DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

October 9, 2012

The Honorable Christy L. Romero
Special Inspector General
for the Troubled Asset Relief Program
1801 L Street, NW, 4th Floor
Washington, D.C. 20036

Re: Treasury Response to SIGTARP LIBOR Recommendation

Dear Ms. Romero:

I am writing in response to your recent letter to Secretary Geithner recommending that the U.S. Department of the Treasury change several TARP programs "to cease reliance on LIBOR." We share your concerns about the integrity of the London Interbank Offered Rate (LIBOR), which is a key benchmark rate used for financial transactions throughout the world. As you may know, a broad global effort is underway to analyze and seek reform to LIBOR and explore alternatives.

Your letter focuses on two TARP programs—the Term Asset-Backed Securities Loan Facility (TALF) and the Legacy Securities Public-Private Investment Program (PPIP)—which are indexed, in part, to LIBOR.

TALF is a joint program by Treasury and the Federal Reserve Board of Governors, and I understand that the Federal Reserve has responded separately to your recommendation. As the Federal Reserve has noted, neither it nor Treasury has the authority to change unilaterally the interest rate on the small number of remaining loans that rely on LIBOR. Moreover, if we sought to renegotiate the rate, it is likely that borrowers either would not agree to a rate change or would agree only to a change that would result in a lower payment to the taxpayers. Accordingly, we do not believe that pursuing such a change would benefit taxpayers. As you know, the program has not sustained any losses to date, and current estimates suggest that it will result in a small gain under TARP.

PPIP is a Treasury program, and I write primarily to respond to your recommendation regarding that program. Treasury launched PPIP in March 2009 to unlock credit markets, to help stabilize the global financial system, and to support the housing market. Specifically, Treasury provided loans and equity capital to nine Public-Private Investment Funds (PPIFs) to purchase non-agency residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS). PPIP is widely credited with helping to stabilize and restart the market for those securities. Moreover, based on current estimates, Treasury expects that this program will generate an overall lifetime

profit for taxpayers. Some of the PPIFs have already wound down their portfolios and have provided net gains for taxpayers.

Your letter recommends that Treasury unilaterally change the benchmark rate for PPIP, because LIBOR may not be reliable and because of a general "lack of confidence" in the rate. You further suggest that such a change "will not be difficult to accomplish." We do not agree. Treasury's legal rights in regard to PPIP—as with most TARP programs—are governed by written contracts. The PPIP contracts provide, in general terms, that the benchmark rate shall change to the Prime rate if Treasury "reasonably determines" that LIBOR does not accurately reflect the current cost of funding the loans in the London interbank market.[1] In other words, Treasury would need evidence that LIBOR is currently misstated in order to have the right to change the benchmark rate unilaterally. As you know, the Commodity Futures Trading Commission conducted an enforcement action regarding LIBOR practices that occurred prior to and during the financial crisis in 2007-09. In addition, global regulators are moving forward to address structural vulnerabilities and weaknesses regarding the LIBOR-setting process. To date, however, enforcement agencies have not released any findings, documentation, or other evidence that the rate is currently misstated. Of course, those reviews are still ongoing.

Moreover, we believe it is possible that changing the benchmark PPIP rate at this time may in fact harm, rather than benefit, taxpayers. LIBOR was chosen as the benchmark for the PPIP loan agreements because it is widely used in the markets that the program was designed to help restart. The securities purchased by the PPIFs often carry interest rates indexed off of LIBOR, as do many of the mortgages underlying the securities. Having a corresponding rate was essential because the PPIFs were designed to be special purpose entities with no other business besides purchasing and managing those investments. Over the last three years, the PPIP fund managers developed their investment strategies and structured their portfolios—including use of permitted interest rate hedges—on the basis that Treasury's debt investment would be indexed to LIBOR. Abruptly altering the benchmark index at this time could have significant adverse consequences on the performance of the PPIFs and to the markets in which they invest, which could reduce the returns from the PPIF's investments and thus proceeds received by taxpayers.[2]

As noted above, the United States and global regulatory communities are conducting a comprehensive review of LIBOR. We support reforms to strengthen the integrity and governance of LIBOR, and we are working with authorities in the United States and abroad to pursue near-term reforms. Recently, the Managing Director of the United Kingdom's Financial Services Authority announced a series of reforms to LIBOR, which

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[1] The contracts state that if Treasury "reasonably determines" that LIBOR "would not adequately and fairly reflect the cost to a commercial bank funding the Loans on a matched basis in the London interbank market of making or maintaining the Loans for such Accrual Period," then the PPIP borrower "shall pay interest on the Principal Amount at a rate per annum equal to the Prime Rate plus the Applicable Margin."

[2] As you know, taxpayers receive approximately half of any PPIF equity proceeds, by virtue of their equity interest in the PPIFs.

were endorsed by the Bank of England. In addition, the United States and the global regulatory community are considering longer-term changes as alternatives to LIBOR, which could include transaction-based benchmarks, where appropriate. These efforts, which are still ongoing, will provide additional information as Treasury considers whether any changes to TARP would be appropriate.

For the reasons outlined above, Treasury is not making changes to the PPIP benchmark rate at this time. Nonetheless, as regulators and enforcement agencies continue to review LIBOR practices and consider potential reforms, we will continue to assess whether any changes to PPIP are necessary and appropriate to protect taxpayers' interests. Of course, we would welcome any additional information, supporting evidence, or analysis that could help inform that judgment.

Thank you for your letter. Please let us know if you would like to discuss these issues further.

Sincerely,

Tim Massad

Timothy G. Massad
Assistant Secretary for Financial Stability