## PAULSON & CO. INC.

Founded 1994

## Statement of John Paulson

President and Founder of Paulson & Co. Inc.

U.S. House of Representatives Committee on Oversight and Government Reform

Hearing – November 13, 2008 Washington D.C.

## Statement of John Paulson, President and Founder of Paulson & Co. Inc.

# U.S. House of Representatives Committee on Oversight and Government Reform Hearing – November 13, 2008

Chairman Waxman, Ranking Member Davis and Members of the Committee, thank you for inviting me to appear and for holding important hearings on the origins of the present financial market challenges in the United States.

Paulson & Co. Inc. is an investment advisory firm that was founded in 1994 and has been registered with the Securities and Exchange Commission since 2004. We currently manage assets of approximately \$36 billion using event-driven strategies. We are based in New York and also have offices in London and Hong Kong. We have approximately seventy employees. Prior to founding the firm, I was a Managing Director in Mergers & Acquisitions at Bear Stearns. I am a summa cum laude graduate from New York University and graduated with high distinction, as a Baker Scholar, from Harvard Business School in 1980.

Our investors include pension funds, endowments, banks, insurance companies, family offices and high-net-worth individuals in the U.S. and around the world. All of the investment funds we manage are open only to "qualified purchasers", which are highly sophisticated investors with \$5 million in investable assets if they are individuals, and \$25 million in investable assets if they are institutions.

Our investors look to us to protect their capital, and to show positive returns in both good and bad markets. We do this by going long securities that we think will rise in value and going short securities that we think will decline in value. By constructing a diverse portfolio of both long and short positions, we have been able to operate profitably in 14 out of the last 15 years, including this year and the 2000-2002 periods when the NASDAQ index lost 78% of its value. We believe that our ability to protect our investors' capital and generate positive absolute returns with low volatility over the long term is the reason we have grown to be one of the largest hedge funds in the world.

In our business, one of the most fundamental principles is alignment of our interests with those of our clients. We share profits with our investors on an 80/20 basis where 80% of the profits go to the investors and 20% remains with us. We only earn performance allocations if our investors are profitable. All of our funds have a "high water mark", which means that if we lose money for our investors, we have to earn it back before we share in future profits. Some of our funds also have a "claw back" provision, requiring us to return profits earned in prior periods if we lose money in subsequent periods. In addition, we invest our own money alongside that of our clients, so we share investment losses along with gains.

We are a private company and have no public shareholders. We receive no taxpayer subsidies. All of our investors invest with us on a voluntary basis. We also use very little leverage. Over the past five years, for over half the time our base portfolios were not funded with any borrowed money, and our maximum borrowing as a percentage of equity capital over this period was 33%.

In February 2004, we voluntarily registered with the SEC as an investment advisor. As a registered investment advisor, we are subject to periodic inspections, focused reviews and ad hoc requests for information. We are also subject to stringent recordkeeping requirements and have to file information regularly on the SEC's website. We comply with all rules and regulations not only in the U.S. but in each of the over 15 countries where we invest.

Hedge funds, together with real estate, private equity and venture capital, are frequently categorized as "alternative investments", in contrast to traditional stock and bond investing. Hedge funds are an important investment category for investors as returns are generally non-correlated with the traditional market. The hedge fund market has grown rapidly over the past five years, from approximately \$800 million to \$2 trillion in assets under management. The US has remained a leader in this area, accounting for approximately 70% of the market, although we have lost share in recent years to London, Asia, and Switzerland – many of which offer various financial incentives to attract the hedge fund industry.

As Americans, we are proud of the leadership position the United States occupies in this industry, the jobs our industry has created, the export earnings we have produced for our country and the taxes we generate for the Treasury. For example, over the last five years, our firm has increased our employee count by 10x, creating numerous high-paying jobs for Americans. In addition, eighty percent of our assets under management come from foreign investors. The

