DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 2, 2009

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

Dear Mr. Barofsky:

This letter and its attachments constitute the response of the Department of the Treasury to the recommendations contained in the Special Inspector General for the Troubled Asset Relief Program's (SIGTARP) *Quarterly Report to Congress*, dated April 21, 2009.

The attached memorandum, entitled *The U.S. Treasury Department Summary Response to SIGTARP Recommendations in the April 21, 2009 SIGTARP Report,* describes the actions Treasury has taken with respect to those recommendations and the recommendations in the SIGTARP's February 2009 quarterly report. The memorandum updates the information set forth in Appendix J of the April SIGTARP Report: *The U.S. Treasury Department Summary Response to SIGTARP Recommendations in the February 6, 2009 SIGTARP Report.*

Treasury welcomes these recommendations. They contain many good ideas and suggestions, and we have considered them carefully. As described in the memorandum, we agree with most of them. We have described how our policies and programs address the issues raised and have discussed, where applicable, additional actions we are taking to ensure that particular concerns are addressed. In a few areas, we believe the recommendation would not help carry out Treasury's statutory duties under EESA. However, in these cases we believe there are alternative ways to address the underlying concerns you have raised and we have explained the measures we are employing to do so.

We appreciate your thoughtful recommendations and look forward to continuing to work with you and your team as we pursue our common goal of carrying out the objectives of EESA, which are to promote financial stability and protect the interests of the taxpayers.

Sincerely,

Herbert M. Allison Jr.
Assistant Secretary
Office of Financial Stability

Enclosure

The U.S. Department of the Treasury
Summary Response to SIGTARP Recommendations

July 2, 2009

The Department of the Treasury (Treasury) welcomes the recommendations on the Troubled Assets Relief Program (TARP) made by the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) in its April 2009 Quarterly Report to Congress. Treasury's ability to achieve the objectives of the Emergency Economic Stabilization Act of 2008 (EESA) is enhanced by the role of the SIGTARP and its review of TARP programs. We have worked closely with SIGTARP and have benefitted from their involvement in the development of TARP programs and policies. The recommendations reviewed in this report contain many good ideas and suggestions, and we have considered them carefully.

In this report, we have addressed the April 2009 recommendations as well as certain of the recommendations in the February 2009 Initial Report to Congress. We have first repeated each SIGTARP recommendation and then set forth Treasury's views. In most cases, Treasury agrees with the suggestions made. We have explained how Treasury's policies and programs have addressed the issues raised in the recommendation, and discussed, where applicable, additional actions we are taking to insure that particular concerns are addressed. In a few areas, Treasury believes the specific recommendation would not help carry out Treasury's statutory duties under EESA. However, in these cases we believe there are alternative ways to address the underlying concern raised by the SIGTARP, and we have explained the measures Treasury is following to do so.

SIGTARP Recommendation 1:
Treasury should require all TARP recipients to report on the actual use of TARP funds.

Treasury's Response

Treasury always seeks to ensure accountability for TARP funds and includes measures in each of its programs to ensure such accountability. Reporting requirements necessarily differ depending on the use of funds or the program at issue. TARP programs can be divided for this purpose into two types: programs that are designed to bolster the capital of an institution and programs designed to provide targeted financing on a case-by-case basis. For example, the Capital Purchase Program (CPP), which represents over $200 billion of TARP funds invested by Treasury, was designed to stabilize the financial system by providing capital to viable institutions of all sizes. TARP funds have been used to purchase preferred stock (or other securities) from over 600 financial institutions. The use of the TARP funds is to bolster the capital of the institution, which is a use that is evidenced in the legal documentation for the transaction.

Because of the fungible nature of money, it is not possible to say that funds invested as capital were used for a particular purpose. Therefore, we do not believe requiring reports as to how the specific funds were spent would be meaningful, since it could never be said with certainty that particular funds were used for a particular purpose. While Treasury could in theory mandate that the funds be used only for particular purposes, that was not the design of the CPP. The terms of the CPP do not require an institution to engage in a particular level of lending, nor do they mandate what an institution can or cannot do in its business generally or specifically with the proceeds of the TARP investment.

Treasury is, however, requiring reporting by CPP participants that is intended to measure the effects of the CPP on lending levels, which we believe is the underlying concern raised by the SIGTARP recommendation, and the concern of American taxpayers. Providing capital to banks helps ensure financial stability of the system as a whole and enables banks to continue to lend to creditworthy borrowers during a crisis. In order to help assess the impact of this program on lending, Treasury therefore requires reporting by banks on general lending and intermediation activities using Treasury's Monthly Lending and Intermediation Survey and Snapshot and Treasury's Lending Report. This reporting is described in more detail below.

Separate from the CPP, Treasury has also created more targeted programs under TARP and the Financial Stability Plan in which funds are used to finance particular purposes. These programs include the Making Home Affordable Program, in which funds are used to provide incentive payments to servicers and homeowners to modify mortgages, and the PPIP, in which funds are to be invested in newly created investment funds and used to purchase legacy securities. In those programs, the program documents impose restrictions on the use of funds and require appropriate reporting to show that the funds were in fact used for the specified purposes.

The following is a program by program description which explains the reporting requirements that are applicable:

Automotive Industry Financing Program (AIFP): Treasury through the TARP has purchased debt obligations and equity. The terms of the debt obligations include restrictions on use of funds and reporting requirements. All debt obligations with Chrysler and GM require the borrower to report on the use of proceeds either at the time of a draw or quarterly. For the Chrysler and GM DIP loans, the use of proceeds is dictated by an approved budget. After emergence from bankruptcy, there are, or are expected to be, additional requirements under TARP loans to the new Chrysler and GM entities to provide information on the use of loan proceeds. The loan agreements will also require the entities to establish internal controls to provide reasonable assurance of compliance with applicable requirements.

- **Capital Assistance Program (CAP):** The CAP is designed to ensure that banks have an adequate capital cushion so that they can withstand larger-than-expected losses and maintain lending to creditworthy borrowers in the event that economic conditions worsen. As with CPP, it is a program in which Treasury provides capital to financial institutions. Although Treasury has not yet finalized the definitive documentation for CAP, the CAP guidelines provide that the following types of reporting on lending activities will be required. First, as part of the application process, banks must submit a plan for how they intend to use this capital to preserve and strengthen their lending capacity – specifically, to increase lending above levels relative to what would have been possible without government support. Treasury will make these plans public when the bank receives the capital under the CAP. In addition, banks receiving capital will be required to submit to Treasury monthly reports on their lending broken out by category. This report will include a comparison to their most rigorous estimate of what their lending likely would have been in the absence of government support. These reports will be posted on Treasury's *FinancialStability.gov* website so that they can be viewed by the public.

