The U.S. Treasury Department
Summary Response to February 6, 2009 Recommendations of SIGTARP

April 7, 2009

Introduction:
The Treasury Department (Treasury) welcomes the recommendations made by the Special Inspector General for the Troubled Asset Relief Program (SIGTARP), including the recent recommendations set forth in SIGTARP's February 6, 2009 report.

This document is Treasury's Summary Response to the SIGTARP'S recommendations in that report. This Summary Reponse provides a written, high level summary of Treasury's progress in implementing the SIGTARP recommendations and identifies the next steps that Treasury plans to take in these areas.

This report is structured as follows:

- Identification of each SIGTARP recommendation

- Summary of the status of the matters to which that recommendation pertained as of the time of the February 6, 2009 SIGTARP Report

- Discussion of Treasury's progress in implementing the recommendation as of the date of this response

- Identification of Treasury's next steps

<u>SIGTARP Recommendation 1</u>: All TARP agreements should contain oversight-related language that (a) acknowledges explicitly the jurisdiction and authority of SIGTARP and other oversight bodies, as relevant, to oversee compliance of the conditions contained in the agreement in question; (b) for each condition imposed, the participant should be required to establish internal controls with respect to that condition, report periodically to OFS-Compliance regarding the implementation of those controls and its compliance with the condition, and provide a signed certification from an appropriate senior official to OFS-Compliance that such report is accurate; and (c) the participant should be required to use best efforts to account for the use of TARP funds, to set up internal controls to comply with such accounting, and to report periodically to OFS-Compliance on the results, with appropriate certification, in the manner discussed above.

<u>Status at time of previous report:</u>

As of February 6, 2009, transactional documents for TARP programs contained varying oversight and compliance provisions. In general, these provisions were more robust in the program documents for the Systemically Significant Failing Institution Program, the Targeted Investment Program, and the Automotive Industry Financing Program than for the Capital Purchase Program.

<u>Summary of Progress Since Previous Report:</u>

Two programs have been fully documented since February 6, 2009: the Term Asset-Backed Securities Lending Facility (TALF) and the Auto Suppliers Support Program. Oversight-related and compliance provisions have been incorporated into documentation for these programs, as follows:

- Term Asset-Backed Securities Lending Facility (TALF):
    - <u>Inspection rights</u> - Section 9.18 of the Credit Agreement among the Treasury, Federal Reserve Bank of New York (FRBNY), and TALF LLC contains specific language allowing SIGTARP, GAO and the Treasury access to personnel and information regarding TALF borrowers to ascertain compliance with the agreement's terms and conditions.
    - <u>Internal Controls</u> – Section 6 of the Credit Agreement specifically requires that TALF LLC maintain evidence of compliance with requirements under the Credit Agreement. The Federal Reserve will monitor internal controls for TALF, as the program administrator, and Treasury will have access to these reports.
    - <u>Use of TARP Funds</u> – Section 4.01(j) of the Credit Agreement targets the use of TALF loan proceeds solely for specific financing asset acquisitions.
- Auto Suppliers Support Program:

- Inspection rights – Section 9.17 of the credit agreement between the Treasury and each special purpose vehicle established by the automobile manufacturers (the "OEM SPVs") to fund the program specifically contains language giving SIGTARP, GAO and the Treasury access to personnel and information regarding compliance with the agreement's terms and conditions. Further, Section 30 of the pledge agreement provides the same inspection rights with respect to the automobile manufacturers and Section 9.16 of the servicing agreement provides the same with respect to the servicer of the program.

- Internal Controls – Section 6 of the credit agreement requires that each OEM SPV borrower maintain evidence of compliance with requirements under the credit agreement. Treasury will receive certifications related to compliance from the borrower in periodic borrowing requests. As set forth in the servicing agreement, the program servicer will also monitor compliance with certain program requirements and will deliver monthly servicing reports and periodic payment calculation reports to Treasury. Under Section 3.3 of the Servicing Agreement, Treasury will also receive a certification on a monthly basis from the program servicer regarding its compliance with requirements of the servicing agreement.

- Use of TARP Funds: Funds drawn under the loan agreement may be used only to purchase automotive supplier receivables that meet criteria specified by Treasury as part of its program to assist General Motors and Chrysler in restructuring.