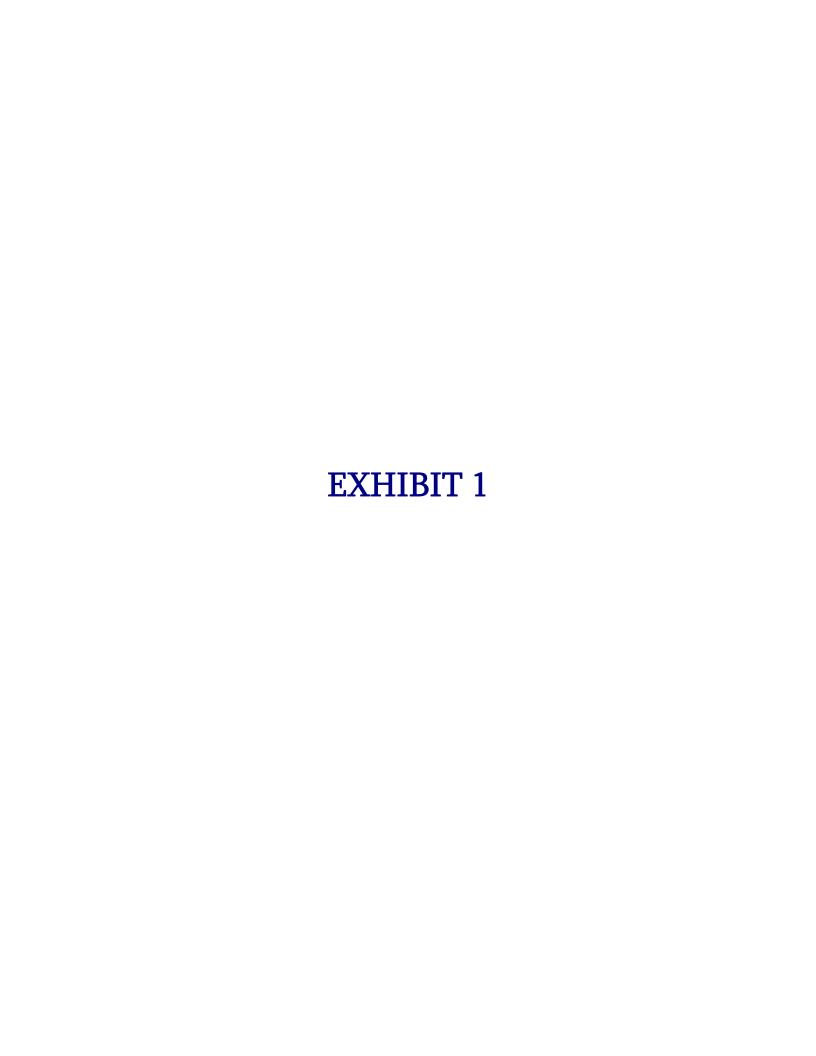
revenues we receive from foreign investors allow us to contribute to the U.S. economy like an exporter of goods, bringing in money from abroad.

In 2005, our firm became very concerned about weak credit underwriting standards, excessive leverage among financial institutions and a fundamental mis-pricing of credit risk. To protect our investors against the risk in the financial markets, we purchased protection through credit default swaps on debt securities we thought would decline in value due to weak credit underwriting. (See Exhibits 1A-1D to this statement.) As credit spreads widened and the value of these securities fell, we realized substantial gains for our investors.

As we saw the difficulty homeowners were having in making mortgage payments, in July 2007, prior to the initiation of any government support programs, Paulson & Co. made a \$15 million charitable contribution to the Center for Responsible Lending to form the Institute for Foreclosure Legal Assistance (IFLA). The institute supports local groups across the country providing legal representation to families facing foreclosure. (See Exhibit 2 to this statement.)

We have also offered some public suggestions on the causes of the credit crisis and what the U.S. government can do to help the situation, specifically purchase senior preferred stock in selected financial institutions. Several weeks ago, the Wall Street Journal ran an op-ed piece which I wrote on this proposal, which provides for maximum taxpayer protection. (See Exhibit 3 to this statement.) Subsequently, the Troubled Asset Recovery Program (TARP) was reoriented to focus on the purchase of preferred stock. I have some thoughts on how future purchases of preferred stock under the TARP can be structured both to protect taxpayers better and to provide greater stability to financial institutions, and I would be pleased to share those thoughts with the Committee. (See Exhibit 4 to this statement.)

Again, thank you for the opportunity to address this Committee and share our views. I would be pleased to take your questions.