- **Capital Purchase Program (CPP):** As noted above, to measure the lending and intermediation activities of the 21 largest banks participating in the CPP, Treasury has launched the Monthly Lending and Intermediation Survey and Snapshot, which will help the public easily assess activities of these banks. 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. In addition, Treasury recently published an expanded CPP Lending Report, which reports on the monthly average outstanding balances of consumer loans, commercial loans, and total loans from all CPP participants.

- **Making Home Affordable Program (HAMP)**: Consistent with the goal of reaching as many borrowers as possible, TARP funds are obligated to loan servicers based on the size of their estimated eligible HAMP portfolios. These obligations (the "servicer cap") represent the maximum amount to be paid for incentive payments to borrowers, servicers, and investors for qualifying loan modifications. Caps may be reset at the discretion of Treasury based on loan modification demand, servicer participation, or other qualified circumstances (sale of loan portfolio, for instance).

  For an individual servicer, a cash payment is made to the servicer at the successful conclusion of the trial loan modification period (90-120 days). Payments represent (i) incentive payments to the servicer for completing the modification, (ii) payments to the servicer to be passed on to the investor as a partial offset to reduced interest income resulting from the loan modification, and (iii) payments to the servicer that would be applied to reduce the principal amount of the residential mortgage loan for the borrower. Servicer and investor payments continue for three and five years, respectively, if the loan remains current and outstanding. While no payments have been made to date, the program administrator (Fannie Mae) will report (by servicer) payments made to servicers, borrowers, and investors relative to the servicer cap beginning in August. In addition, the HAMP compliance agent will verify that Treasury cash disbursements are applied to investors and borrowers, as appropriate.

- **Public Private Investment Partnership (PPIP)**: TARP funds for the Legacy Securities Public Private Investment Program (S-PPIP) will be used to (i) make equity investments in investment funds (PPIFs) formed by the fund managers selected by Treasury to participate in S-PPIP and (ii) provide loans to the PPIFs. The funds received through the TARP's investment in the PPIFs are required to be used to purchase commercial mortgage backed securities and non-agency residential mortgage backed securities issued prior to 2009 that were originally rated AAA or an equivalent rating by two or more nationally recognized statistical rating organizations without ratings enhancement and that are secured directly by the actual mortgage loans, leases, or other assets and not other securities (Eligible Assets) (or in Treasury securities and other cash equivalents on a temporary basis (Temporary Investments)). In light of the single purpose nature of the PPIF, definitive documentation will also contain detailed provisions governing the application of all proceeds received by the funds from such investments in legacy securities. Fund managers will be required to provide monthly and periodic reports and financial information to Treasury so that Treasury can monitor compliance with such provisions.

- **Systemically Significant Failing Institution Program (SSFI)**: This program is for systemically significant institutions that are in danger of failing. Treasury through TARP invested $40 billion in AIG in November 2008 which was used to pay down debt provided to AIG by the Federal Reserve Bank of New York. In an April 2009 restructuring of the government's investments in AIG, Treasury committed to provide additional funds under certain circumstances. Because this program provides exceptional assistance to failing institutions, the transaction documents contain more extensive restrictions on the recipient than in the CPP or CAP, including with respect to dividends, corporate expenses, lobbying, executive compensation and risk management. The transaction documents require establishment of internal controls to ensure compliance with the restrictions and certified quarterly reports regarding such compliance and regarding use of the capital.

- **Targeted Investment Program/Asset Guarantee Program**: Treasury invested $20 billion in each of Citigroup and Bank of America pursuant to the Targeted Investment Program. Because this program provides exceptional assistance to systematically significant institutions, the transaction documents contain more extensive restrictions on the recipient than in CPP or CAP, including with respect to dividends, corporate expenses, lobbying, executive compensation, and risk management. The transaction documents require establishment of internal controls to insure compliance with the restrictions and certified quarterly reports regarding such compliance and regarding use of the capital. Under the Asset Guarantee Program, Treasury agreed to provide a guarantee with respect to a specified pool of assets. Funds are used for the specific purpose of covering losses with respect to such assets.

- **Term Asset-Backed Securities Loan Facility (TALF)**: TALF provides loans to borrowers to purchase certain asset backed securities. The transaction documents provide that the loans can only be used for specific types of asset acquisitions and the funds are only advanced for such use.

SIGTARP Recommendation 2:
Treasury should formalize its going-forward valuation methodology and begin providing values of the TARP investments to the public.

Treasury's Response

Treasury develops asset valuation methodologies for financial statement and accounting purposes as well as for risk analysis and portfolio management purposes. For its financial statements, Treasury is required to follow the Federal Credit Reform Act of 1990. Treasury has created models consistent with OMB guidelines for credit reform cost estimation to derive and account for the values of the assets in the TARP portfolio. Treasury has engaged Ernst & Young to perform independent verification and validation of the models. In addition, GAO will also receive and review the credit reform models produced by Treasury as part of its oversight and financial statement audit responsibilities. The values of TARP assets derived by the validated credit reform models will be used to reflect the estimated costs to the government in the year-end financial statements of the Office for Financial Stability (OFS) and the President's annual budget, both of which are publicly available.

In addition to the credit reform asset valuation, Treasury tracks the fair market value of the assets in the TARP portfolio as part of its risk analysis and portfolio management functions. To this end, Treasury is developing internal market-based valuation models. It has also engaged external pricing vendors through its custodian bank, and selected three asset management firms as financial agents to provide asset management services, including valuation services.

The securities in Treasury's portfolio consist primarily of preferred stock and warrants for common stock. The external asset managers use a discounted cash model to estimate the value of the preferred securities. The two primary assumptions necessary for accurately estimating the value of the preferred securities in such a model are the maturity point (i.e., when a financial institution will choose to redeem the security) and the rate used for discounting the cash flows. The external asset managers analyze each institution's financial condition along with comparable market data to appropriately calibrate their valuation models for preferred securities.