In addition, the following steps have been taken with respect to programs that were operational prior to SIGTARP's February 6, 2009 report:

- Capital Purchase Program Treasury has launched a monthly lending survey of the 21 largest recipients of funds under the Capital Purchase Program (CPP). The Snapshot contains quantitative information on three major categories of lending – consumer, commercial, and other activities – based on banks' internal reporting, as well as commentary to explain changes in lending levels for each category. Treasury has already published 2 Snapshots that are available on our web site at http://www.financialstability.gov/impact/surveys.htm, and will publish the next one in mid-April. Treasury plans to expand the monthly lending survey to all CPP participants. The expanded CPP monthly lending report is expected to be published by mid-May.

- Targeted Investment Program/Asset Guarantee Program – Under existing agreements, participants under the Targeted Investment Program and Asset Guarantee Program are required to report and certify internal controls established to ensure compliance with certain terms and conditions under the securities purchase agreement and participant's use of funds received under these programs.

- Automotive Industry Financing Program – Treasury currently requires extensive reporting from the auto companies on program operation requirements in their respective agreements. Funds received by auto companies are specifically targeted to bridge cash shortfalls as identified and described in these reports.

Treasury's Next Steps:

- Systemically Significantly Failing Institutions Program – Treasury is currently drafting agreements for additional investments in AIG. These agreements will include the inspection rights and internal control provisions. In addition, the agreements will require AIG to provide a plan, both on the closing date and when funds are drawn from the capital facility, on how capital received will be utilized.

- New programs in the process of being documented: Treasury is in the process of drafting program agreements for the programs announced since SIGTARP's initial Congressional report published on February 6, 2009. Treasury is committed to include inspection rights and internal control requirements in the appropriate agreements for each of the new programs.

<u>SIGTARP Recommendation 2</u>: Treasury needs to begin developing a more complete strategy on what to do with the very substantial portfolio that it now manages on behalf of the American people. In particular, Treasury needs to develop effective valuation methodologies to value the preferred shares and warrants that it holds and an overall investment strategy to manage the equity portfolio it holds.

<u>Status at time of previous report:</u>

On November 7, 2008, Treasury issued a notice soliciting interested institutions to serve as financial agents to manage the portfolio of securities issued to Treasury by public and private Financial Institutions participating in the Capital Purchase Program (CPP) and other similar programs that may be established under the Act. The notice set forth a variety of portfolio management and asset valuation services sought by Treasury.

<u>Summary of progress since previous report:</u>

- Over several months, Treasury thoroughly evaluated the 205 submissions received in response to its notice for asset management services, and has identified but not yet engaged a cadre of potential managers best suited to the portfolio.

- Treasury has drafted provisions for formal investment policies and asset manager guidelines to govern administration of the portfolio, and coordinated the development of its investment policy approach with Federal banking agencies.

- Treasury has hired experienced personnel in portfolio management, who have developed internal models for the valuation of preferred shares and warrants, and evaluated a variety of commercial tools and software products to assist in warrant valuations.

  - The valuation methods will be based on observable market prices for securities with similar characteristics, a set of well-studied financial models (such as discounted cash flow, regression analysis, binomials, and Black-Scholes pricing), fundamental analysis of each Financial Institution's assets, capital, credit and cash flow, and on the input of outside consultants with independent models.

  - For Financial Institutions with publicly traded preferred stock or subordinated debt, the valuation method for preferred shares will incorporate yields on comparable securities and estimations of the timing of repayment for each Financial Institution. For Financial Institutions without publicly traded preferred stock or subordinated debt, the valuation method will incorporate estimated timing of repayment and an appropriate discount rate applied to the schedule of cash flows.

- Pending selection of the asset managers, Treasury tasked its custodian Bank of New York Mellon (BNY Mellon) to provide initial market valuations for the portfolio. BNY Mellon engaged Gifford Fong Associates to assist with these initial valuations.

- Treasury and BNY Mellon have implemented policies and procedures to monitor and respond to the Financial Institution corporate actions and other counterparty events that may have an impact on the value of holdings.

- Treasury has hired additional dedicated staff to develop models for credit reform subsidies and accounting, following the new administration's policy decision to reflect assets in the portfolio consistent with the Federal Credit Reform Act.

