply liquidity discounts to any of its valuations; however, as noted above, Treasury’s policy is to apply liquidity discounts between 0 to 50 percent depending on the liquidity of the underlying stock and the possibility of greater participation in an auction. Treasury applied, on average, a 31 percent liquidity discount for the model valuations for the first 11 institutions, which received 66 percent of the Panel’s estimates. If the liquidity discount is removed for Treasury’s final prices for all banks,²² the resulting prices are approximately 92 percent of the Panel’s estimates.
- *For the first two warrant sales, Treasury was operating under a different legislative mandate and did not yet have its asset managers in place:* At the time of the first two warrant sales, Treasury believed that it was statutorily required to liquidate warrants expeditiously after a CPP participant repaid Treasury’s CPP investment. This time pressure was compounded by the fact that Treasury had not yet finalized its process or had even hired its asset managers to assist in determining valuation.²³
- *Treasury has refined its model assumptions over time:* As previously discussed, Treasury continued to refine its assumptions for its model over time, particularly assumptions on volatility. According to Treasury, the first three auctions that took place in December 2009 established a secondary market for 10-year options allowing Treasury to use market-based assumptions when it runs its financial models. In addition, the number of banks that repurchased the warrants from Treasury provided more market-based information to refine the inputs.
- *Treasury did not agree with the initial valuations of the third-party asset managers:* According to Treasury, for the first 11 warrants, “the CPP team often felt the volatility assumption used by the external asset managers was too high given the historical volatility of the institution. In addition, the CPP team also often assumed a higher illiquidity discount given the size of the institution and the limited trading volume of its stock.” SIGTARP found that, after the initial warrant sales, the asset managers refined their models and became more relevant to Treasury’s calculation of a composite value. Treasury’s largest asset manager—AllianceBernstein—told SIGTARP that the recent auctions, as well as the number of valuations resulting from banks that repurchased the warrants from Treasury, provided more market-based information that the firm used to

²² For the purpose of comparison to the Panel’s analysis, SIGTARP removed the liquidity discount from the final prices; however, the liquidity discount generally is applied to the financial modeling outputs generated by Treasury.

²³ Instead, Treasury used Gifford Fong, which it acknowledged was not an experienced valuation firm and whose valuation model was found to be missing certain vital assumptions that Treasury thought were fundamental to the valuation.

refine the inputs, specifically regarding volatility. The firm has thus been able to recalibrate its calculations to reflect new market-based data.

- *Subsequent sales were to larger banks and Treasury rejected more bids before agreeing on a final price:* After the first 11 banks, Treasury rejected more offers before arriving at final prices than in the negotiations for the first 11 banks. Treasury rejected 65 percent of the offers from institutions that received more than \$1 billion in TARP funds, compared to 52 percent of the first 11 banks, all of which received less than \$200 million in capital investments. Treasury stated that, for smaller institutions, qualitative factors play more of a role in the decision making. For larger institutions, Treasury is less concerned about liquidity and the possibility that no bidders would participate in an auction, and, therefore, it was more willing to reject bids that were not close to Treasury's composite value.

Auction Results

As of March 19, 2010, Treasury had auctioned warrants for seven banks: four banks that did not submit a repurchase offer to Treasury (Bank of America, Texas Capital Bancshares, Inc., Signature Bank, and Washington Federal Inc.) and three banks that could not agree with Treasury on fair market value and revoked their offers (Capital One, JP Morgan Chase, and TCF Financial).

Table 3 deals with those firms that made offers to repurchase but could not agree with Treasury and provides these banks' initial offers, Treasury's composite value, and the auction results. Table 4 provides a summary of the auction results of the first seven banks' auctions compared to Treasury's minimum price and also shows the current price of the 10-year warrants that Treasury sold into the market.

Table 3: Results of Treasury’s Warrant Auctions for Institutions that Revoked and/or rejected Offers through March 12, 2010 (\$000s)

Institutions	Investment Date	TARP Investment	Date of Bank’s Offer	Bank’s Offer	Treasury Composite Value	Auction Date	Treasury Minimum Price	Proceeds From Auction
Capital One, Inc.	11/14/08	\$3,555,199	6/30/09	\$46,500	\$110,000	12/3/09	\$94,900	\$148,731
JP Morgan Chase	10/28/08	\$25,000,000	6/17/09	\$825,539	\$1,000,000	12/10/09	\$707,200	\$950,318
TCF Financial	11/14/08	\$361,172	5/5/09	\$3,200	\$13,000	12/15/09	\$4,800	\$9,600
Totals				\$875,239	\$1,123,000		\$806,900	\$1,108,649

Source: SIGTARP analysis of Treasury data.

Table 4: Results of Treasury’s Warrant Auctions Compared to Treasury’s Minimum Price, as of April 13, 2010

Institutions	Program	Auction Date	Minimum Proceeds ^b	Auction Proceeds	Minimum Price / Warrant	Auction (i.e. Clearing) Price / Warrant	Warrants Trading Price (3/18/10)
Capital One, Inc.	CPP	12/3/09	\$94,900	\$148,731	\$7.50	\$11.75	\$14.81
JP Morgan Chase	CPP	12/10/09	\$707,200	\$950,318	\$8.00	\$10.75	\$14.22
TCF Financial	CPP	12/15/09	\$4,800	\$9,600	\$1.50	\$3.00	\$4.42
Bank of America ^a	CPP	3/3/10	\$182,689	\$310,572	\$1.50	\$2.55	\$2.98
Bank of America ^a	TIP	3/3/10	\$1,052,630	\$1,255,639	\$7.00	\$8.35	\$8.88
Washington Federal	CPP	3/9/10	\$8,500	\$15,623	\$5.00	\$9.15	\$7.32
Signature Bank	CPP	3/10/10	\$9,500	\$11,321	\$16.00	\$19.00	\$18.98
Texas Capital	CPP	3/11/10	\$4,900	\$6,709	\$6.50	\$8.85	\$8.90

Notes: a. Treasury conducted two auctions of Bank of America’s warrants. One auction priced the warrants received under the CPP, and the other priced the warrants received under the Targeted Investment Program.

b. Minimum proceeds were calculated by multiplying the total number of warrants sold by the minimum price.

Source: SIGTARP review of Treasury data and NYSE closing prices. Bloomberg.

Treasury does not recalculate a composite value using the three pricing methods at or near the time that an auction was to commence, but instead uses a different, albeit related, procedure to establish a minimum price that Treasury would accept at auctions.²⁴ Deutsche Bank suggests the minimum price, and Treasury calculates a reserve price that is not shared with Deutsche Bank. If the final auction price is below reserve price, Treasury will retain the warrants.

²⁴ For the seven banks’ warrant auctions, Treasury utilized modified “Dutch” auctions to dispose of the warrants. The public auctions were registered under the Securities Act of 1933. Only one bank’s warrants were sold in each auction. With advice from its external asset managers and the auction agent, Treasury publicly disclosed a minimum bid and privately set a reserve price for each auction. Bidders were able to submit one or more independent bids at different price-quantity combinations at or above the set minimum price. The auction agent did not provide bidders with any information about the bids of other bidders or auction trends, or with advice regarding bidding strategies, in connection with the auction. The issuers of the warrants were able to bid for their warrants in the auctions. Bids were accepted by the auction agent from 8:00 a.m. to 6:30 p.m. on the day of the auction. The warrants were sold to all winning bids at the uniform price that cleared the auction. Deutsche Bank Securities Inc. was Treasury’s auction agent for all the auctions. Deutsche Bank received fees equal to approximately 1.5 percent of the gross proceeds which is significantly below typical secondary equity offering fees that run around 3.5 percent to 4.5 percent depending on the size of the offering.

Treasury also solicits their asset manager to provide a minimum price for auctions. Treasury runs a financial model valuation to set the reserve price. Treasury has set higher reserve prices as the successive auctions went well. Starting with the Bank of America auction, Treasury was able to use actual market data made available by the first three auctions to run its financial model valuation.

Conclusions and Recommendations

EESA mandated that financial institutions receiving TARP assistance provide warrants to Treasury as a way to generate additional returns for taxpayers. For publicly traded companies, warrants give Treasury the right to purchase additional shares of common stock in the TARP beneficiary at a predetermined price for up to ten years after the TARP investment. As recipient institutions repay their TARP investments, Treasury sells the warrants, either directly to the recipient institution at a negotiated price or via public auction.

Because warrants of this duration are not typically traded on an open market, determining their value is not straightforward. Treasury determines a fair market value estimate for the warrants, called a “composite value,” after referencing three different pricing methods: market quotes, financial modeling outputs and third-party estimates. Treasury uses the composite value as a reference when considering whether to accept recipients’ bids for the warrants.

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

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

The first area of concern is that Treasury does not sufficiently document important parts of the process, impairing transparency and making a comprehensive review of the integrity of the decision-making process impossible. This documentation issue manifests itself in two important contexts. One, Treasury lacks detailed documentation supporting the decisions of the Warrant Committee, the internal Treasury committee that reviews TARP recipients’ offers to repurchase their warrants and makes recommendations to the Assistant Secretary on whether to accept or reject them. Most of the meeting minutes from Warrant Committee sessions were extremely limited and included only the name of the institution, the institution’s offer amount, the name of the analyst who presented Treasury’s analysis of fair market value, the analyst’s

recommendation on whether to accept or reject the offer, whether the offer was at or close to the analyst's composite value, and the final vote of the Warrant Committee members. Significantly, the minutes generally do not reflect the qualitative factors considered by the Warrant Committee members when making determinations whether to accept or reject a bank's offer, or their justifications or explanations for their decisions.

This lack of documentation contrasts significantly to that of Treasury's Investment Committee (part of the decision-making process for making TARP investments), even though both processes are designed to support a financial decision about a particular firm²⁵ and both committees discuss analysts' assessments of potential transactions. Investment Committee minutes, for example, capture details regarding the qualitative factors that the Investment Committee members consider in support of each decision. SIGTARP found far less documentation supporting the warrants sale decision-making process than was standardized and required for the comparable TARP investment process.

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

Even more troubling, Treasury similarly does not document the substance of its conversations and negotiations with the recipient institutions. Treasury officials can interact directly with the recipient institution on several occasions during the warrant repurchase process. As discussed below, the transactions examined in detail in this audit suggest that the amount of information provided to recipient institutions concerning the price that Treasury is likely to accept, information that is only shared with some institutions, can have a significant impact on the return

²⁵ SIGTARP's August 6, 2009 audit, "Opportunities to Strengthen Controls to Avoid Undue External Influence over Capital Purchase Program Decision-Making," assessed the controls in place throughout Treasury's process to approve applications for CPP investments. SIGTARP made recommendations, which Treasury adopted, relating to documenting Investment Committee votes and all communications with third parties concerning the investment decision. That audit can be found at www.sig tarp.gov.

realized by taxpayers. Because Treasury does not make note of these conversations (or even keep a list of the institutions with which it shares such information), however, SIGTARP was only able to partially reconstruct, for the sample of eight institutions interviewed for this audit, the substance of the conversations and their import based on interviews conducted at times long after the fact. Again, memories fade and with the passage of time and the occurrence of intervening negotiations, different parties to a conversation may have different recollections of what occurred. When a brief telephone call can mean the difference of tens of millions of dollars, it is a basic and essential element of transparency and accountability that the substance of that call be documented contemporaneously.

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

- Old National Bancorp received information about Treasury's valuation range even though its bid was less than half of Treasury's composite value; it came back with a bid just under the composite, which was accepted.
- Sun Bancorp's initial bid was only about half of Treasury's composite value. Treasury responded with a specific number that was substantially higher than its composite value. Sun's next bid was just over the composite value and was accepted.
- SCBT Financial was told expressly that its initial bid used too large a liquidity discount; SCBT's subsequent bid, which utilized Treasury's suggested discount, was essentially at Treasury's composite value and was accepted.
- Following conversations with Treasury, Somerset Hills was clear what Treasury's valuation range was; their subsequent bid was right at Treasury's composite value and was accepted.
- Treasury gave essentially no information to American Express about its valuation even though the bank's second offer, \$260 million, was just \$20 million (7.1 percent) less than Treasury's composite value of \$280 million and thus within the percentage range where other offers had been accepted. American Express's next bid, which was accepted, was \$340 million, far in excess of Treasury's composite value.

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

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

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

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

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

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

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

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

Recommendations

To address these deficiencies, SIGTARP recommends that:

1. Treasury should ensure that more detail is captured by the Warrant Committee meeting minutes. At a minimum, the minutes should include the members' qualitative considerations regarding the reasons bids were accepted or rejected within fair market value ranges.
2. Treasury should document in detail the substance of all communications with recipients concerning warrant repurchases.
3. Treasury should develop and follow guidelines and internal controls concerning how negotiations will be pursued, including the degree and nature of information to be shared with repurchasing institutions concerning Treasury's valuation of the warrants.

Management Comments and Audit Response

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

Appendix A—Scope and Methodology

We performed the audit under the authority of Public Law 110-343, as amended, which also incorporates the duties and responsibilities of inspectors general under the Inspector General Act of 1978, as amended. The audit's specific objectives were to determine the process and procedures Treasury has established to ensure that the Government receives fair market value for the warrants and to determine the extent to which Treasury follows a clear, consistent, and objective process in reaching decisions where differing valuations of warrants existed.

We performed work at the Department of the Treasury's Office of Financial Stability in Washington, DC. We also performed field interviews in New York, New Jersey, and California. The scope of this audit covered 33 initiated and completed warrant transactions from May 8, 2009, through March 19, 2010, between the CPP recipient and Treasury. We also reviewed auctions of warrants for stock in seven TARP recipients that did not repurchase the warrants directly from Treasury.

To determine the process and procedures Treasury has established to ensure that the Government receives fair market value for the warrants, we reviewed available Treasury guidance on its warrant negotiation and auction process, Treasury's internal controls documentation, the contracts signed by Treasury and the banks upon receipt of funds, and other relevant Treasury publications on its disposition process. In addition, we reviewed the Emergency Economic Stabilization Act of 2008, the American Recovery and Reinvestment Act of 2009, and Helping Families Save Their Homes Act of 2009. We interviewed legal, compliance, policy, and CPP team officials to understand Treasury's process. We also interviewed Secretary Geithner and the Assistant Secretary Allison to determine their roles in warrant disposition. We also judgmentally sampled eight institutions that had participated in Treasury's warrant disposition process to gain an understanding of the banks' perspective on Treasury's procedures. We also consulted academic experts and industry participants on general valuation techniques. We also observed two auctions to determine the steps involved in selling warrants through the auction mechanism.

To determine the extent to which Treasury follows a clear, consistent, and objective process in reaching decisions where differing valuations of warrants existed, we reviewed Treasury's warrant repurchase files for completed warrant transactions and reviewed decision-making documentation for each transaction. We reviewed Warrant Committee meeting minutes and evidence of approval, which included email exchanges between CPP officials and the Assistant Secretary. We interviewed the CPP warrant valuation team to understand the rationale for Treasury's valuation methodologies and fair market value assessment. We also interviewed Warrant Committee members and the Assistant Secretary to understand the factors considered during decision making.

This audit was performed in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We completed our review from June 2009 to April 2010. We believe that the evidence obtained during this period of review provides a reasonable basis for our findings and conclusions based on audit objectives.

Limitations on Data

Some of the decision makers involved at the beginning of TARP and the CPP were no longer at Treasury at the time of SIGTARP's review. Moreover, SIGTARP was unable to determine all of the decision-making factors when Treasury assessed each CPP institution's warrant offer because Treasury did not document all of the qualitative factors it considered during the recommendation, negotiation, and approval process.

Use of Computer-processed Data

To perform this audit, we used data provided by Treasury's valuation models. To assess the extent to which these models generate reliable outputs, we reviewed documentation from Ernst and Young, the independent firm contracted by Treasury to validate the models' results. We reviewed the validation report that the firm submitted to Treasury and found nothing material that would impede the use of the models on the basis of model reliability.

Internal Controls

As part of the overall evaluation of the CPP warrant valuation and disposition process, we examined internal controls related to the submission, valuation, recommendation, and approval of financial institutions' offers for warrant transfer. We also conducted an evaluation of documentation procedures regarding various decision-making points throughout the process and examined internal controls as they relate to policies and procedures in place to ensure consistency throughout the valuation and decision-making process.

Prior Coverage

Congressional Oversight Panel, "July Oversight Report: TARP Repayments, Including the Repurchase of Stock Warrants," July 10, 2009.

Congressional Oversight Panel, "January Oversight Report: Exiting TARP and Unwinding Its Impact on the Financial Markets," January 13, 2010. This report includes an update on the Panel's July 2009 report.

Congressional Oversight Panel, "Commercial Real Estate Losses and the Risk to Financial Stability," February 11, 2010. This report includes an update on the Panel's July 2009 report.

Government Accountability Office, Report GAO-09-658, "Troubled Asset Relief Program: June 2009 Status of Efforts to Address Transparency and Accountability Issues," June 2009.

Government Accountability Office, Report GAO-09-889, "Troubled Asset Relief Program: Status of Participants' Dividend Payments and Repurchase of Preferred Stock and Warrants," July 2009.

United States Department of the Treasury, Office of Financial Stability, "Warrant Disposition Report," January 20, 2010.

Appendix B—Largest Positions in Warrants Held by Treasury, By Program, as of March 19, 2010

Participant	Transaction Date	Current Number of Warrants Outstanding	Current Strike Price	Stock Price as of 3/31/2010	In or Out of the Money	Amount "In the Money" or "Out of the Money" as of 3/31/2010
Capital Purchase Program:						
Citigroup Inc.	10/28/2008	210,084,034	\$17.85	\$4.05	Out	\$(13.80)
Wells Fargo & Company	10/28/2008	110,261,688	\$34.01	\$31.12	Out	\$(2.89)
Systemically Significant Failing Institutions Program/AIG Investment Program:						
AIG ^a	11/25/2008	2,689,938	\$50.00	\$34.14	Out	\$(15.86)
AIG ^a	4/17/2009	150	\$0.00	\$34.14	In	\$34.14
Targeted Investment Program:						
Citigroup Inc.	12/31/2008	188,501,414	\$10.61	\$4.05	Out	\$(6.56)
Asset Guarantee Program:						
Citigroup Inc.	1/16/2009	66,531,728	\$10.61	\$4.05	Out	\$(6.56)

Notes: Numbers affected by rounding.

^a All warrant and stock data for AIG are based on the 6/30/2009 reverse stock split of 1 for 20.

Sources: Treasury, Transactions Report, 1/4/2010; Treasury, responses to SIGTARP data call, 1/5/2010 and 10/7/2009; Capital IQ, Inc. (a division of Standard & Poor's), www.capitaliq.com. Wall Street Journal.

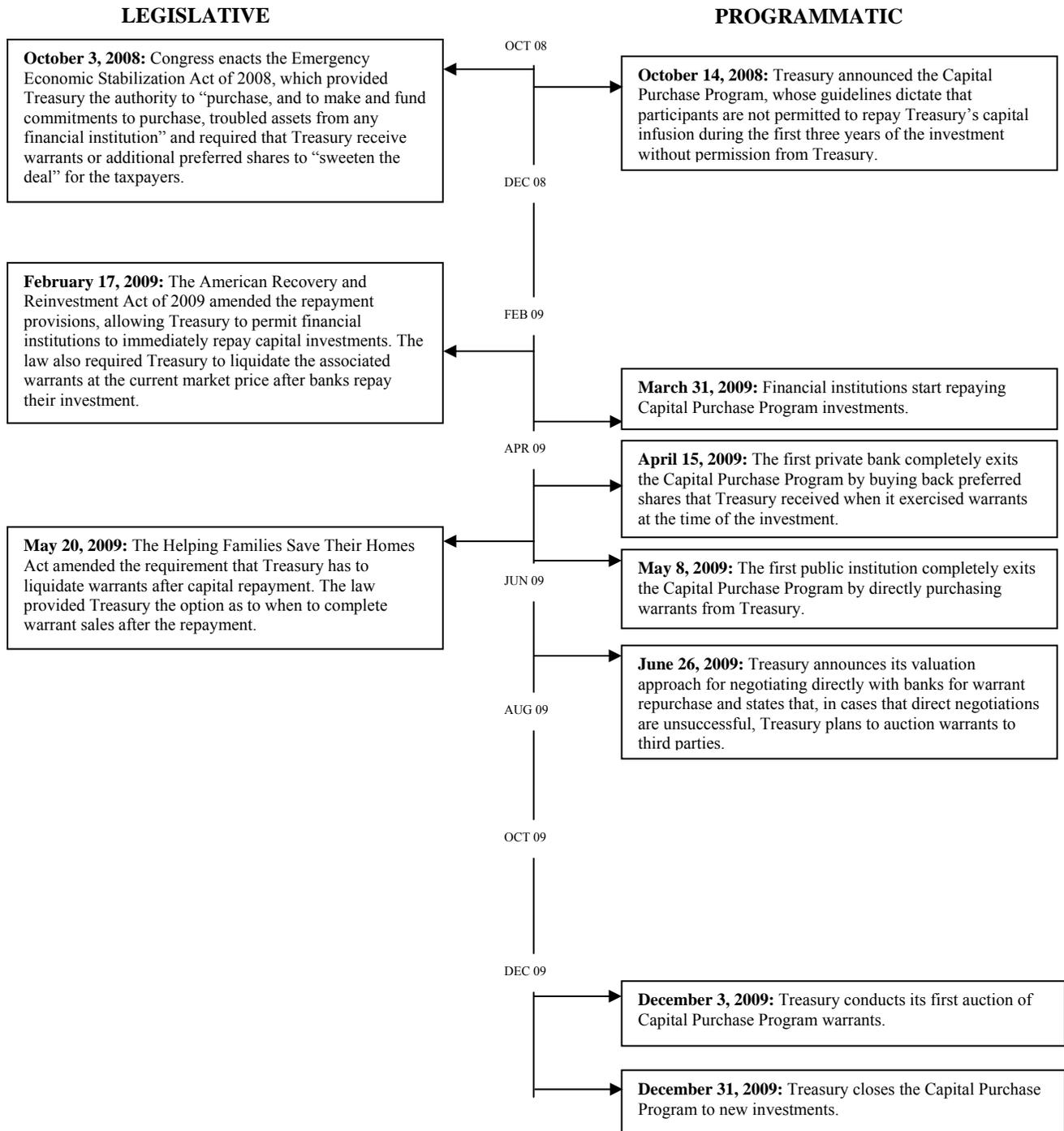
Appendix C—Investments in 707 CPP Banks

Treasury's Investments, as of March 19, 2010	Number of Institutions^a
Preferred Stock with Exercised Warrants	353
Preferred Stock with Warrants	277
Subordinated Debentures with Exercised Warrants	49
Preferred Stock	19
Subordinated Debentures	4
Trust Preferred Securities with Warrants	2
Common Stock with Warrants	1
Contingent Value Rights	1
Mandatory Convertible Stock with Warrants	1
TOTAL	707

Note: ^aThirty-one institutions received more than one CPP investment. For purposes of this table, these institutions are only counted once.

Source: Treasury Transaction Report, 3/19/2010.

Appendix D—CPP Warrant Disposition Timeline



Sources: Emergency Economic Stabilization Act of 2008, American Recovery and Reinvestment Act of 2009, Helping Families Save Their Homes Act, Securities Purchase Agreement, and Treasury press releases.

Appendix E—Treasury’s Warrant Process Description (Excerpt)

Treasury Announces Warrant Repurchase and Disposition Process for the Capital Purchase Program June 26, 2009

Today, Treasury is announcing its policy with respect to the disposition of the warrants received in connection with investments made under the Capital Purchase Program (CPP). In the case of investments in publicly-traded institutions, Treasury received warrants to purchase common shares which have not been exercised. (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.)

Repurchasing Warrants under the CPP Contract

When a publicly-traded institution repays Treasury’s CPP investment, the original contract under the CPP provides the bank a right to repurchase the warrants at fair market value via an independent valuation process. The relevant sections of the transaction documentation describing this process can be found in the Warrants FAQ on www.financialstability.gov.

The warrant repurchase process works as follows:

- Step 1:** Within 15 days of repayment, a bank wishing to repurchase the warrants should submit a determination of fair market value to Treasury.
- Step 2:** Treasury will ensure that taxpayers’ interests are protected by conducting a process (described below) to determine whether or not to accept the bank’s initial determination. Under the contract, Treasury has 10 days to respond to the initial determination.
- Step 3:** If Treasury objects to the bank’s determination and cannot reach agreement with the bank regarding fair market value, the transaction documents outline an appraisal procedure by which the two parties will reach a final price. In this appraisal procedure, the bank and Treasury will each select an independent appraiser. These independent appraisers will conduct their own valuations and attempt to agree upon the fair market value.
- Step 4:** If these appraisers fail to agree, a third appraiser is hired, and subject to some limitations, a composite valuation of the three appraisals is used to establish the fair market value.

In order to protect taxpayers in this process, Treasury has developed a robust set of procedures for evaluating repurchase offers in Step 2 above. Treasury’s determination of value is based on three categories of input:

1. Market Prices

When available, observable market prices are used. However, Treasury has warrants that are not listed on a securities exchange nor otherwise traded. These warrants do vary from typical listed warrants, mostly due to their long term (10 years). Therefore, the only observable market prices are for securities that have similar characteristics. The prices of these comparable securities can be used to assess the fair market value of the warrants held by Treasury.

- Comparable securities for the warrants held by Treasury include: traded warrants, traded options, and common equity issued by the institution as well as similar securities of peer institutions. Generally speaking, the largest institutions in the CPP have a broad array of comparable securities with observable market prices. Mid-sized institutions have fewer comparable securities and those securities may trade somewhat infrequently. Many of the smallest CPP participants have no meaningful comparable securities with observable market prices, so Treasury will rely on other valuation methods.
- Treasury will also obtain quotations for the warrants from 5 - 10 relevant market participants that may include investment banks regularly trading options or other securities with embedded options (e.g. convertible bonds) or asset management firms focusing on the financial sector.

2. Financial Modeling

Treasury will also use a set of well-known financial models to assess the fair value of the warrants. These models will include, but will not be limited to, binomial and Black-Scholes option-pricing models, and are widely used in financial markets to value options and warrants.

- These models depend on known inputs (the expiration date, interest rates, and the current stock price) and on assumptions about the future volatility and dividends of the underlying common stock.
- Assumptions about future volatility will be based on both the historical volatility and the option-implied volatility for a given stock and, where necessary, adjustments will be made for the expected mean-reversion of volatility over time. Treasury uses the average 60-day trailing volatility for the last ten years to determine a stock's historical volatility. Some larger publicly-traded institutions have existing short-dated options and longer-dated options (with maturities of up to two years) that provide data on option-implied volatility, so we use these also.

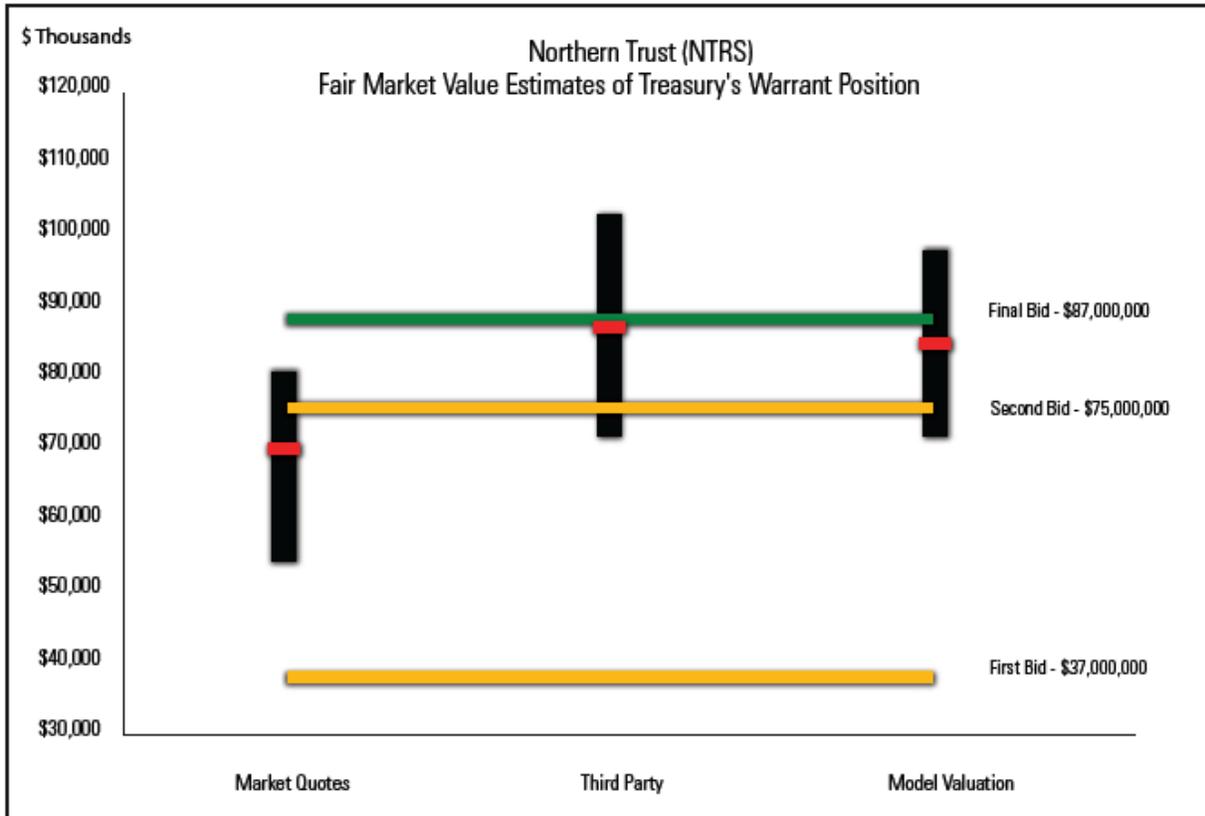
Transparency

Treasury publishes information on all CPP transactions, including investments, repayments and warrant repurchases, in the TARP Transactions Reports within 2 business days of closing. All Transaction reports are available on our website at www.financialstability.gov.

Further, Treasury will begin publishing additional information on each warrant that is repurchased, including a bank's initial and subsequent determinations of fair market value, if applicable. Following the completion of each repurchase, Treasury will also publish the independent valuation inputs used to assess the bank's determination of fair market value. All of this information will be available www.financialstability.gov.

Appendix F—Example of Treasury’s Warrant Valuation Analysis

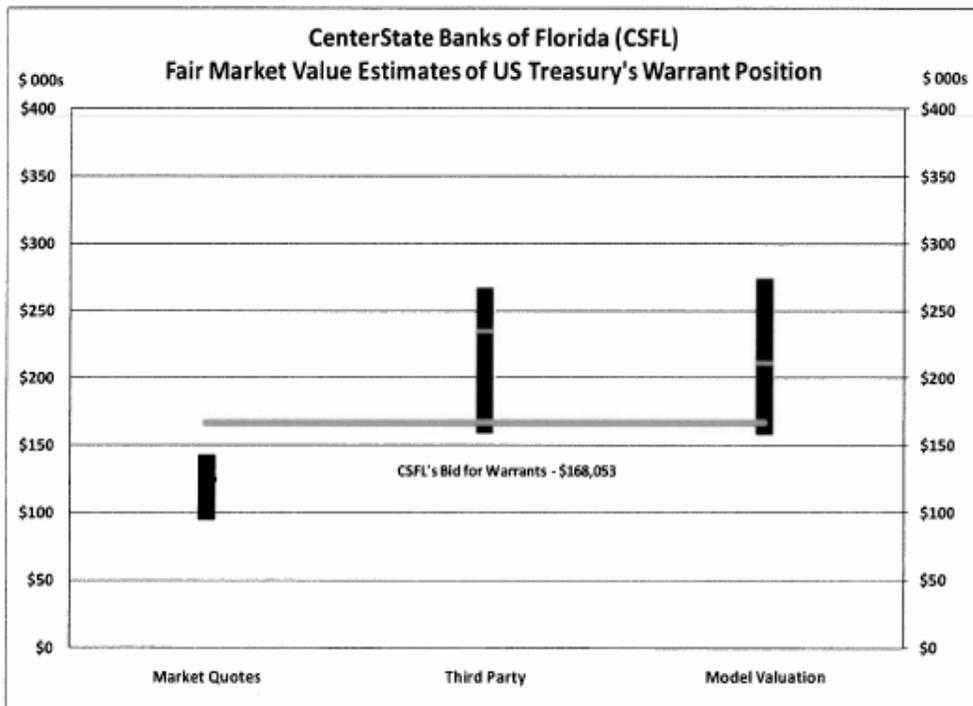
This appendix is an excerpt from Treasury’s January 20, 2010 Warrant Disposition Report. The figure below “demonstrates the three elements of Treasury’s warrant valuation analysis together with an institution’s bid for the warrants, using Northern Trust Corporation as an example. The market quotes are presented as a range from the low to the high estimate of value provided by market participants (black bar) as well as the average of all the market indications collected (red point). The third party estimate of value (red point) is presented along with a reasonable range (black bar) that is also prepared by the third party. Treasury’s estimate of value (red point) based on its internal model is presented along with a reasonable range (black bar). The ranges of estimates presented below show the final estimates utilized by Treasury officials to analyze the bank’s final bid.”



Appendix G—Analyst’s Fair Market Value Determination (Example)

CenterState Banks of Florida (CSFL) Estimate of Fair Market Value for CSFL Warrant

CenterState Banks of Florida (CSFL) has offered to pay \$168,053 for the warrants held by the US Treasury which entitles the holder of the warrant to purchase 125,413 shares of CSFL at a strike price of \$16.67 per share. The warrant expires on November 21, 2018.



Valuation Estimates for Warrant

	Low	High	Estimate	Details
Market Quotes	\$94	\$143	\$125	Three market quotes ranging from \$94 thousand to \$143 thousand with an average of \$125 thousand. Average stock price used in valuation was \$7.64.
Third Party	\$159	\$264	\$236	Binomial option model adjusted for American style options. Assumes 20 day trailing average stock price of \$7.81, volatility of 57.59%, dividend yield of 0.9%. Estimate variance based on volatility range of 50.0% to 60.0% and dividend yield range of 0.5% to 1.5%.
Model Valuation	\$158	\$275	\$212	Binomial option model adjusted for American style options. Assumes stock price of \$7.77, volatility of 40.0%, dividend yield plus borrow cost of 1.30%. Estimate variance based on volatility range of 35% to 45% and dividend yield range of 0.8% to 1.8%.

Date: October 16, 2009

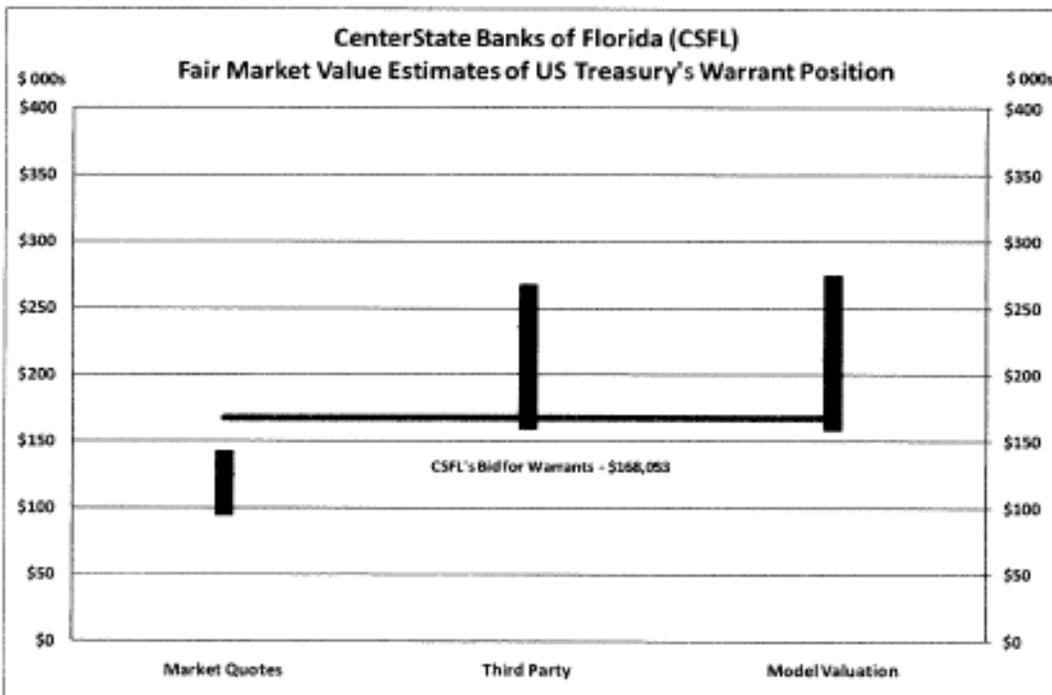
Subject: Fair Market Value Determination for CSFL Warrants

To: CPP Warrant Committee

From: [REDACTED]

The U.S. Department of the Treasury invested \$27,875,000 in CenterState Banks of Florida, Inc. (CSFL, UST 23) on November 21, 2008. The investor received 27,850 preferred shares with a liquidation preference of \$1,000 each and a warrant to purchase 250,825 shares at a \$16.67 per share strike price. In the third quarter of 2009, CSFL completed a public offering of its Common Stock in an amount in excess of the value of preferred shares issued to Treasury, which meets the requirements for a Qualified Equity Offering within the meaning of the Purchase Agreement and the Warrant. Upon completion of the public offering, the number of shares issuable upon exercise of the Warrant was reduced to 125,413. On September 30, 2009, the Company redeemed at par all shares of preferred stock issued to the Treasury. On October 9, 2009, CSFL's Board of Directors presented the Treasury with a resolution indicating the Company's desire to repurchase the outstanding warrant associated with the Treasury's investment and their determination of Fair Market Value for those warrant. The Board determined the Fair Market Value of the warrant to be \$168,053 (\$1.34 per share). If the Treasury does not agree with the Board's determination of Fair Market Value, it must object in writing by **Monday, October 19, 2009**.

The CPP Asset Management valuation process has estimated the current Fair Market Value of the CSFL warrant held by the Treasury to be approximately **\$215 thousand** with a valuation range of \$160 thousand to \$275 thousand.

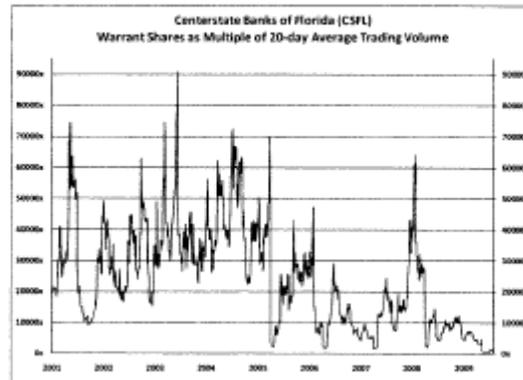


Market Prices

CPP Asset Management sought out market indications for the CSFL warrant held by Treasury. The market participants indicated prices at which they would be willing to purchase the warrant and provided background information on assumptions and parameters used when valuing the warrant. Participants provided reference information including common stock prices, volatility, dividend yields and other inputs. CPP Asset Management could find no comparable securities with observable market prices. Market bids provide an average estimated value of **\$124,995**.

Market Analysis of Warrant Valuation

	Gross Bid (\$ thousands)	Bid Per Share	Reference Stock Price
HF	\$143	\$1.14	\$7.67
IB	\$138	\$1.10	\$7.57
IB	\$94	\$0.75	\$7.67
Avg.	\$125	\$1.00	\$7.64

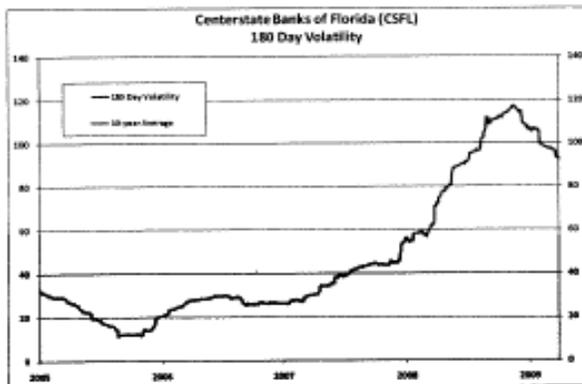


Financial Modeling

CPP Asset Management estimated the value of Treasury's CSFL warrant using a set of financial models. These models, which include the Black-Scholes and binomial option pricing models, depend on known parameters (such as the warrant's strike price, the Company's stock price, and US Treasury rates) and assumptions for unknown parameters (such as future stock volatility and dividend yield). The stock price used for valuation was the 20-day average of closing stock prices ending October 15, 2009. This 20-day average is \$7.77 (CSFL's current stock price as of October 15, 2009 is \$7.37). To reach reasonable assumptions about future stock volatility and dividend yield, CPP Asset Management examined CSFL's implied and historical volatility levels and volatility levels of comparable banks. The recent unusually high volatility and the long-term average volatility for CSFL were also considered. For a dividend yield assumption, historical dividend amounts and dividends yields were examined for trends and long-term averages. A yield of 1.00%, slightly higher than historical experience, was used in the analysis. A marginal borrow cost of 0.30% was included, as indicated by market participants. Using the current 20-day trailing average stock price and assuming long-term annual volatility of 40.0%, an average dividend yield + borrow cost of 1.30%, and an illiquidity discount of 20.0%, the CSFL warrants have an estimated value of **\$212,000**. Using the current stock price of \$7.37, the model estimates a value of \$192 thousand.

Financial Model Analysis of Warrant Valuation Estimate (\$ thousands)

		Annual Stock Volatility		
		35.0%	40.0%	45.0%
Dividend Yield	0.80%	\$184	\$231	\$275
	1.30%	\$170	\$212	\$257
	1.80%	\$158	\$197	\$239



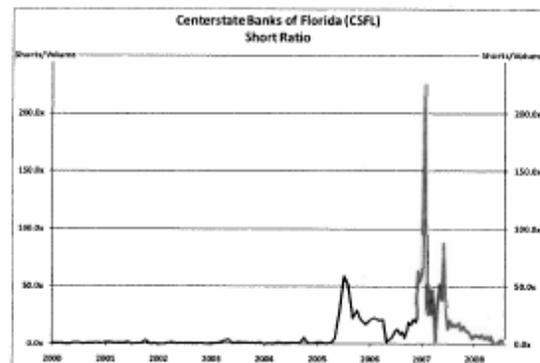
Third Party Analysis

Piedmont Investment Advisors, the CPP external asset manager that covers CSFL, provided a third party model valuation of the CSFL warrant using a binomial model for American style options. The final valuation they provided utilized a dividend yield of 0.90%, an annualized price volatility of 57.59%, and a liquidity discount of 49.10%. Using the current stock price of \$7.57 as of October 13, 2009, Piedmont estimates a value of \$221,034. Using the assumed dividend yield, annualized price volatility, and illiquidity discount with the 20-day trailing average stock price of \$7.81, Piedmont estimated the value of the CSFL warrant to be \$236,020.

Piedmont Estimate of Warrant Valuation

Estimate (\$ thousands)

		Annual Stock Volatility		
		50.00%	57.59%	60.00%
Dividend Yield	0.50%	\$194	\$251	\$268
	0.90%	\$179	\$236	\$253
	1.50%	\$159	\$214	\$232



Appendix H—Supplemental Prospectus

Auction Process

The following describes the auction process used to determine the public offering price of the warrants. That process differs from methods traditionally used in other underwritten public offerings. The selling security holder and the underwriter will determine the public offering price and the allocation of the warrants in this offering by an auction process conducted by the sole book-running manager, Deutsche Bank Securities, in its capacity as the "auction agent." This auction process will involve a modified "Dutch auction" mechanism in which the auction agent (working with a number of other brokers) will receive and accept bids from bidders at either the minimum bid price of \$1.50 or at price increments of \$0.05 in excess of the minimum bid price. We may (but are not required to) bid in the auction for some or all of the warrants. After the auction process closes and those bids become irrevocable (which will occur automatically at the submission deadline to the extent such bids have not been modified or withdrawn at that time), the auction agent will determine the clearing price for the sale of the warrants offered hereby and, if the selling security holder chooses to proceed with the offering, the underwriter will allocate warrants to the winning bidders. The auction agent has reserved the right to round allocations to eliminate odd-lots. The clearing price for the warrants may bear little or no relationship to the price that would be established using traditional valuation methods. You should carefully consider the risks described under "Risk Factors—Risks Related to the Auction Process" beginning on page S-7.

Eligibility and Account Status

In order to participate in the auction process, bidders must have an account with, and submit bids to purchase warrants through, either the auction agent or one of the other brokers that is a member of the broker network (collectively, the "network brokers") established in connection with the auction process. Brokers that are not network brokers will need to submit their bids, either for their own account or on behalf of their customers, through the auction agent or a network broker. If you wish to bid in the auction and do not have an account with the auction agent or a network broker, you will either need to establish such an account prior to bidding in the auction (which may be difficult to do before the submission deadline) or contact your existing broker and request that it submit a bid through the auction agent or a network broker. Network brokers and other brokers will have deadlines relating to the auction that are earlier than those imposed by the auction agent, as described below under "—The Auction

Because the warrants are complex financial instruments for which there is no established trading market, the auction agent, each network broker and any other broker that submits bids through the auction agent or any network broker will be required to establish and enforce client suitability standards, including eligibility, account status and size, to evaluate whether an investment in the warrants is appropriate for any particular investor. Each of them will individually apply its own standards in making that determination, but in each case those standards will be implemented in accordance with the applicable requirements and guidelines of FINRA. If you do not meet the relevant suitability requirements of the auction agent or another

broker, you will not be able to bid in the auction. Accounts at the auction agent or any other broker, including broker accounts, are also subject to the customary rules of those institutions. You should contact your brokerage firm to better understand how you may submit bids in the

The auction agent or network brokers may require bidders (including any brokers that may be bidding on behalf of their customers) to submit additional information, such as tax identification numbers, a valid e-mail address and other contact information, and other information that may be required to establish or maintain an account.

The auction agent and the network brokers, upon request, will provide certain information to you in connection with the offering, including this prospectus supplement and the accompanying prospectus and forms used by such brokers, if any, to submit bids. Additionally, you should understand that:

- before submitting a bid in the auction, you should read this prospectus supplement, including all the risk factors;
- the minimum bid price was agreed by the auction agent and Treasury, and we did not participate in that determination and therefore cannot provide any information regarding the factors that Treasury and Deutsche Bank Securities considered in determining the minimum bid price;
- if bids are received for 100% or more of the offered warrants, the public offering price will be set at the auction clearing price (unless the selling security holder decides, in its sole discretion, not to sell any warrants in the offering after the clearing price is determined);
- if bids are received for half or more, but less than all, of the offered warrants, then the selling security holder may (but is not required to) sell, at the minimum bid price in the auction (which will be deemed the clearing price) as many warrants as it chooses to sell up to the number of bids received in the auction, so long as at least half of the offered warrants are sold, and that in such a case if the selling security holder chooses to sell fewer warrants than the number of warrants for which bids were received, then all bids will experience equal pro-rata allocation;
- if bids are received for less than half of the offered warrants, the selling security holder will not sell any warrants in this offering;
- if there is little or no demand for the warrants at or above the clearing price once trading begins, the price of the warrants will decline;
- we will be allowed (but are not required) to bid in the auction and, if we do participate, will participate on the same basis as all other bidders without receiving preferential treatment of any kind;
- the liquidity of any market for the warrants may be affected by the number of warrants that the selling security holder elects to sell in this offering and the number of warrants, if any, that we purchase in the auction process, and the price of the warrants may decline if the warrants are illiquid;

- the auction agent has the right to reconfirm any bid at its discretion by contacting the purported bidder directly and to impose size limits on the aggregate size of bids that it chooses to accept from any bidder, including network brokers (although the auction agent is under no obligation to reconfirm bids for any reason). If you are requested to reconfirm a bid and fail to do so in a timely manner, the auction agent may deem your bid to have been withdrawn, but alternatively may in its discretion choose to accept any such bid even it has not been reconfirmed;
- the auction agent may reject any bid that it determines, in its discretion, has a potentially manipulative, disruptive or other adverse effect on the auction process or the offering; and
- the auction agent will not provide bidders (including us) with any information about the bids of other bidders or auction trends, or with advice regarding bidding strategies, in connection with the auction process.

None of the underwriter, the selling security holder, or we have undertaken any efforts to qualify the warrants for sale in any jurisdiction outside the United States. Except to the limited extent that this offering will be open to certain non-U.S. investors under private placement exemptions in certain countries other than the United States, investors located outside the United States should not expect to be eligible to participate in this offering.

Even if a bidder places a bid in the auction, it may not receive an allocation of the warrants in the offering for a number of reasons described below. You should consider all the information in this prospectus supplement and the accompanying prospectus in determining whether to submit a bid, the number of warrants you seek to purchase and the price per warrant you are willing to pay.

The following brokers have agreed to be network brokers for purposes of the auction process: BB&T Capital Markets, a Division of Scott & Stringfellow, LLC; Blaylock Robert Van, LLC; Cabrera Capital Markets, LLC; Cantor Fitzgerald & Co.; CastleOak Securities, L.P.; Guzman & Company; Keefe, Bruyette & Woods, Inc.; Loop Capital Markets, LLC; Nomura Securities International, Inc.; Samuel A. Ramirez & Company, Inc.; Sandler O'Neill & Partners, L.P.; Muriel Siebert & Co., Inc.; SL Hare Capital, Inc.; Stifel, Nicolaus & Company, Incorporated; Toussaint Capital Partners, LLC; Utendahl Capital Group, LLC; Wedbush Morgan Securities Inc.; and The Williams Capital Group, L.P. The network brokers will not share in any underwriting discounts or fees paid by the selling security holder in connection with the offering of the warrants but may, subject to applicable FINRA and SEC rules and regulations, charge a separate commission to their own customers.

The Auction Process

The following describes how the auction agent will conduct the auction process:

General

- The auction commenced at 8:00 a.m., New York City time, on December 15, 2009, the date specified by the auction agent via press release prior to the opening of the equity markets on such day, and closed at 6:30 p.m., New York City time, on that same day (the "submission deadline"). Unless you submit your bids through the auction agent, your broker will have an earlier deadline for accepting bids. If a malfunction, technical or mechanical problem, calamity, crisis or other similar event occurs that the auction agent

believes may interfere with the auction process, the auction agent may (in consultation with the selling security holder) decide to extend the auction or cancel and reschedule the auction. The auction agent and the network brokers will advise bidders of any such decision to extend or cancel and reschedule the auction using e-mail, telephone or facsimile, and will attempt to make such notification prior to the time the auction is scheduled to close. If the auction process is extended such that it closes at a later time on the same business day, any bids previously submitted will continue to be valid unless amended or cancelled by the bidder, but if the auction is extended such that it closes on the following business day or later, or is cancelled, all bids will be cancelled at the time of such extension or cancellation. We are permitted (but are not required) to bid in the auction in the manner described in the last bullet point under "—The Bidding Process" below.

- During the auction period, bids may be placed at any price (in increments of \$0.05) at or above the minimum bid price of \$1.50 per warrant.
- The auction agent and the network brokers will contact potential investors with information about the auction process and how to participate and will solicit bids from prospective investors via electronic message, telephone and facsimile. The minimum size of any bid is 100 warrants.

The Bidding Process

- The auction agent and the network brokers will only accept bids in the auction process at the minimum bid price and above the minimum bid price at increments of \$0.05.
- No maximum price or auction price range has been established in connection with the auction process, which means that there is no ceiling on the price per warrant that you or any other bidder can bid in the auction. If you submit a market bid (*i.e.*, a bid that specifies the number of warrants you are willing to purchase without specifying the price you are willing to pay), that bid will be treated as a bid at the highest price received from any bidder in the auction.
- Once the auction begins, you may submit your bids either directly through the auction agent or through any network broker. Bids through the network brokers will be aggregated and submitted to the auction agent as single bids at each price increment by those brokers. Bids will only be accepted if they are made on an unconditional basis (*i.e.*, no "all-or-none" bids will be accepted).

In connection with submitting a bid, you will be required to provide the following information:

- the number of warrants that you are interested in purchasing;
- the price per warrant you are willing to pay; and
- any additional information that may be required to enable the auction agent and/or network broker to identify you, confirm your eligibility and suitability for participating in this offering, and, if you submit a successful bid, consummate a sale of warrants to you.
- You may submit multiple bids. Canceling one bid does not cancel any other bid.

However, as bids are independent, each bid may result in an allocation of warrants. Consequently, the sum of your bid sizes should be no more than the total number of warrants you are willing to purchase. In addition, the auction agent may impose size limits on the aggregate size of bids that it chooses to accept from any bidder (including any network broker), although the auction agent is under no obligation to do so or to reconfirm bids for any reason.

- At any time prior to the submission deadline, you may modify your bids to increase or decrease the number of warrants bid for or the price bid per warrant and may withdraw your bid and reenter the auction. Network brokers, however, will impose earlier submission deadlines than that imposed by the auction agent in order to have sufficient time to aggregate bids received from their respective customers and to transmit the aggregate bid to the auction agent before the auction closes. If you are bidding through a network broker, or another broker that is submitting bids through the auction agent or network broker, you should be aware of any earlier submission deadlines that may be imposed by your broker.
- Conditions for valid bids, including eligibility standards and account funding requirements, may vary from broker to broker. Some brokers, for example, may require a prospective investor to maintain a minimum account balance or to ensure that its account balance is equal to or in excess of the amount of its bid. No funds will be transferred to the underwriter until the acceptance of the bid and the allocation of warrants.
- A bid received by the auction agent or any network broker involves no obligation or commitment of any kind prior to the submission deadline. Therefore, you will be able to withdraw a bid at any time prior to the submission deadline (or any deadline imposed by a network broker, if you are bidding through a network broker). Following the submission deadline, however, all bids that have not been modified or withdrawn by you prior to the submission deadline will be considered final and irrevocable and may be accepted. The auction agent and the selling security holder will rely on your bid in setting the public offering price and in sending notices of acceptance to successful bidders.
- If you are requested to reconfirm a bid and fail to do so in a timely manner, the auction agent may deem your bid to have been withdrawn. The auction agent may, however, choose to accept your bid even if it has not been reconfirmed.
- The auction agent may reject any bid that it determines, in its discretion, has a potentially manipulative, disruptive or other adverse effect on the auction process or the offering.
- The auction agent will not provide bidders (including us) with any information about the bids of other bidders or auction trends, or with advice regarding bidding strategies, in connection with the auction process.
- The auction agent or any network broker may require you to deposit funds or securities in your brokerage accounts with value sufficient to cover the aggregate dollar amount of your bids. Bids may be rejected if you do not provide the required funds or securities

within the required time. The auction agent or any network broker may, however, decide to accept successful bids regardless of whether you have deposited funds or securities in your brokerage accounts. In any case, if you are a successful bidder, you will be obligated to purchase the warrants allocated to you in the allocation process and will be required to deposit funds in your brokerage accounts prior to settlement, which is expected to occur three or four business days after the notices of acceptance are sent to you.

- We will be allowed (but we are not required) to bid in the auction. If we decide to bid, we will participate on the same basis as all other bidders without receiving preferential treatment of any kind. You will not be notified by either the auction agent, the network brokers or the selling security holder whether we have bid in the auction or, should we elect to participate in the auction, the terms of any bid or bids we may place. We will be required to submit any bids we make through the auction agent. The submission of issuer bids may cause the clearing price in the auction process to be higher than it would otherwise have been absent such bids.

Pricing and Allocation

- Deutsche Bank Securities will manage the master order book that will aggregate all bids and will include the identity of the bidders (or their brokers, in the case of bids submitted through a network broker). The master order book will not be available for viewing by bidders (including us). Bidders whose bids are accepted will be informed about the result of their bids.
- If valid, irrevocable bids are received for all or more of the warrants being offered, the clearing price will equal the highest price in the auction process at which the quantity of all aggregated bids at or above such price equals 100% or more of the number of warrants being offered.
- If valid irrevocable bids are received for at least 50% but less than 100% of the warrants being offered, the clearing price will equal the minimum bid price.
- Unless the selling security holder decides not to sell any warrants or as otherwise described below, all warrants will be sold to bidders at the clearing price.

If the number of warrants for which bids are received in the auction is:

- 100% or more of the number of warrants offered in this offering as disclosed on the cover of this prospectus supplement (the "Number of Offered Warrants"), then all warrants sold in the offering will be sold at the clearing price (although the selling security holder could, in its discretion, decide to refrain from selling any warrants in the offering after the clearing price has been determined);
- 50% or more but less than 100% of the Number of Offered Warrants, then the selling security holder may, but will not be required to, sell, at the clearing price (equal to the minimum bid price) as many warrants as it chooses to sell up to the number of bids received in the auction; provided that if it chooses to sell any warrants in such a case it will sell a number of warrants equal to at least 50% of the Number of Offered Warrants; or

- Less than 50% of the Number of Offered Warrants, then the selling security holder will not sell any warrants in this offering.
- Promptly after the auction agent determines the clearing price, it will communicate that clearing price to the selling security holder. The selling security holder may decide not to sell any warrants after the clearing price is determined. Once the selling security holder confirms its acceptance of the clearing price (and, in the case where bids are received for fewer than 100% of the warrants being offered, the number of warrants to be sold), the auction agent will confirm allocations of warrants to its clients and the network brokers. The underwriter will sell all warrants at the same price per warrant.
- If bids for all the warrants offered in this offering are received, and the selling security holder elects to sell warrants in the offering, allocation of the warrants will be determined by, first, allocating warrants to any bids made above the clearing price, and second, allocating warrants on a pro-rata basis among bids made at the clearing price. The pro-rata allocation percentage for bids made at the clearing price will be determined by dividing the number of warrants to be allocated at the bidding increment equal to the clearing price by the number of warrants represented by bids at that bidding increment. Each bid submitted at the clearing price will be allocated a number of warrants approximately equal to the pro-rata allocation percentage multiplied by the number of warrants represented by its bid, rounded to the nearest whole number of warrants; *provided* that bids at the clearing price that are pro-rated may be rounded to the nearest 100 warrants. In no case, however, will any rounded amount exceed the original bid size.
- If bids for half or more, but fewer than all of the warrants offered in this offering are received, and the selling security holder chooses to sell fewer warrants than the number of warrants for which bids were received, then all bids will experience equal pro-rata allocation. In other words, each bid, not just those at the lowest price increment, will be allocated a number of warrants approximately equal to the pro-rata allocation percentage multiplied by the number of warrants represented by its bid, rounded to the nearest whole number of warrants; *provided* that the clearing price that are pro-rated may be rounded to the nearest 100 warrants. In no case, however, will any rounded amount exceed the original bid size.
- After the selling security holder confirms its acceptance of the clearing price (and, in the case where bids are received for fewer than 100% of the warrants being offered, the number of warrants to be sold), the auction agent and each network broker that has submitted bids will notify you, in the event your bids have been accepted, by electronic message, telephone, facsimile or otherwise that the auction has closed and that your bids have been accepted. They may also provide you with a preliminary allocation estimate, which will be subsequently followed by a final allocation and confirmation of sale. In the event your bids are not accepted, you may be notified that your bids have not been accepted. As a result of the varying delivery times involved in sending e-mails over the Internet and other methods of delivery, you may receive notices of acceptance before or after other bidders.
- The clearing price and number of warrants being sold are expected to be announced via press release prior to the opening of the equity markets on the business day following the end of the auction. The price will also be included in the notice of acceptance and the

confirmation of sale that will be sent to successful bidders, and will also be included in the final prospectus supplement for the offering.

- Sales to investors bidding directly through the auction agent will be settled via their accounts with Deutsche Bank Securities, while sales through network brokers will be settled through your account with the broker through which your bid was submitted.
- If you submit successful bids, you will be obligated to purchase the warrants allocated to you regardless of whether you are aware that the notice of acceptance of your bid has been sent. Once an underwriter has sent out a notice of acceptance and confirmation of sale, it will not cancel or reject your bid. The auction agent and the selling security holder will rely on your bid in setting the public offering price and in sending notices of acceptance to successful bidders. As a result, you will be responsible for paying for all of the warrants that are finally allocated to you, at the public offering price.

You should carefully review the procedures of, and communications from, the institution through which you bid to purchase warrants.

Auction Process Developments

You should keep in contact with the institution through which your bid has been submitted and monitor your relevant e-mail accounts, telephone and facsimile for notifications related to this offering, which may include:

- **Potential Request for Reconfirmation.** The auction agent may ask you to reconfirm your bid at its discretion by directly contacting you (or your broker, if you submitted your bid through a broker other than the auction agent), although the auction agent is under no obligation to reconfirm bids for any reason. If you are requested to reconfirm a bid and fail to do so in a timely manner, the auction agent may deem your bid to have been withdrawn. The auction agent may, however, choose to accept your bid even if it has not been reconfirmed.
- **Notice of Additional Information Conveyed by Free-Writing Prospectus.** Notification that additional information relating to this offering is available in a free-writing prospectus.
- **Notice of Acceptance.** Notification as to whether any of your bids are successful and have been accepted. This notification will include the final clearing price. If your bids have been accepted, you will be informed about the results of the auction process

Appendix I—Acronyms

Acronym	Definition
ARRA	American Recovery and Reinvestment Act of 2009
COP	Congressional Oversight Panel
CPP	Capital Purchase Program
EESA	Emergency Economic Stabilization Act of 2008
FMV	Fair Market Value
GAO	Government Accountability Office
OFS	Office of Financial Stability
QEO	Qualified Equity Offering
SIGTARP	Special Inspector General for the Troubled Asset Relief Program
SPA	Securities Purchase Agreement
TARP	Troubled Asset Relief Program

Appendix J—Audit Team Members

This report was prepared and the review was conducted under the direction of Kurt Hyde, Deputy Inspector General for Audits, Office of the Special Inspector General for the Troubled Asset Relief Program. The staff members who conducted the audit and contributed to the report include James Shafer, Anne Keenaghan, Amy Poster, and Kamruz Zaman.

Appendix K—Treasury’s Comments



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

May 7, 2010

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

RE: SIGTARP Official Draft Audit Report

Dear Mr. Barofsky:

Thank you for giving the U.S. Department of the Treasury (Treasury) the opportunity to review and comment on your official draft audit report regarding the warrant disposition process. This letter provides our official comment on the draft report.

We are pleased that your report concludes that we have succeeded in negotiating prices from institutions for their warrants that are at or above our estimates of fair market value. Your summary of our methodology for estimating fair market value is particularly informative, and we believe your report should be helpful in explaining this complicated subject to the public.

With respect to your recommendations, we welcome your suggestions. Although we disagree with some of your findings, we will review our procedures to ensure that there is sufficient consistency in our process. We will respond more fully to your findings and provide a detailed description of the actions that Treasury will take with regard to the concerns expressed in the recommendations within 30 days of the issuance of the final audit report.

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

Sincerely,

A handwritten signature in black ink, appearing to read "Herbert M. Allison, Jr.", written in a cursive style.

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

SIGTARP Hotline

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

By Online Form: www.SIGTARP.gov

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

By Fax: (202) 622-4559

By Mail:

**Hotline: Office of the Special Inspector General
for the Troubled Asset Relief Program**
1801 L Street., NW, 4th Floor
Washington, D.C. 20220

Press Inquiries

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

Kristine Belisle
Director of Communications
Kris.Belisle@do.treas.gov
202-927-8940

Legislative Affairs

For Congressional inquiries, please contact our Legislative Affairs Office:

Lori Hayman
Legislative Affairs
Lori.Hayman@do.treas.gov
202-927-8941

Obtaining Copies of Testimony and Reports

To obtain copies of testimony and reports, please log on to our website at www.sigtar.gov.