The valuation of the warrants in Treasury's portfolio is directly relevant to the process for disposing of the warrants. That is, the contracts under which Treasury acquired the warrants provide that a financial institution that redeems the preferred securities has a right to repurchase the warrants at fair market value. The contract specifies an independent valuation process for determining fair market value. Treasury has recently posted a description of the internal procedures it will follow in valuing warrants for purposes of this process at www.financialstability.gov. These procedures involve applying a robust valuation methodology developed by Treasury as well as relying on the advice of Treasury's external asset managers. Treasury will also publish valuation information on each warrant that is repurchased.

SIGTARP Recommendation 3:
Treasury should develop an overall investment strategy to address the vast portfolio of securities that it holds; Treasury should decide whether it has any intention of exercising warrants in order to hold the common stock.

Treasury's Response

Treasury's investment strategy, and in particular its asset management decisions with respect to the investments it has made, are determined by statutory requirements and the policy goals that have been developed in light of such statutory requirements. Treasury's responsibilities under EESA are to promote financial stability and prevent disruption to financial markets, while at the same time protecting the taxpayer. Treasury is given the authority to manage assets, including the discretion to hold assets to maturity or for resale for and until such time as the Secretary determines that the market is optimal for selling such assets, in order to maximize the value for taxpayers. EESA, as amended by the American Recovery and Reinvestment Act, also specifically provides that any financial institution that has received assistance may repay that assistance from any source of funds, and that when such assistance is repaid, the Secretary may liquidate the warrants at market price.

In light of these statutory mandates, Treasury's primary portfolio objective is to protect the principal of the portfolio and limit the risk of capital loss to the taxpayer while still insuring that it carries out its responsibility to promote financial stability. This objective is to be measured based on the portfolio as a whole, and not necessarily based on the performance of individual positions. A secondary portfolio objective is to implement a rigorous asset management framework that will identify and monitor risks with individual investments and across investment positions that may jeopardize the return of capital to Treasury, with the ultimate purpose of achieving positive returns to the taxpayer, if possible. An additional objective is to ensure that Treasury's external asset managers provide Treasury with stable, thoughtful, transparent, and impartial asset management so as to preserve the integrity of the portfolio valuation process and certainty for market participants.

Treasury is currently in the process of developing its investment policy and asset management guidelines for financial institutions participating in the CPP program, which it will publish once such guidelines are completed. Treasury's investment policy with respect to the preferred stock investments under CPP can generally be described as a "buy and hold" strategy. Its strategy must also recognize the financial institution's right to redeem Treasury's investment under the ARRA as described above. Portfolio management is intended to be relatively passive, and Treasury will not initiate trading, hedging, or exiting of a position at this time. Treasury's general posture will be to collect dividend and interest income from the portfolio pending individual financial institution redemptions or until market conditions allow market participants to displace Treasury's investment in a particular financial institution.

Treasury also holds warrants for common stock of CPP recipients. When an institution redeems its preferred stock, it has a contractual right to repurchase the warrants at fair market value. The contractual right provides for an independent valuation process. Treasury has recently published its policy in regard to how it will determine fair market value in connection with such process. The policy also sets forth that Treasury intends to sell the warrants in an auction process if the institution does not elect to repurchase. This policy can be found at www.financialstability.gov. Treasury does not, at this time, intend to exercise the warrants except under certain circumstances related to mergers and acquisitions activity, although Treasury could consider exercising the warrants in the future. Treasury will review its policies from time to time to ensure they serve the goals of promoting financial stability and protecting the taxpayer.

SIGTARP Recommendation 4:
Treasury should consider requiring that beneficiaries (i.e., the TALF borrowers, the originators/sponsors, and the primary dealers) sign an agreement that includes oversight-enabling provisions.

Treasury's Response

Treasury has worked with the Federal Reserve Bank of New York (FRBNY) to implement TALF, which is designed to improve credit conditions for consumer, small business, and commercial mortgage loans by facilitating purchases of a variety of asset-backed securities by investors. TALF is run principally by the FRBNY; Treasury's role is to provide debt to an asset disposition vehicle owned and managed by FRBNY which would use such funds in the event TALF borrowers default on the TALF loan or surrender their asset-backed securities. Treasury is not a party to the contracts with TALF borrowers, primary dealers and originators/sponsors and does not provide funds directly to TALF borrowers. However, Treasury has worked closely with the FRBNY in the development of controls and procedures for the program.

Treasury shares the FRBNY's view that granting the oversight agencies access to the books and records of beneficiaries would discourage participation in the TALF program and is therefore not the best way to address the underlying concerns raised by this recommendation. Treasury has instead worked with the FRBNY to develop appropriate controls in light of the nature of the program. In this regard, the FRBNY has included a number of oversight-related provisions in the TALF transaction agreements that apply to TALF borrowers, including the following:

- 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.
- 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.

In addition to these fraud prevention requirements, FRBNY is establishing an inspection program in order to ensure that the primary dealers are faithfully carrying out their responsibilities under TALF.

SIGTARP Recommendation 5:
Treasury and the Federal Reserve should provide to SIGTARP, for public disclosure in SIGTARP's quarterly reports, the identities of the borrowers who surrender collateral in TALF.

Treasury's Response

As noted in the response to recommendation 4, while Treasury has worked with the FRBNY to develop TALF and to develop appropriate controls and oversight measures, the FRBNY administers TALF. The FRBNY, after conducting extensive research, specifically designed TALF to be a limited recourse lending facility with anonymity for public participants. Treasury agreed with the FRBNY that the identities of the TALF borrowers would not be disclosed to Treasury or the public, because such disclosure is unnecessary given the other controls in place and because such disclosure would have a chilling effect on participation in the program. Implementing this recommendation would significantly alter that design.

SIGTARP Recommendation 6:
Treasury should design a robust compliance protocol, with complete access rights for itself, SIGTARP, and other relevant oversight bodies, to all TALF transaction participants.

Treasury's Response

As noted in the response to recommendation 4, while the TALF program was developed by the FRBNY and Treasury, the FRBNY administers the TALF lending facility and enters into contracts with participants. It therefore has the primary responsibility for TALF compliance and has a risk and compliance protocol for TALF. Treasury's role in TALF is limited as described above. However, Treasury is very concerned with the compliance protocol. The FRBNY provides regular updates to Treasury on the program, and works with Treasury on major design aspects of the compliance program. Treasury has the right to monitor the FRBNY's internal controls and compliance measures for the TALF facility. As such, Treasury continues to have a dialogue with the FRBNY and meets with FRBNY's Risk Management and Compliance Office on a regular basis to ensure that the compliance protocol is robust.