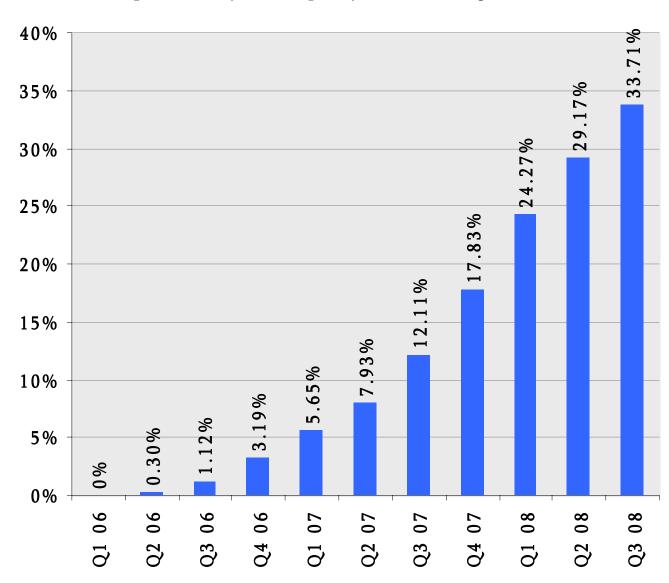
## SUBPRIME RESIDENTIAL MORTGAGE-BACKED SECURITIZATION EXAMPLE

<u>Class</u>	Ratings	Class Amount Outstanding		Subordination	Spread to One- Month <u>LIBOR</u>
A1A	Aaa (AAA)	\$ 7	757,819,000		0.14
A1B1	Aaa (AAA)		417,082,000		0.15
A1B2	Aaa (AAA)		104,270,000		0.15
A2A	Aaa (AAA)		356,980,000		0.04
A2B	Aaa (AAA)		127,685,000		0.09
A2C	Aaa (AAA)		88,606,000		0.15
A2D	Aaa (AAA)		78,490,000	23.9%	0.25
M1	Aa1 (AA+)		101,428,000	19.9%	0.27
M2	Aa2 (AA)		92,553,000	16.2%	0.29
M3	Aa3 (AA-)		57,053,000	14.0%	0.30
M4	A1 (A+)		48,178,000	12.1%	0.45
M5	A2 (A)		45,643,000	10.3%	0.48
M6	A3 (A-)		41,839,000	8.6%	0.58
M7	Baa1 (BBB+)		40,571,000	7.0%	0.95
M8	Baa2 (BBB)		36,768,000	5.6%	1.35
M9	Baa3 (BBB-)		26,625,000	4.5%	2.45
M10	Ba1 (BB+)		31,696,000	3.3%	5.50
Over Collateralization			82,415,903		
		\$ 2,5	535,701,903		
(a) Equi	valent S&P rating in	n parenthe	ses.		

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Subprime 60 Days+ Delinquency Rate (including FCL & REO)