Treasury's next steps:

- Treasury will shortly engage its initial asset managers and will assign each with investment positions in the portfolio.

- After collective consultation with and input from the chosen asset managers, Treasury will issue its investment policies and asset manager guidelines, to include instructions on portfolio goals and strategy, asset valuation, asset monitoring and management, portfolio analytics, risk management, and reporting.

<u>SIGTARP Recommendation 3</u>: Treasury should consider requiring that some baseline fraud prevention standards be adopted.

<u>Status at time of previous report:</u>

As of February 6, 2009, the Federal Reserve Bank of New York (FRBNY) and the Board of Governors of the Federal Reserve System (the Fed) were still developing the specific details of TALF, including broad baseline fraud prevention measures.

<u>Summary of progress since previous report:</u>

Treasury, in collaboration with FRBNY and the Fed, has put in place an extensive set of requirements that address both fraud and credit loss prevention. Treasury believes these measures (listed below) are consistent with achieving TALF's purpose of encouraging lending to consumers and small businesses. Those guidelines include:

- Fraud Prevention Requirements
    - A borrower acceptance standard and an assurance program related to borrower eligibility requirements.
    - On-site inspection rights over borrowers and the right to reject a borrower for any reason.
    - The right to review all loan files held by the custodian pertaining to each borrower.
    - A telephone and internet-based hotline for reporting of fraudulent conduct or activity associated with the TALF.
    - The ABS issuer must provide a certification in connection with the prospectus that the ABS is TALF eligible, that a nationally recognized certified independent accounting firm has certified that the ABS is TALF eligible, and that the issuer has not made any untrue statements of material fact to an NRSRO to obtain the credit rating of the ABS.
    - The ABS issuer and ABS sponsor must provide an indemnity certification which acts as an additional deterrent for fraudulent behavior. This indemnity also protects Treasury.
    - If a borrower who has participated in the program is found to be ineligible or is found to have knowingly breached a representation related to the eligibility of the collateral, the non-recourse feature of the loan becomes inapplicable and the borrower must repay the loan.
    - To assist FRBNY in screening borrowers, primary dealers are required to apply their internal customer identification program and due diligence procedures to

each borrower and escalate information relating to those borrowers assessed as high risk to FRBNY.

- Credit Loss Protection Requirements

    - Investors are required to supply risk capital in the form of haircuts that will provide the first loss position in front of the U.S. Government. Investors therefore have significant incentive to conduct due diligence about the quality of the underlying securities and underwriting standards.

    - TALF haircut methodology is risk-sensitive across asset classes and maturities. Rigorous analytical studies (by both FRBNY and Treasury's outside advisor) project minimal credit loss even under highly stressed scenarios.

    - TALF only accepts collateral that has received two credit ratings in the highest investment-grade rating category of AAA (and no rating below that category) or that is fully U.S. Government-guaranteed.

- Fraud Prevention and Credit Loss Protection at the Disposition SPV Level

    - With respect to the Disposition SPV (TALF LLC) to which the US Treasury will be providing a $20 billion subordinated loan, additional credit loss protection, fraud prevention and compliance mechanisms have been put in place which will govern the Treasury's relationship with TALF and TALF LLC, including:

        - Loan-spread interest will pass to the SPV and accumulate to provide the first loss cash cushion to any potential losses that may occur if collateral is put to the SPV.

        - UST will retain the right to refuse any changes in the TALF loan haircuts or loan fee charged to borrowers.

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        - UST will have access to information and reports regarding TALF loans outstanding and underlying collateral in addition to SPV financial reporting and notices.

        - UST will have the right to monitor the FRBNY's internal controls and compliance measures for TALF.

<u>Treasury's Next Steps:</u>

- UST is continuing to build out its team dedicated to monitoring all aspects of the program and working with FRBNY and UST's Office of Financial Stability oversight and compliance personnel.

- Treasury will exercise its rights to receive information regarding collateral not yet "put" to TALF LLC in order to fully assess the likelihood of ABS reaching TALF LLC.

- Treasury has met, and will continue to meet with SIGTARP, to determine the best financial metrics to use in tracking the performance of collateral that could be put to TALF LLC.