SIGTARP Recommendation 7:
Treasury should dispense with rating agency determinations in connection with TALF and require a security-by-security screening for each legacy RMBS. Treasury should refuse to participate if the program is not designed so that RMBS, whether new or legacy, will be rejected as collateral if the loans backing particular RMBS do not meet certain baseline underwriting criteria or are in categories that have been proven to be riddled with fraud, including certain undocumented subprime residential mortgages (i.e., "liar loans").

Treasury's Response

A decision has not been reached on whether to include RMBS as eligible collateral in TALF. To the extent the Federal Reserve decides to move forward with the proposed expansion, Treasury will work closely with the FRBNY to ensure risk management measures are in place, including requiring a security-by-security screening of each legacy RMBS.

Treasury, in collaboration with the FRBNY and the Federal Reserve, has developed a number of provisions for the CMBS program that will help protect the government against loss or fraud. Specifically, Federal Reserve economists have conducted due diligence on rating agency methodologies for eligible CMBS. In addition to agency ratings, the TALF program employs other safeguards to protect taxpayer interests, including interest rate premiums and risk-based collateral haircuts. Other fraud prevention measures include the use of a collateral monitor who will independently verify whether transactions are conducted at arm's-length and whether the transactions are occurring at market prices.

SIGTARP Recommendation 8:
Treasury should require additional anti-fraud and credit protection provisions, specific to all MBS before participating in an expanded TALF, including minimum underwriting standards and other fraud prevention measures.

Treasury's Response

A decision has not been reached on whether to include RMBS as eligible collateral in TALF. To the extent the Federal Reserve expands TALF to include RMBS, Treasury will work closely with the FRBNY to ensure appropriate anti-fraud and credit protection provisions are in place.

Treasury continues to collaborate with the FRBNY on anti-fraud and credit protection provisions for each new eligible asset class under TALF, including provisions for the expansion of TALF to AAA-rated legacy CMBS. For example, only fixed-rate CMBS that has substantial credit support is eligible for TALF. Additionally, FRBNY has hired a collateral monitor to review each CMBS proposed as collateral. Treasury and the Federal Reserve designed the criteria that the collateral monitor will use in its evaluations.

Other anti-fraud and credit protection provisions for the CMBS program under TALF include the following areas:

Fraud Prevention Requirements

- The CMBS issuer must provide a certification in connection with the prospectus that the CMBS is TALF eligible, that a nationally recognized certified independent accounting firm has certified that the CMBS 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 CMBS issuer and CMBS sponsor must provide an indemnity certification, which protects FRBNY and Treasury from any losses resulting from a contractual breach of representations and warranties specified in the transaction document.

Credit Loss Protection Requirements

- TALF borrowers are required to supply risk capital in the form of haircuts that will provide the first loss protection before usage of U.S. Government funds. TALF borrowers therefore have significant incentives to investigate 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 stressed scenarios.

Fraud Prevention and Credit Loss Protection at the TALF LLC Level

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

- A portion of the excess loan spread paid by TALF borrowers will pass to the SPV and accumulate to provide the first loss cushion to any potential losses that may occur if collateral is put to TALF LLC and subsequently sold for a loss.

- Treasury has the right to approve or disapprove any modifications to the TALF loan haircuts or loan fee charged to TALF borrowers.

- Treasury has access to information and reports regarding TALF loans outstanding and underlying collateral in addition to TALF LLC financial reporting and notices.

- Treasury has the right to monitor the FRBNY's internal controls and compliance measures for TALF.

SIGTARP Recommendation 9:
Treasury should require significantly higher haircuts for all MBS, with particularly high haircuts for legacy RMBS, or other equally effective mitigation efforts.

Treasury's Response

A decision has not been reached on whether to include RMBS as eligible collateral in TALF. To the extent any future expansion of TALF includes RMBS, Treasury will work with the FRBNY to develop and enhance risk management protocols for haircuts.

As with previous asset classes, the CMBS program under TALF employs conservative haircuts to address the risk that the collateral may decline in value and ensure that investors have an equity stake in the transaction. CMBS haircuts will be calculated against par, but the FRBNY applies that haircut to the current discount price of legacy CMBS securities, thus resulting in a larger percentage haircut and greater protection against credit loss for the more discounted securities.

SIGTARP Recommendation 10:
Treasury should address the confusion and uncertainty on executive compensation by immediately issuing the required regulations.

Treasury's Response

Treasury published an Interim Final Rule on executive compensation which can be found in the June 15, 2009 edition of the Federal Register. The Department of Treasury issued a press release, conducted a press conference regarding the announcement of the Special Master for Executive Compensation, and the newly appointed Special Master has begun to communicate with TARP participants to implement the rule.

SIGTARP Recommendation 11:
Treasury should significantly increase the staffing levels of OFS-Compliance and ensure the timely development and implementation of an integrated risk management and compliance program.

Treasury's Response

OFS has made significant progress in staffing its compliance functions, although there are still a number of compliance positions to be filled. OFS has posted job descriptions and is reviewing resumes and conducting interviews to fill compliance positions at all levels in the organization. When fully staffed, the compliance department will have senior compliance professionals and supporting teams overseeing each TARP program, a team of executive compensation professionals to handle compensation and related compliance issues across all programs, and a team overseeing conflicts issues involving contractors and financial agents.

In the meantime, the compliance staff is receiving assistance from other OFS personnel, including those in the risk management, financial management, home ownership preservation and investment areas, to ensure that TARP participants are meeting their responsibilities under the statutes, rules and investment agreements. In addition, OFS is using financial agents and contractors to provide substantive expertise and program monitoring services under the direction of the compliance staff.

SIGTARP Recommendation 12:
Treasury should require CAP participants to (i) establish an internal control to monitor their actual use of TARP funds, (ii) provide periodic reporting on their actual use of TARP funds, and (iii) certify to OFS-Compliance, under the penalty of criminal sanction, that the report is accurate; the same criteria of internal controls and regular certified reports should be applied to all conditions imposed on CAP participants; Treasury should require CAP participants to acknowledge explicitly the jurisdiction and authority of SIGTARP and other oversight bodies, as appropriate, to oversee conditions contained in the agreement.