#### Source: Loan Performance

## **ABX BBB: Historical Prices**

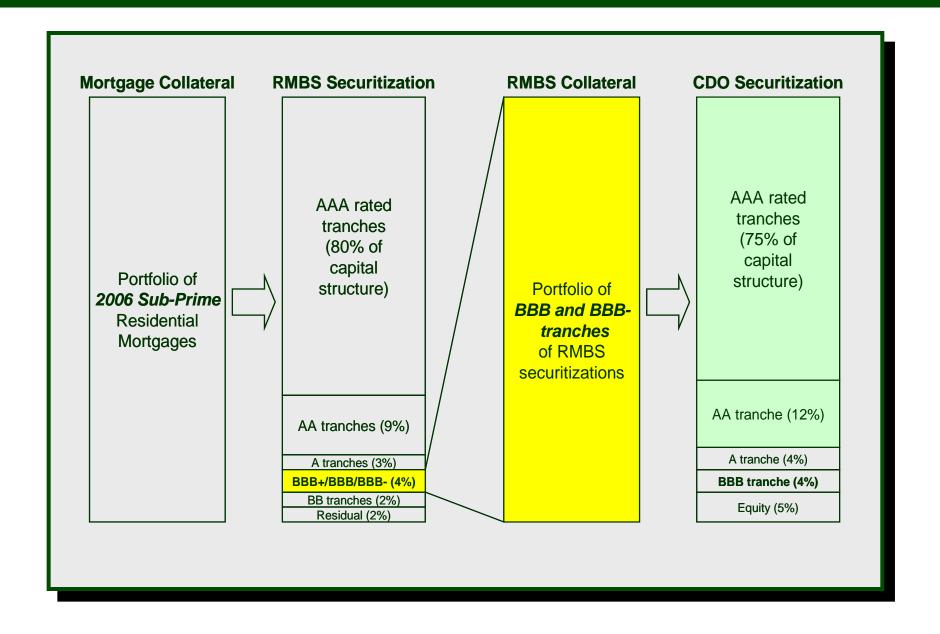


#### Source: Goldman Sachs

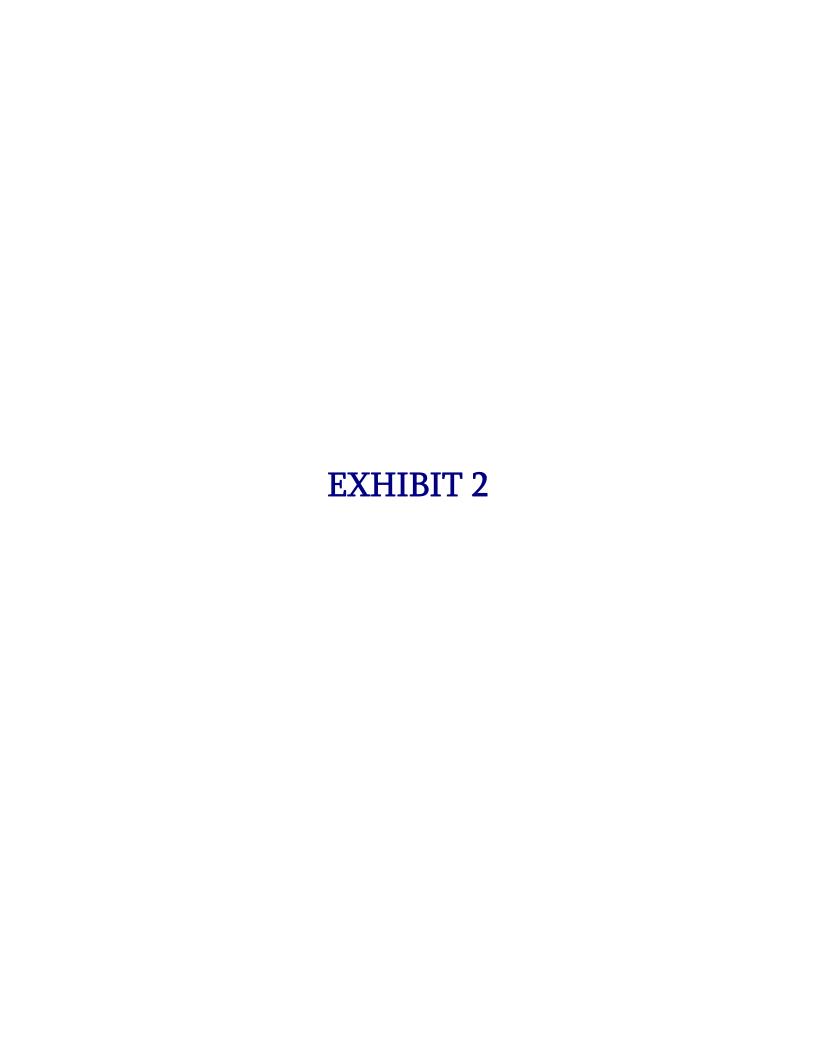
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### MORTGAGE/RMBS/CDO SECURITIZATION CHAIN



INC.







## FOR IMMEDIATE RELEASE October 12, 2007

# Helping Americans Keep Their Homes: Center for Responsible Lending Establishes New Institute to Help Homeowners Threatened by Subprime Lending Crisis

Institute to Provide Legal Assistance to Families Facing Surge in Foreclosures

WASHINGTON, D.C. (October 12, 2007)—As the nation's foreclosure epidemic continues to worsen, the Center for Responsible Lending (CRL) has formed the Institute for Foreclosure Legal Assistance (IFLA) to support groups giving legal representation to families facing foreclosure and financial ruin because of abusive subprime mortgages. The National Association of Consumer Advocates (NACA) will manage the project, which recognizes that one of the biggest barriers families face to avoid losing their homes is the lack of access to quality legal services.

The Institute, launched with a \$15 million grant from investment management firm Paulson & Co. Inc., will provide funding and training to organizations that help homeowners negotiate alternatives to foreclosure. The majority of the funds will be grants to support direct legal assistance to borrowers in 10 or more states to fight foreclosure, predatory lenders and abusive loan servicers. It will do this primarily by providing money to top non-profit legal-aid groups and law school clinics.

Formation of the Institute comes as the rate of subprime foreclosures, already alarmingly high, is set to accelerate. Analysts have predicted that as many as 1.7 million foreclosures will occur in the next two to three years. Within the next eighteen months, up to four million subprime borrowers will see their monthly mortgage payments jump approximately 40% as initial "teaser" interest rates expire. Servicers and lenders have largely refused to modify these abusive subprime loans. According to a recent study by Moody's, only 1% of loans that reset to a higher interest rate were modified by servicers. Lenders and servicers are simply not modifying these mortgages in sufficient numbers to help homeowners.

"Legal resources available to help struggling families fall far short of that needed to address the millions of abusive loans that have been made in recent years," said Martin Eakes, Chief Executive Officer of CRL. "By providing funding and other support for attorneys who can review loan documents and negotiate with loan servicers, we believe that many more homeowners will be able to stay in their homes."

NACA executive director Ira Rheingold will manage the new Institute. "The only meaningful way to help families save their homes is to help them get access to quality legal assistance," he said. "In many cases, families need legal help to keep their homes.

Helping Americans Keep Their Homes Page 2 of 3

We hope to be able to help provide legal representation to at least 5,000 families with these funds so that families can keep their homes."

John Paulson, founder and head of Paulson & Co. Inc., said he hopes that his firm's donation is just the beginning: "CRL and NACA both have long histories of working to ensure that homeowners get fair treatment from mortgage lenders. We are pleased to help them provide legal services to distressed homeowners, many of whom have been victimized by predatory lenders. We hope that our grant will spur additional funds for these types of efforts from public and private sources to help more homeowners avoid foreclosure."

Willard Ogburn, Executive Director of the National Consumer Law Center, said, "We see every day the desperate need for quality legal help for families in financial crisis facing the loss of their home. Additional resources will mean more essential assistance for families in need. The Center will do all that it can to help address the current crisis in homeownership."

Wade Henderson, President and CEO of the Leadership Conference on Civil Rights, said, "Every day we hear about industry bail-outs from the foreclosure crisis they created, but homeowners trying to save the roofs over their heads have very limited options for getting help and industry does not seem interested in taking meaningful steps that would make a real difference. The Institute was created to help borrowers today who can't wait for tomorrow to try to save their homes. This initiative is an important step in the right direction to help provide effective legal assistance to those who desperately need it."

Shanna Smith, President and CEO of the National Fair Housing Alliance, said of the announcement, "It's high time that Americans facing foreclosure got some helpful news. This Institute for Foreclosure Legal Assistance is critical because without it families will lose their homes. We can no longer wait on industry to fix the problem."

The Institute should be up and running within a few months. It will be headquartered in Washington, DC at the offices of CRL and NACA.

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The Center for Responsible Lending is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions. For more information visit <a href="www.responsiblelending.org">www.responsiblelending.org</a>

The National Association of Consumer Advocates (NACA) is a nationwide organization of more than 1000 attorneys who represent and have represented hundreds of thousands of consumers victimized by fraudulent, abusive and predatory business practices. As an organization fully committed to promoting justice for consumers, NACA's members and their clients are actively engaged in promoting a fair and open marketplace that forcefully protects the rights of consumers, particularly those of modest means. For more information visit <a href="https://www.naca.net">www.naca.net</a>

Paulson & Co. Inc. is a New York-based investment management firm, with \$23.5 billion in assets across merger, event-driven, distressed and credit-focused strategies.

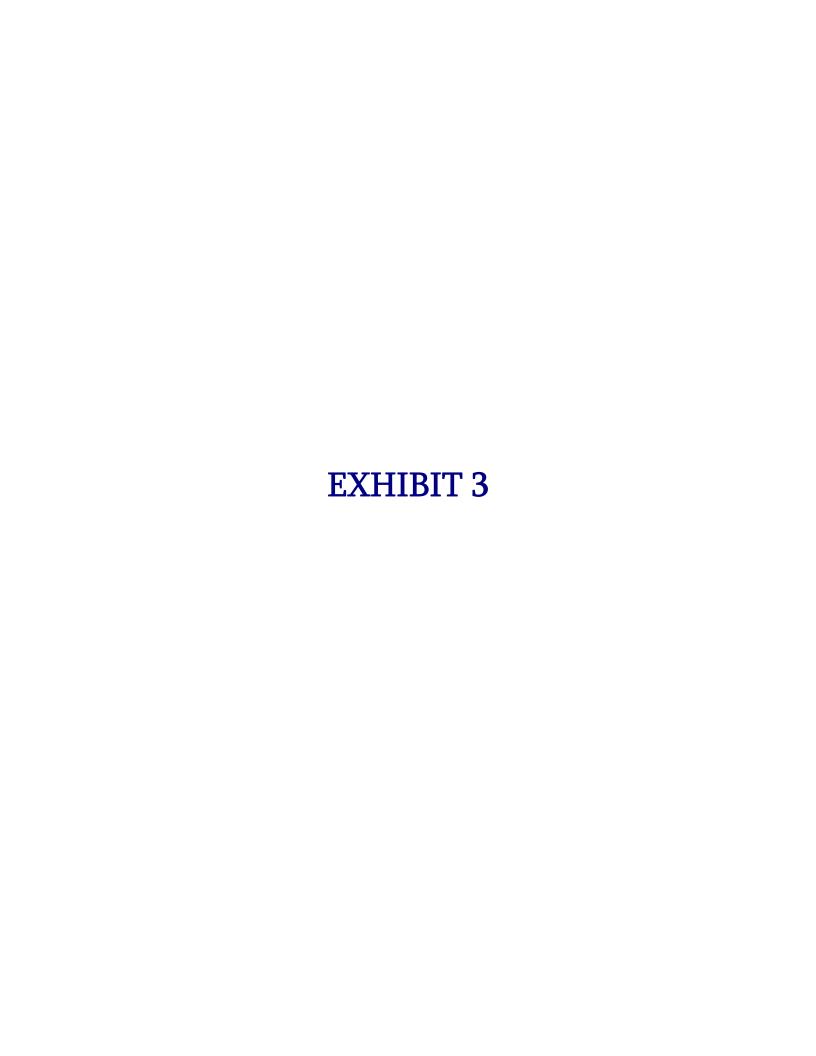
#### Helping Americans Keep Their Homes Page 3 of 3

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#### THE WALL STREET JOURNAL

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OPINION | SEPTEMBER 26, 2008

### The Public Deserves a Better Deal

By JOHN PAULSON

The Treasury plan to buy illiquid financial assets has been widely criticized as being unfair to taxpayers, who will have to bear losses ahead of shareholders of the institutions that will be bailed out.

There is a better alternative to stabilize the markets: Invest the \$700 billion of taxpayer money in senior preferred stock of the troubled financial institutions that pose systemic risks. Let's call this the "Preferred plan." In fact, it is the Fannie Mae and Freddie Mac model -- which the Treasury Department has already endorsed and used in practice. It is also the approach Warren Buffett used for his investment in Goldman Sachs.

There are major problems with the Treasury plan. First, by buying banks' worst assets at above-market prices, taxpayers take an immediate economic loss -- while transferring wealth to shareholders and executives of the very institutions that brought on the financial crisis.

Second, this plan puts too much discretionary power in the hands of Treasury officials. Who determines what financial assets are purchased and at what prices? Who determines which bank gets to benefit from these taxpayer subsidies? Will bank shareholders continue to receive dividends, and executives continue to get paid huge bonuses?

When financial institutions borrow massive amounts of money to invest in assets that are now found to be illiquid and poorly performing, it is not the responsibility of taxpayers to bear the resulting losses. These losses should be borne by the shareholders.

If taxpayers have to step in and provide capital to keep operating enterprises that the government decides are key to the functioning of the economy as a whole, taxpayers must receive protection.

Treasury Secretary Henry Paulson said at the Senate Banking Committee hearing this week, "[the] Fannie Mae and Freddie Mac [interventions] worked the way they were supposed to." These enterprises continued to function, maintaining

homeowner access to and lowering the cost of mortgage financing. However, managements of these companies had to leave and forfeit the compensation packages they had negotiated.

Shareholders had their dividends blocked and remain first in line to bear losses, as they should have been. Taxpayers came both first and last -- first to get paid back, as the new preferred stock is senior to all shareholders; and last in realizing losses, as common and other preferred equity would be extinguished before the taxpayers would be at risk.

This mechanism -- purchases of senior preferred stock with warrants in troubled institutions -- addresses the problems with the Treasury plan. The financial market is stabilized, companies get recapitalized, failures are avoided, debt securities are supported, and time is gained for illiquid assets to mature.

The institutions continue to function, their cost of funding will decline as equity capital increases, and innocent third parties like bank depositors, broker/dealer clients and insurance-policy holders are all protected. The only difference is that potential losses are kept with the shareholders where they belong.

The Treasury plan would also entail larger outlays than the Preferred plan. By allowing all banks to sell their worst assets to Treasury at inflated prices, taxpayers would be subsidizing healthy banks which have access to private capital (Goldman Sachs, J.P. Morgan, Wells Fargo, and Bank of America, for example) as well as banks that don't have a private alternative. But under a Preferred plan, only banks that don't have a private alternative will be given federal assistance. This would reduce the outlay otherwise required to solve the crisis.

Few people familiar with the issues deny that Treasury action is needed to stabilize the financial markets. However, the question is who should bear the cost?

Under the Treasury plan the taxpayer pays the price. Under a Preferred plan, the shareholders of the firms who created the problems bear the first loss. Who do you think should pay?

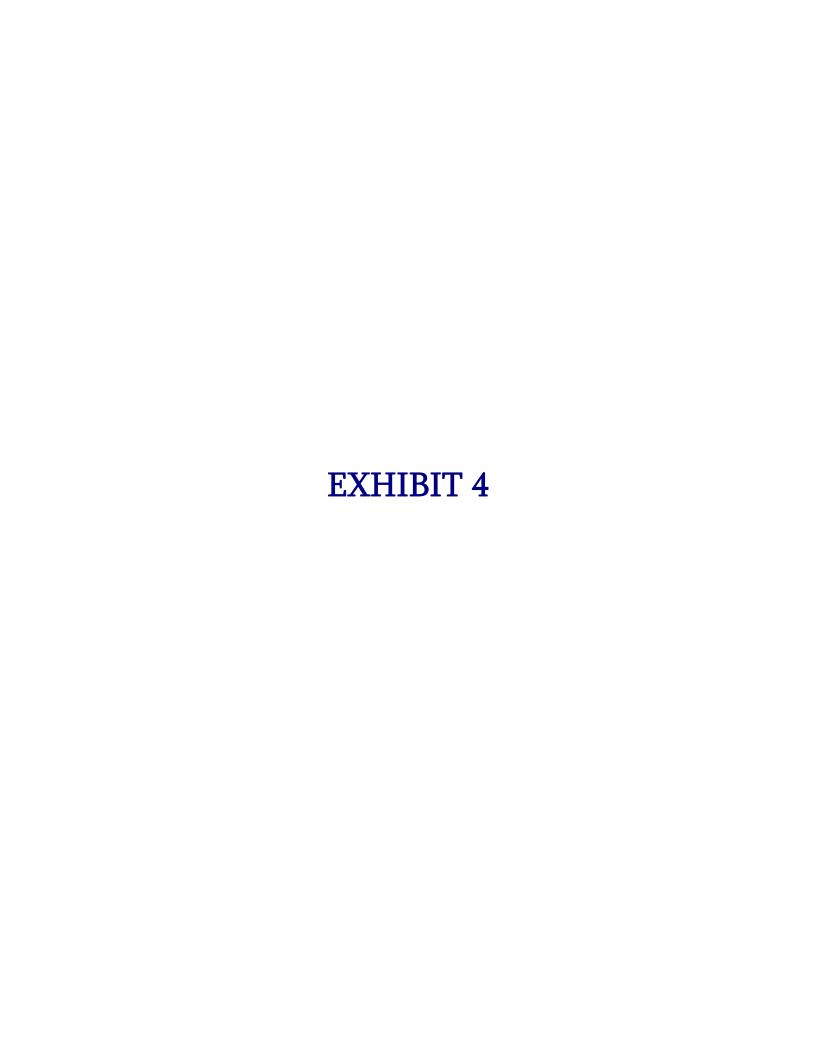
Before committing \$700 billion of our money, we should encourage Congress to take a few extra days to get this legislation right.

 $\operatorname{Mr.}$  Paulson is president and portfolio manager of Paulson & Co. Inc., a New York-based investment management firm.

Please add your comments to the Opinion Journal forum.

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#### A Strategic Plan to Restore the Financial System Back to Health By John Paulson, President, Paulson & Co. Inc.

#### Prepared for the Committee on Oversight & Government Reform on Nov. 13, 2008

- 1. The problem in the US financial system is one of solvency. In general, financial institutions are undercapitalized and have insufficient tangible common equity to support their over-levered and deteriorating balance sheets. Remarkably, the average tangible common equity to total tangible assets for the 10 largest U.S. banks is only 3.4%, or 30x leverage. The solution to solve the problem is to strengthen their balance sheets by raising equity both privately and publicly.
- 2. The use of \$250 billion of the TARP authorization to inject equity into banks is a step in the right direction. It directly addresses the problem of solvency. More equity supports the liabilities of financial institutions, causing debt spreads to contract and permitting institutions to fund their operations without government guarantees. Additional equity also permits institutions to absorb losses in their credit portfolio without threatening their viability. Importantly, additional equity provides a larger capital base to permit banks to resume lending. For example, at a target leverage ratio of 12:1, each dollar of additional equity allows for the expansion of \$12 of additional lending.
- 3. Merely buying toxic assets from banks at "fair value," as originally envisioned by TARP, does little to increase banks' shareholder equity. Unless the government overpays for assets and thereby subsidizes losses of banks by taxpayers, swapping toxic assets for cash does not increase the equity of the banks. If buying assets does not increase equity, then it does little to strengthen banks' balance sheets or to spur increases in lending. Furthermore, there are many problems in implementing asset purchases under TARP including who gets to participate and at what price. Because of the inefficiency of TARP's original focus and the difficulty of implementation, we believe the asset purchase part of TARP should be immediately abandoned.
- 4. The remaining \$450 authorization needs to be reserved for additional equity injections into institutions that are at risk of failure and whose failure could pose systemic risk to the economy. The amount of additional equity needed can be estimated by the IMF's current forecast of \$1.4 trillion of credit losses in the U.S. as compared to approximately \$700 billion of writedowns to date. To replenish balance sheets for the \$700 billion of writedowns, approximately \$650 billion of equity has been raised including the \$250 billion from TARP. The expected \$700 billion of additional writedowns implies a need for a potential additional \$650 billion of equity to absorb future losses, assuming similar ratios.
- 5. While the shift of the TARP program from asset purchases to equity injections is a move in the right direction, the terms of TARP equity injections are overly generous

to recipients and result in an indirect transfer of wealth from taxpayers to financial firms. In one recent U.S. capital-raising transaction, for example, the purchase of preferred stock was done at a 10% yield with warrants exercisable into stock equal to 100% of the value of the preferred, compared to only a 5% yield and 15% warrants under TARP. In the U.K. in the private sector, Barclays is paying an investor group led by Qatar a 14% yield with warrants also equal to the value of their investment. In the public sector, when the U.K. and Switzerland governments injected equity to strengthen their banks' balance sheets, they received yields of 12% and 12.5% respectively for their equity injections.

- 6. As importantly, in addition to higher yields, all of the Foreign Government injections insisted on restrictions on common dividends and limitations on bonuses until government funding is repaid. In the U.K. and Germany, common dividends are prohibited and for Commerzbank in Germany, bonuses are eliminated and executive pay is capped at €500,000. Eliminating common dividends and restricting cash compensation are essential to rebuild depleted common equity capital.
- 7. We fail to see why U.S. taxpayers receive only a 5% yield while private sector investors and other governments receive over 10%; why other public and private investors receive substantial equity stakes in recipient institutions while U.S. taxpayers get only token warrants; and why U.S. taxpayers' investment capital can be used to pay common dividends and employee bonuses while all other sovereign investments prohibit the use of taxpayer funds for such transfers. It makes sense to adopt similar policies in the U.S. Such policies protect the taxpayer against loss and increase bank equity by increasing income and retaining earnings. Why should the \$250 billion of taxpayer money go in one door and out the other through dividends on common stock and bonuses?
- 8. We suggest the following to correct these imbalances:
  - A. For previous TARP funding, common dividends should be eliminated until the TARP preferred is repaid.
  - B. Compensation should be capped to maximize retained earnings in the firm. Bonuses should be paid in common stock to replenish bank capital.
  - C. In addition to the above, on new TARP equity investments, the dividend yield should be raised to 10% and the warrants raised to 100% of the value of the preferred.
- 9. These terms may be criticized by Treasury as too onerous for banks to participate. If so, and if banks can raise the capital they need on better terms in the market, they should be encouraged to tap the private sector instead.
- 10. Finally, TARP equity injections need to be expanded to include aid for financial institutions in danger of failure that pose systemic risk. Auto finance companies, insurance companies, other finance companies as well as banks should be included in this list if their failure would cause unacceptable consequences to the economy as a

whole. The sooner TARP acts to restore the solvency of our financial institutions, the lower the ultimate cost to the system and the faster will be the road to recovery.