- As new classes of securities are added to TALF, Treasury will work with fraud-prevention professionals and SIGTARP to identify appropriate measures for fraud prevention and credit loss protection.

- UST plans to add fraud-prevention expertise to the TARP team, either by hiring staff with expertise in this area or by contracting for outside assistance.

SIGTARP Recommendation 4:

Treasury should consider, before committing TARP funds, requiring that beneficiaries of TALF sign an agreement that includes oversight-enabling provisions.

Status at time of previous report:

As of February 6, 2009 FRBNY and the Fed were still developing the specific details of TALF.

Summary of progress since previous report:

- Treasury required that SIGTARP and the Government Accountability Office (GAO) be given specific oversight rights with regard to TALF LLC and FRBNY. See Section 9.18 of the Credit Agreement by and among TALF LLC, FRBNY and Treasury.

- Treasury also required that SIGTARP and GAO be given access rights to the ABS sponsors in the event that any ABS collateral of that sponsor was deemed to be ineligible. This access right governs all causes of the ineligibility of the ABS.

Treasury's Next Steps:

- As new classes of securities are added to TALF, Treasury will work with SIGTARP to identify appropriate oversight standards.

SIGTARP Recommendations 5 and 6:

Treasury should give careful consideration before agreeing to the expansion of TALF to include mortgage-backed securities ("MBS") without further review. (4) TALF should not be expanded to existing "legacy" MBS in its current format.

Status at time of previous report:

As of February 6, 2009 FRBNY and the Fed were still developing the specific details of TALF. Neither asset class has yet been included in TALF.

Summary of progress since previous report:

The asset-backed securities (ABS) markets historically have funded a substantial share of credit to home owners, consumers and businesses. Continued disruption of these markets could significantly limit the availability of credit to households and businesses of all sizes and thereby contribute to further weakening of U.S. economic activity. TALF is designed to increase credit availability and support economic activity by facilitating renewed issuance of consumer and business ABS at more normal interest rate spreads. We have begun to see some of the first few signs of success from TALF's first subscription in stimulating new demand and issuance for consumer and business loans.

The Federal Reserve and the Treasury are currently analyzing the appropriate terms and conditions for accepting commercial mortgage-backed securities, including acceptable sponsor haircuts and other protections. In addition, the Federal Reserve and the Treasury have been evaluating expanding TALF to residential mortgage-backed securities, both newly issued and possibly 'legacy' ABS. Our goal is to include securities that will have the greatest macroeconomic impact and that could most efficiently be added at a low and manageable risk to the government. The TALF facility will cease making loans on December 31, 2009, unless the Board of Governors of the Federal Reserve Board extends the facility.

Treasury's Next Steps:

- Treasury will continue to explore the expansion of TALF as noted above. In connection with the proposed expansion, Treasury will work closely with fraud-prevention professionals and SIGTARP to structure appropriate safeguards and compliance measures.

<u>SIGTARP Recommendation 7</u>:

Treasury should establish a compliance protocol with the Federal Reserve before TALF is put into effect.

<u>Status at time of previous report:</u>

As of February 6, 2009, FRBNY and the Fed were still developing the specific details of TALF

<u>Summary of progress since previous report:</u>

- Compliance protocol put into effect included extensive eligibility requirements, collateral eligibility requirements, issuer assurances, auditor attestation, conflicts of interest guidelines, collateral sufficiency tests, and Know Your Customer ('KYC') standards. The requirements can be found at: http://www.newyorkfed.org/markets/talf_docs.html

- Treasury required specific representations, warranties, covenants and certifications from TALF LLC prior to closing the initial version of TALF.

- Treasury has specific and extensive information rights with regard to TALF LLC and FRBNY.

- Treasury has the right to receive all compliance certificates (sponsor, issuer, auditor) received by FRBNY in connection with the loans made by FRBNY.

- As there are not ongoing compliance functions at the SPV-level for an SPV owned and controlled by FRBNY, it is not anticipated that Treasury will receive periodic compliance certificates. Treasury will, however, receive extensive informational reports with regard to the ABS used as collateral for FRBNY loans.

<u>Treasury's Next Steps:</u>

- Treasury will study whether the expansion of TALF creates new compliance concerns and will adjust the compliance regime accordingly.