Treasury's Response

Treasury is in the process of finalizing the CAP documents, the drafts of which incorporate most of the suggestions made by SIGTARP. With respect to the reporting of the use of TARP funds, as discussed above, this program is designed to increase the capital cushion of banks so that they are in a position to continue lending to creditworthy borrowers. Toward that end, CAP participants will be required to provide certified monthly lending reports to Treasury. The reports will break loans out by category, show how many new loans are provided to businesses and consumers, and show how many asset-backed and mortgage-backed securities are purchased on a monthly basis. To provide context for the raw data, institutions will be required to include a narrative description of the lending environment, including loan demand, in the communities and markets they serve. In addition, they will be required to compare lending activity each month to a rigorous estimate of what their lending would have been in the absence of government assistance. CAP participants will also be required to acknowledge the jurisdiction of the oversight bodies, including SIGTARP.

SIGTARP Recommendation 13:
Treasury should impose strict conflict-of-interest rules upon PPIF managers across all programs that specifically address whether and to what extent the managers can (i) invest PPIF funds in legacy assets that they hold or manage on behalf of themselves or their clients or (ii) conduct PPIF transactions with entities in which they have invested on behalf of themselves or others. SIGTARP recognizes that there is a trade-off between hiring managers with significant experience in the marketplace (who have the expertise to make them effective asset managers but who have complex conflict-of-interest issues as a result) and hiring managers who are not in the market at all (who have less expertise but also no conflicts); however, Treasury should at least consider whether its fund manager requirements address the serious conflict issues. It may very well be that some of the conflicts cannot be mitigated under the current structure of the programs unless the fund managers have no interests (and have no clients who have interests) in the kinds of legacy assets that the PPIFs are purchasing. This may, in turn, significantly limit what entities should be making PPIF investment decisions.

Treasury's Response

Treasury agrees with SIGTARP on the importance of strict conflict of interest rules and protections in the PPIP program and has worked closely with the SIGTARP to achieve this objective. From the outset of the development of the PPIP, Treasury has focused on the need for a strong set of conflict of interest rules and ethical guidelines. Treasury's conflict of interest rules and ethical guidelines are the product of a rigorous and thorough development process that included extensive interaction with the SIGTARP staff, as well as with prospective PPIP fund managers and the compliance professionals at the Federal Reserve Bank of New York (FRBNY).

It may be helpful to summarize the process Treasury followed to investigate and mitigate actual and potential conflicts of interest that could affect a PPIF. This process was conducted in connection with the evaluation of PPIP fund manager applicants. Treasury worked closely with the SIGTARP in this process, which included the following steps:

- Treasury required applicants to identify all conflicts of interest and how they would adopt to avoid or mitigate those conflicts in its publicly-released application for prospective PPIP fund managers;

- Treasury assessed each potential PPIP fund manager's response for thoroughness (noting any deficiencies) and identified best practices with respect to governance and conflicts mitigation controls;

- For those applicants selected as finalists, Treasury developed extensive legal and compliance diligence questionnaires that addressed detailed questions regarding governance and conflicts of interest issues, including:

    - Internal audit methodology, accounting policies/procedures and internal controls;

    - Mechanisms in place to identify, track, eliminate, mitigate, and monitor organizational and personal conflicts of interest;

    - Policies and procedures regarding affiliates, "round tripping," valuation, trade allocations and handling material non-public/sensitive information;

    - Responsibilities, authorities and independence of the Chief Compliance Officer; and

    - Other governance and management policies and procedures.

- Treasury evaluated each finalist's responses for thoughtfulness, feasibility, and completeness and benchmarked these responses across several key compliance and conflicts related metrics;

- Treasury then compiled subsequent legal, governance and conflicts of interest questions for each finalist, as necessary; and,

- Treasury discussed several key questions with finalists during in-person presentations made to Treasury at Treasury's offices. A representative from SIGTARP was invited to attend and observe and was present at most of these meetings.

After completion of the evaluation process, Treasury held numerous discussions focused specifically on conflict of interest issues with representatives from potential PPIP fund managers, the SIGTARP staff, and the FRBNY, including FRBNY's Chief Compliance Officer, several professionals in compliance and risk departments, and several individuals responsible for administering various governance-related portions of FRBNY's recovery related programs. As part of this process,

- Treasury also had a comprehensive, multi-hour, in-person discussion with FRBNY personnel at its New York headquarters to address governance issues. The meeting was attended by OFS compliance and risk personnel along with the Acting Chief Investment Officer of OFS. A representative from the SIGTARP also attended these meetings;

- Treasury took into consideration information obtained from all of these discussions in developing the conflict rules and ethical guidelines. Throughout this process, Treasury communicated closely with the SIGTARP. Drafts of the term sheets and rules were shared and discussed with SIGTARP, and Treasury benefitted from SIGTARP's involvement and suggestions.

This process resulted in the development of conflicts standards and procedures that we believe will ensure that the PPIP can attract private capital and investment expertise to markets that have been substantially frozen for many months and protect taxpayers' interests at the same time. We also believe these standards and procedures incorporate almost all of the SIGTARP's suggestions. All PPIP fund managers will be required to adopt these standards and procedures – known as "Ethical Standards and Conflicts of Interest Rules" (the "Rules"). These measures include, but are not limited to:

- Adoption of the following policies and associated compliance procedures which must be approved by Treasury and any identified violations reported to Treasury and SIGTARP:
    - Allocation and valuation/pricing policy which must comply with the Investment Advisers Act of 1940, as amended, in all material respects;
    - "Arm's length" transactions with affiliates policy;
    - Prohibition of use of affiliated broker-dealers to execute transactions; and,
    - Code of ethics and associated personal trading policy;
- Investment of a minimum of 20 million of the General Partner's own capital in the PPIF;
- Establishment of "watch lists" and associated compliance procedures;
- Reporting to Treasury of any information in the PPIP fund manager's possession regarding the beneficial owners in equity of a PPIF in their capacity as beneficial owners;
- Reporting to Treasury of 10 largest positions of the PPIF within 15 days after the end of each calendar quarter (and public disclosure of such positions at such time as Treasury determines that such disclosure will not harm the ongoing operations of the PPIF); and,
- Retention of an independent annual internal controls and financial audit.

To address the proprietary interests and/or interests potential PPIP fund managers hold for other clients in Eligible Assets, Treasury will require PPIP fund managers to:

- Be SEC-registered as an Investment Advisor (all recommended pre-qualified PPIP fund managers are);

- Have a trade allocation policy approved by Treasury and report all positions in Eligible Assets (PPIF, non-PPIF funds) to Treasury on an on-going basis;

- Require a PPIP fund manager to invest a minimum of $20 million in the PPIF fund and allow co-investment by PPIP fund manager staff and employees in the PPIF they manage to better align incentives;

- Require a PPIP fund manager to demonstrate that its compensation system aligns the economic interests of Key Persons with the interests of investors in the PPIF;

- Permit Treasury and SIGTARP to conduct annual and ad hoc audits of compliance with all policies;

- Maintain an independent Compliance Department that keeps an Eligible Assets Watch List that includes information on Eligible Assets held across a PPIP fund manager's funds in addition to the PPIF;

- Disclose to Treasury and SIGTARP actual and potential conflicts of interest; and

- Obtain a Type II SAS 70 report and ensure independent third-party verification of its valuations, returns calculations, and internal controls.

With respect to conflicts with PPIP fund manager affiliates holding or servicing Eligible Assets, Treasury will require PPIP fund managers to:

- Not acquire Eligible Assets from or sell Eligible Assets to: (i) its affiliates; (ii) any other PPIF managed by a different PPIP fund manager (as defined in the definitive documentation); or (iii) any investor that has invested 10% or more of the aggregate private capital raised by the PPIF; and

- Ensure all PPIF transactions must be at arm's length, commercially reasonable, and on terms no less favorable to the PPIF than in transactions with unrelated parties.

With respect to conflicts with PPIP fund manager placement agents and broker-dealer relationships, Treasury will require that:

- A PPIF may not execute trades through a broker-dealer affiliated with the PPIF fund manager; and

- PPIP fund managers may not have "pay-to-play" arrangements with placement agents, underwriters, and other service providers in which money or other forms of direct or indirect compensation are exchanged for services for the privilege to engage (i.e. play) in such activities.

With respect to personal conflicts of interest of PPIP fund manager employees, Treasury will require that:

- All PPIP fund manager key individuals must be subject to a Code of Ethics and associated Personal Trading Policy; and
- PPIP fund managers must maintain policies that cover handling of material non-public information, personal trading, outside business affiliations, and giving and accepting gifts and entertainment.

Treasury will also require that PPIP fund managers certify on a quarterly basis to Treasury their compliance with their internal policies, and that they negotiate with Treasury in good faith over material proposed changes to their policies. Moreover, PPIP fund managers may be removed for material non-compliance with the Rules.

As noted, Treasury's policies incorporate practically all of SIGTARP's recommendations. The only substantial recommendation that Treasury has declined to accept is to require that PPIP fund managers provide an investment team that is exclusively devoted to the PPIF and that the team be walled off from other employees of the fund manager, a procedure that the FRBNY has required in certain of its programs. After careful review of this possibility and extensive consultations with SIGTARP, the FRBNY and potential PPIP fund managers, as well as review of the use of information barriers or walls generally, Treasury decided not to impose such a requirement.

While using a segregated team to manage the PPIF might reduce the possibility that non-PPIF investors could benefit at the expense of taxpayers, Treasury concluded that such an arrangement is simply not practicable in the context of S-PPIP. The goal of the PPIP is to restart legacy securities markets by providing capital for investment and promoting price discovery. The PPIP is meant to be a catalyst to stimulate activity by other investors. In order to serve that purpose, the fund managers who are selected for the PPIP must have the experience and expertise to attract private capital and make investment decisions about legacy assets based on limited market information. The managers selected by Treasury already advise funds that have investments in these markets. Indeed, that is one of the primary reasons they have been selected. For the reasons discussed below, it is not practicable or necessary to insist that they assign a segregated investment team to manage PPIF assets. Instead, conflicts of interest can be adequately addressed through the alternative procedures that Treasury has developed.

a. Requiring a segregated investment team would be likely to reduce investment performance of the PPIF. Any potential benefits associated with walling off the PPIF investment team from the rest of their firm would be far outweighed by a multitude of very significant drawbacks, including the following:

- Requiring a segregated team would significantly diminish or eliminate the program's access to a PPIP fund manager's "A Team" of investment professionals. It is usual and customary for investment professionals to work across multiple funds that invest in similar assets. Fund managers told us they owe a fiduciary duty to all investors and Treasury should not expect to be treated differently. Were Treasury to require that PPIP fund managers provide a segregated investment team, either the fund manager would not participate at all or Treasury's investment would be managed by a junior team that would not be able to consult with the PPIP fund manager's most experienced decision makers. The likely results would be lower returns to taxpayers as well as diminished ability for PPIP fund managers to raise private capital because private investors would be less likely to want to co-invest with Treasury in PPIFs if junior teams of investment professionals would be managing those PPIFs.
- Walling off a few professionals to make all investment decisions would run contrary to the team-oriented investment process that all PPIP fund managers employ. PPIP fund managers have been selected based on their experience and firm resources. This investment process allows the investment professionals working on the PPIFs to leverage the firm's collective experience and pooled resources across all investment areas and provides significant synergy to the investment process. Implementing a wall would significantly reduce performance and thereby potentially harm the taxpayer.

b. Requiring segregated investment teams for PPIP would increase risk by limiting fund manager participation in the PPIP and forcing Treasury to invest through a smaller number of funds and investment strategies. In addition to reducing returns to taxpayers, requiring segregated investment teams would increase risks.

- Many PPIP fund managers have indicated that they would withdraw themselves from consideration as potential PPIP fund managers should Treasury require a segregated investment team. This would require Treasury to concentrate its investment into the hands of a few PPIP fund managers, which runs contrary to Treasury's goals of establishing a broad and deep market for Eligible Assets as well as diffusing the influence of any particular PPIP fund manager.

- Requiring a segregated investment team would undermine protections against fund manager misconduct. The team approach to investment decisions provides checks and balances within the organization. PPIP fund managers indicated that the transparent nature of their investment approach within the firm draws on senior professionals across business units and inclusive of senior management. This provides enhanced supervision and balances any one individual PPIP fund manager from acting in his/her own interests or other potential conflicts of interest.
- "Walling off" personnel and establishing separate software/systems would be time-consuming, costly and not feasible for many firms (especially smaller firms).

c. <u>Requiring segregated investment teams for PPIP is not necessary to mitigate the risks that are presented by this program</u>.

- The PPIP does not present the same kinds of risks as those that led FRBNY to require segregated teams for some of its programs. Treasury has spent considerable time discussing conflicts concerns and mitigation strategies with FRBNY compliance personnel in order to understand why they elected to require segregated managerial teams for certain of their programs. We learned that FRBNY requires such segregation for its MBS, commercial paper funding facility, and Maiden Lane programs because those teams are in possession of material, non-public information of FRBNY, which could be leaked to the rest of the asset manager's organization. PPIP fund managers will not have material non-public information from Treasury. Instead, they will make their own investment decisions and Treasury will be a passive investor. Although Treasury has broadly defined the criteria for Eligible Assets for the PPIP, Treasury will not be involved in the PPIP fund manager's investment decision making and analysis process, nor will it provide feedback or guidance on what a PPIP fund manager should be purchasing. To the extent there is a parallel to any of FRBNY's programs, the analogous program is TALF, in which FRBNY does not require a segregated team because it does not pass any non-public information to TALF recipients or any related agents.
- Treasury's Rules contain key mitigation controls and procedures that provide much stronger protections for taxpayers interests without the drawbacks of "walling off" investment professionals.
    - The Rules require each fund manager to adopt and follow a fair and equitable trade allocation policy. Treasury will approve that policy and Treasury and the oversight bodies will be able to review compliance with that policy.
    - The PPIP term sheets give Treasury and SIGTARP access to data outside of the books and records of the PPIF. Treasury and

SIGTARP will be able to review all trades in Eligible Assets by the PPIF and any other fund managed by the PPIF fund manager no less frequently than on a monthly basis (although some fund managers have stated that they can provide daily access to this information should Treasury or SIGTARP require it). This allows monitoring and auditing of all funds in the PPIP fund manager's firm that trade in Eligible Assets and allows Treasury and SIGTARP to see the flow of Eligible Assets throughout the firm. Treasury will hire a consultant with robust trading analysis systems to review such data. Thus, Treasury will be able to evaluate whether the PPIP fund manager is purposely disadvantaging the PPIF relative to non-PPIF funds.

- The PPIP term sheets strictly prohibit a PPIP fund manager from trading with affiliate funds.
- Treasury will have the unilateral right to remove the PPIP fund manager for cause and has certain rights to remove the PPIP fund manager without cause with the consent of 51% of the private investors.
- PPIP fund managers have internal/external audit and corporate governance processes. The PPIP fund managers have impressive track records and reputations and all maintain strict internal policies regarding ethics and compliance. Each maintains internal and external auditors and corporate governance processes.

▪ While "walling off" investment professionals could further limit the risk that bad actors could inappropriately share material non-public information, doing so would not eliminate such risks. Walls are permeable and can be evaded by individuals determined to do so. Only through the development of a fair trade allocation policy and robust reporting/ monitoring of the PPIP fund manager's compliance regime can we protect the interests of taxpayers. Specifically, Treasury believes the best control over the risk of inappropriate activities like front-running and improper affiliate transactions is to monitor and analyze actual trading data on a frequent basis.

In summary, Treasury believes the rules and procedures outlined above constitute a comprehensive and robust regime for preventing or mitigating manager conflicts of interest. These rules and procedures will further the purposes of the PPIP and provide better protection for taxpayers without imposing the risks of requiring a segregated PPIF investment team.

Finally, Treasury's Office of Financial Stability has strong compliance and risk capabilities to ensure that recipients of TARP funding comply with their obligations under EESA, the transaction documents related to the TARP funding and applicable rules and regulations. Treasury is in the process of expanding the compliance and risk department in connection with the launch of the PPIP program. Treasury will devote whatever resources are necessary to ensure that the compliance and risk regime it has developed for PPIP is fully implemented. The compliance function as it pertains to PPIP will include not only Treasury employees but third party professional advisors, including advisors to monitor trading and allocation activity in legacy assets across each fund complex. Treasury staffing levels will be sufficient to oversee the independent compliance function within each PPIF as well as the ongoing independent audit function that is required to be performed on all PPIP fund managers. Treasury compliance staff will also maintain regular dialogue with each PPIF fund manager's compliance department. It is only through such robust compliance efforts that we can ensure that American taxpayers' interests are protected. We look forward to receiving continued input from SIGTARP with respect to the design, staffing, and operation of this function.

SIGTARP Recommendation 14:
Treasury should mandate transparency with respect to the participation and management of PPIFs. This should include disclosure of the beneficial owners of all of the private equity stakes in the PPIFs and of all transactions undertaken in them. In addition to the reporting requirements contained in the PPIP term sheets, Treasury should obtain and publicly disclose certified reports from all PPIFs across all programs that include all transactions and the current valuation of all assets. To the extent that PPIF managers are permitted to hold or engage in transactions in the same securities that they are buying and selling in the PPIFs, Treasury should require PPIF managers to report to Treasury on any and all holdings and transactions in the same types of legacy assets on their own behalf or on behalf of their clients. Moreover, in addition to the requirement that SIGTARP will have access to all of the PPIF's books and records, as set forth in the term sheets, Treasury should impose a requirement that PPIF managers retain all books and records pertaining in any way to the PPIF (including all e-mails, instant messages, and all other documents), and permit SIGTARP and other oversight entities access to the fund manager's books and records and employees, upon request.

Treasury's Response

Treasury agrees with the need for transparency with respect to the participation in and management of PPIFs and has worked with the SIGTARP to ensure this. Treasury has sought to develop measures that achieve this goal while still ensuring that the program succeeds in attracting wide participation from private investors. As required under Section 402 of the Helping Families Save Their Homes Act of 2009 ("Ensign"), each PPIF fund manager will be required to disclose to Treasury each beneficial owner of 10% or more of the total equity in the PPIF. Under the requirements of Treasury's term sheets and "Ethical Standards and Conflicts of Interest for Public-Private Investment Fund Managers," Treasury has further required each PPIP fund manager to disclose to Treasury any information in the PPIP fund manager's possession regarding the beneficial owners in equity of a PPIF in their capacity as beneficial owners.

Treasury will not require public disclosure of all transactions undertaken in the PPIF. However, as required under Ensign, each PPIP fund manager will be required to make a quarterly report to the Secretary of the Treasury that discloses the ten largest positions of such PPIF and these reports will be publicly disclosed at such time as Treasury determines that such disclosure will not harm the ongoing business operations of the PPIF.

Treasury and SIGTARP will be able to review all trades in Eligible Assets by the PPIF and any other fund managed by the PPIF fund manager on a no less frequently than monthly basis (although some fund managers have stated that they can provide daily access to this information should Treasury or SIGTARP require it).

Treasury agrees with SIGTARP with respect to access to records and will impose a requirement that PPIP fund managers retain all books and records pertaining to the PPIF. PPIP fund managers will also be required to provide access to such books and records to Treasury and the oversight bodies (including SIGTARP) and be available to discuss the PPIF and its activities at the request of Treasury.

SIGTARP Recommendation 15:
Treasury should require PPIF managers to provide PPIF equity stakeholders (including TARP) "most-favored nations clauses," requiring that the fund managers treat the PPIFs (and the taxpayers backing the PPIFs) on at least as favorable terms as given to all other parties with whom they deal. In that same vein, PPIF managers should be required to acknowledge that they owe the PPIF investors – both the private investors and TARP – a fiduciary duty with respect to the management of the PPIFs. Treasury should also require that each PPIF fund manager have a robust ethics policy in place and a compliance apparatus to ensure adherence to such code.

Treasury's Response

Treasury has included a "most-favored nations" clause in the PPIP term sheets in which other PPIF investors will not be treated "in a manner more favorable than the rights and benefits established in favor of UST by the Partnership Agreement, other than any rights or benefits established in favor of any investor in the Private Vehicles by reason of the fact that such investor is subject to any laws, rules or regulations to which UST is not also subject."

Treasury will also require PPIP fund managers to:

- Acknowledge their fiduciary duty to Treasury in addition to private investors; and
- Adhere to rigorous code of ethics policies both prior to closing and thereafter, which will be reviewed by the Office of Financial Stability's risk, compliance and legal departments.

Treasury will also require PPIP fund managers to establish and abide by a code of ethics policy that will address, but not be limited to:

- Handling of material nonpublic information;
- Personal trading;
- Outside business affiliations; and
- Giving and accepting gifts and entertainment.

SIGTARP Recommendation 16:
In order to prevent money laundering and the participation of actors prone to abusing the system, Treasury should require that all PPIF fund managers have stringent investor-screening procedures, including comprehensive "Know Your Customer" requirements at least as rigorous as that of a commercial bank or retail brokerage operation. Fund managers should be required to provide Treasury with the identities of all of the beneficial owners of the private interests in the fund so that Treasury can do appropriate diligence to ensure that investors in the funds are legitimate.

Treasury's Response

To prevent money laundering and the participation of actors prone to abusing the system, Treasury will require that all PPIP fund managers have stringent investor-screening procedures, including comprehensive "Know Your Customer" regulations, OFAC statutes and regulations and all relevant federal securities screening laws and anti-money laundering obligations. In addition, PPIP fund managers will be required to provide Treasury any information in the PPIP fund manager's possession regarding the beneficial owners in equity of a PPIF in their capacity as beneficial owners.

SIGTARP Recommendation 17:
Treasury should not allow Legacy Securities PPIFs to invest in TALF, unless significant mitigating measures are included to address these dangers. These might include prohibiting the use of TARP leverage if the PPIF invests through TALF, or proportionately increasing haircuts for PPIFs that do so.

Treasury's Response

Treasury and the Federal Reserve have spent considerable time analyzing these concerns and believe that, subject to implementing appropriate controls, allowing PPIFs to invest in TALF is appropriate. Treasury also agrees that the additional leverage TALF offers to a PPIF creates the need to consider additional controls. While the Federal Reserve and Treasury are currently working on details of program interaction, the FRBNY and Treasury have agreed that the FRBNY will allow PPIFs to access TALF subject to the TALF haircuts being adjusted upward to take into account Treasury debt. In particular, the haircuts will be increased so that the combination of Treasury- and TALF-supplied debt will not exceed the total amount of TALF debt that would be available leveraging the PPIF equity alone. In addition, there will be a total leverage cap of 5.0x to ensure that all PPIFs have adequate equity capital at risk. It is expected that, at closing, all PPIP fund managers will utilize debt capital from Treasury, which would be a maximum of 100% of the aggregate equity capital commitments in the PPIF. PPIP fund managers are prohibited from utilizing TALF or third party debt financing if Treasury debt capital comprises more than 50% of the aggregate equity capital commitments of the PPIF. Moreover, Treasury's debt investment would be priced to reflect the additional risk associated with higher leverage.

In addition, as noted earlier, a decision has not been reached on whether to include RMBS as eligible collateral for TALF.

SIGTARP Recommendation 18:
All TALF modeling and decisions, whether on haircuts or any other credit or fraud loss mechanisms, should account for potential losses to Government interests broadly, including TARP funds, and not just potential losses to the Federal Reserve.

Treasury's Response

Treasury, the Federal Reserve and FRBNY have spent considerable time modeling and analyzing the haircuts and credit exposure for TALF collateral (both current and proposed classes of assets). In order to protect the taxpayer, those models and analyses take into account the potential exposure to the Government broadly. Treasury, the Federal Reserve, and FRBNY believe the current haircut levels and other modeling decisions are appropriate for the risk involved. Treasury, the Federal Reserve and FRBNY will continue to use the entire Government exposure methodology for additional classes of assets for TALF.

SIGTARP Recommendation 19:
Before funding a mortgage modification, Treasury should require the servicer to submit third-party verified evidence that the applicant is residing in the subject property.

Treasury's Response

The published servicer guidelines of the HAMP program address this concern. Servicers are required to verify owner occupancy of a borrower using a variety of third-party sources including: matching addresses to printed checks received from borrowers, noting when mail sent to the property address is returned as undeliverable, and checking against tax returns, credit reports, paystubs, and utility bills. This third-party verification must be retained by the servicer in the case file and submitted to Treasury or its agent upon request or during a mandatory compliance audit.

Freddie Mac will review documents received by the servicers for compliance with program guidelines. In addition, