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**Testimony by Henry M. Paulson
Before the House Committee on
Oversight and Government Reform
July 16, 2009, 10:00 a.m.**

Chairman Towns, Ranking Member Issa, and distinguished Members of the Committee.

I served as Secretary of the Treasury from July 2006 to January 2009. During my tenure, the world experienced a financial crisis unprecedented in our lifetimes. The crisis presented a relentless series of novel challenges that required swift, innovative, and dramatic responses. I am proud to have been among the many public servants—in the Congress and at Treasury, the Federal Reserve, the FDIC, the OCC, and other agencies of the government—who came together to confront these challenges and to prevent a far more damaging meltdown of our financial system.

Had the crisis of 2008 been left to unfold without strong federal reaction and intervention, the world of 2009 would look very different from the world we live in today. Many more Americans would be without their homes, their jobs, their businesses, their savings, and their way of life. Although commentary on the crisis often focuses on events at financial institutions, the human suffering of the crisis has been staggering in ways that are beyond measure. Unemployment reached historic levels. Savings were depleted. Americans lost trillions of dollars in home value, and many lost their homes. Yet without the actions taken in 2008, that suffering would have been far more profound and disturbing.

Our financial system underpins our modern economy; commerce today requires a string of payments, whether that string of payments is for delivering a gallon of milk from farm to consumer or for delivering a new product from idea to production. And that string of payments depends on trust. Our financial system works because consumers and investors have confidence in the strength of financial institutions.

Last fall, that confidence was largely gone, especially among those who lend to financial institutions by purchasing their debt. The crisis of confidence threatened to disrupt our entire financial system—not just the institutions that had high credit losses on their mortgage investments, but all financial firms, whether weak or solvent, would have suffered as widespread fear prevented investors from lending to any financial institution. As liquidity dried up, the continued collapse of financial institutions that provide credit and handle payments for our economy would have meant that firms across industries—not just Wall Street, but every street—would have seen a massive curtailment of their access to liquidity and thus their ability to purchase supplies and pay employees. Missed payrolls would quickly have turned into even more millions of layoffs, and this in turn would have meant an even greater retreat of consumer spending than we have witnessed since last September. It would have been extremely difficult to break the momentum of this downward spiral.

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Fortunately, the most dire of consequences were averted. I am proud that, along with many others, I brought what experience, talent, and efforts I could to right our nation's course.

Now that the financial system has stabilized, many, including this Committee, have begun to look back to analyze the efficacy of our responses to the crisis as it unfolded. Learning the lessons of the past is a necessary and important step as we forge our way forward. The complexity of the crisis and the multifaceted character of the solutions, coupled with the short time in which decisions had to be made, will all require careful consideration and analysis to help the current Administration and future generations understand and confront issues of economic crisis. Our responses were not perfect, and, even when our actions proved effective, Congress and many in the private sector played a significant role. But, having had the benefit of some time to reflect, and to consider views expressed by others, I am confident that our responses were substantially correct and that they saved this nation from great peril.

One component of our response, which I have been invited to discuss today, was the assistance that the Federal Government provided to Bank of America in January of this year in a transaction that surely prevented destabilization of our financial system.

* * *

During his testimony before this Committee, Ken Lewis, the CEO of Bank of America, set forth the relevant events, which I will reiterate briefly. On September 15, 2008, Bank of America entered into an agreement to acquire Merrill Lynch. On November 26, 2008, the Board of Governors of the Federal Reserve approved the merger. The shareholders of both firms ratified the merger agreement on December 5, 2008.

On December 17, 2008, Mr. Lewis called me and told me that Bank of America was considering exercising the "material adverse change"—or MAC—clause to terminate the Merrill Lynch acquisition. I recognized the danger that the potential dispute arising from invocation of the MAC clause would pose for Bank of America, for Merrill Lynch, and for the economy as a whole, and that evening, at my request, Mr. Lewis met with Chairman Bernanke, me, and other Federal Reserve and Treasury officials to discuss the matter. Mr. Lewis explained that Bank of America's concerns related to Merrill Lynch's accelerating fourth quarter loss projections and the effect they would have on the combined entity.

Late December of 2008 was a period of great vulnerability for our markets and our economy. In December our economy hit a low point. Bank earnings were particularly weak and our financial markets and institutions were fragile. There was not sufficient TARP capacity to respond to the financial chaos that would have been triggered by Bank of America's invocation of the MAC clause.

In the few days following Mr. Lewis's call to me, officials from the Federal Reserve and Treasury conferred among themselves and with Bank of America representatives

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regarding these issues. My participation in that process consisted of conversations with people from the Federal Reserve, including several with Chairman Bernanke, and with Treasury personnel. During this period, the clear conclusion of Federal Reserve lawyers was that exercise of the MAC clause was not a legally reasonable option and, accordingly, that the merger contract was binding. Moreover, all public officials involved, including Mr. Bernanke and me, believed that the failure to consummate the merger would likely create immediate financial market instability, would threaten the viability of both firms, and would call into serious question the judgment of Bank of America's leadership.

On December 21, 2008, I relayed the substance of those conclusions to Mr. Lewis. My conversation with Mr. Lewis, which has been the subject of much subsequent commentary, was accurately recounted in Mr. Lewis's testimony before this Committee, and I will discuss it again in a moment.

On December 22, 2008, we learned that Bank of America's board had determined not to exercise the MAC clause, and that Bank of America intended to work with the Federal Reserve and Treasury to obtain government financial support for the combined entity once the merger was closed. Although Bank of America did not, at that time, have any firm agreement with the government, its decision was reached against the backdrop of a clear public commitment undertaken by Chairman Bernanke and me, dating back at least to October 14, 2008, that the government would act to prevent the failure of any systemically important financial institution. I had reiterated that commitment often in the months preceding Bank of America's decision to forgo any attempt to invoke the MAC clause. Given that commitment, it was clear that if the merger proceeded and the combined Bank of America Merrill Lynch entity needed financial support, the government would work to provide such appropriate and necessary support.

On January 1, 2009, the Bank of America Merrill Lynch merger was completed as planned. Over the following weeks, representatives of Bank of America worked closely with officials from the Federal Reserve, Treasury, and the FDIC to arrange an appropriate support package. On January 16, 2009, Treasury, the Federal Reserve, and the FDIC announced an agreement to provide Bank of America with \$20 billion in TARP funds, as well as FDIC protection against losses on certain assets, in exchange for preferred stock, restrictions on executive compensation, and other covenants.

* * *

Subsequent analysis of these events has raised three issues that should be addressed at the outset of this hearing.

First, some have opined that government officials involved in examining the Bank of America Merrill Lynch merger—myself included—allowed concerns about systemic risk to our nation's financial system to outweigh concerns about potential harm to Bank of America and its shareholders. That simply did not happen. In my view, and the view of the numerous government officials working on the matter, the interests of the nation and

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Bank of America were aligned with respect to the closing of the Merrill Lynch transaction. An attempt by Bank of America to break its contract to acquire Merrill Lynch would have threatened the stability of our entire financial system and the viability of both Bank of America and Merrill Lynch. Those who participated in the discussions concerning this matter recognize this point. For example, as Mr. Lewis explained to this Committee last month, “I think they thought that by us—by all of this happening [i.e., the potential failure of the merger], and the uncertainty coming back into the financial system, that, in fact, that would hurt the system and us.”¹

I agree with that general sentiment. Also, although I did not see the document at the time, I agree with the detailed analysis conducted by Bank of America’s regulator, the Federal Reserve, which concluded that the failure of the merger would have caused significant disruption to the interbank and credit markets which would have rippled out to financial institutions broadly and Bank of America specifically.² In his testimony on June 25th before this Committee, Chairman Bernanke said it succinctly: “. . . I expressed concern that invoking the MAC would entail significant risks not only for the financial system as a whole, but also for Bank of America itself.”³

Moreover, based on my own experience working in financial markets, I knew that the attempt to revoke the merger contract would have caused great uncertainty and fear in the market, would likely have caused the markets to question Bank of America’s financial strength and managerial competence, and would have led to rating downgrades, weakened liquidity, possible failure and, of course, regulatory action. In short, Bank of America’s completion of the merger, and the subsequent assistance from the government, not only protected our country’s financial system, but also was in the best interest of the shareholders, customers, employees, and creditors of Bank of America and Merrill Lynch. Or, as Mr. Lewis put it, “there was serious risk to declaring a material adverse change and . . . proceeding with the transaction with governmental support was the better course. This course made sense for Bank of America and its shareholders, and it made sense for the stability of the markets.”⁴

Second, some have suggested that there was something inappropriate about my conversation of December 21st with Mr. Lewis in which I mentioned the possibility that the Federal Reserve could remove management and the board of Bank of America if the bank invoked the MAC clause. I believe my remarks to Mr. Lewis were appropriate. I explained to him that the government was supportive of Bank of America, but that it felt very strongly that if Bank of America exercised the MAC clause, such an action would show a colossal lack of judgment and would jeopardize Bank of America, Merrill Lynch, and the financial system. I further explained to him that, under such circumstances, the

¹ Testimony of Kenneth Lewis, Committee on Oversight and Governance Reform, June 11, 2009 (“Lewis Testimony”).

² Analysis of Bank of America & Merrill Lynch Merger, December 21, 2008, at BOG-BAC-ML-COGR-00039.

³ Testimony of Ben Bernanke, Committee on Oversight and Governance Reform, June 25, 2009 (“Bernanke Testimony”).

⁴ Lewis Testimony.

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Federal Reserve could exercise its authority to remove management and the board of Bank of America. By referring to the Federal Reserve's supervisory powers, I intended to deliver a strong message reinforcing the view that had been consistently expressed by the Federal Reserve, as Bank of America's regulator, and shared by the Treasury, that it would be unthinkable for Bank of America to take this destructive action for which there was no reasonable legal basis and which would show a lack of judgment.

I want to make clear that my words in speaking to Mr. Lewis were my own. Chairman Bernanke never asked me to indicate any specific action the Federal Reserve might take. I also want to make clear, however, that I was expressing what I am confident was the strong opinion of the Federal Reserve, namely, that exercise of the MAC clause was not a legally viable option; that it threatened significant harm to Bank of America and to the financial system; and that it would raise serious questions about the competence and judgment of Bank of America's management and board. I had gained this understanding of the Federal Reserve's position over the course of meetings and several telephone calls in the preceding days. I note that what I said echoes sentiments expressed in internal Federal Reserve emails, including the sentiment attributed to Chairman Bernanke in a December 20, 2008 email from Jeffrey Lacker, in which Chairman Bernanke is said to have remarked the he "intend[ed] to make it even more clear that if [Bank of America] plays that card [invokes the MAC clause] and then need[s] assistance, management is gone."⁵ Chairman Bernanke, when he appeared before this committee in June, put it this way: ". . . I don't think it's unreasonable if someone makes a decision that endangers his company, that he'd be accountable for that."⁶

The sentiment makes sense to me. The management and board of a regulated entity that triggered such destabilization within their own institution could be subject to removal by the Federal Reserve under federal statute,⁷ and should be. Mr. Lewis, in his testimony, acknowledged this authority held by the Federal Reserve. And, Chairman Bernanke also recognized this in his June 25th testimony before this Committee when he said, "the supervisors at the Federal Reserve can make changes or recommend changes in management . . ."⁸ I hasten to add that I do not believe the circumstances ever brought us close to that eventuality, and Bank of America, after its own detailed consideration, acted appropriately in deciding not to invoke the MAC clause.

Third, the suggestion has been made that I discouraged Mr. Lewis from making required disclosures to the public markets about losses at Merrill Lynch. That simply did not happen—and Mr. Lewis has accordingly denied it unequivocally in testimony before this Committee. Mr. Lewis said, "[n]either Secretary Paulson nor the chairman of the Federal Reserve, Mr. Bernanke, ever told me not to disclose something that we publicly—that we felt should be publicly disclosed."⁹ And, he further stated that, "[d]uring all of that time

⁵ E-mail from J. Lacker, Dec. 20, 2008, BOG-BAC-ML-COGR-00020.

⁶ Bernanke Testimony.

⁷ See, e.g., 12 U.S.C. § 1818(e).

⁸ Bernanke Testimony.

⁹ Lewis Testimony.

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there was never, ever a time that the Federal Reserve or the Treasury Department told me that we should not disclose something that we thought would be a disclosable event.”¹⁰

As Mr. Lewis recounted, he did request a letter from me confirming government support, and I declined to provide it. In doing so, I told him that a letter would be vague and unsatisfactory because no program had yet been developed. For example, we had not determined the size of the potential program, the type of equity it would use, or which assets it would involve. I also told him that if Treasury provided a letter, then Treasury would publicly disclose it. I did not—nor to my knowledge did anyone at the Federal Reserve or Treasury—tell Mr. Lewis not to disclose any information to the public markets, including Merrill Lynch losses, that Bank of America believed it was legally required to disclose.

* * *

Although attention has recently focused on brief moments of stress during the events of December 2008, those moments are not foremost in my recollection. What I recall most vividly is a nation faced with the threat of an unparalleled economic crisis and the efforts of the men and women from both the public and private sectors who worked hard to steer our country away from that precipice. It was my privilege to work with them, and I am proud of what we accomplished.

The programs we put in place at the height of the turmoil continue to provide critical support to our financial markets. As the markets stabilize and begin to recover, we are now entering a critical phase of reforming our regulatory system so a crisis like this never happens again. There are many parts of our fragmented regulatory system that must be reformed, reshaped, and reconstituted, so that lines of authority are clear, regulators can make decisions, and no institution can exploit seams in the system. Among the most important steps we must take is the creation of a resolution authority so that large, interconnected institutions can fail without a systemic impact. I began calling for such authority last summer, and I applaud the recent proposal to that effect put forward by President Obama. Had the government had such authority in early 2008, three of the important events that rattled markets—Bear Stearns, Lehman Brothers, and AIG—could have been handled very differently, with far less impact on the stability of our financial system and our economy.

I urge all of you to move quickly and thoughtfully to build a regulatory framework that gives government the appropriate authorities to intervene and facilitate the orderly wind down of a systemically important institution, and to make the other reforms necessary to create a coherent, flexible regulatory structure. I urge you to build a structure where regulators have clear accountability for market stability, institutional safety and soundness, and consumer and investor protection. And I urge you to build a structure that can meet those objectives even as innovation constantly brings new products and new business models into the market. Dynamic markets, and a flexible regulatory

¹⁰ *Id.*

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framework that provides clear guidance to all participants, are vital to our economic recovery and to the restoration of American prosperity.

Thank you, and I would be happy to answer any questions.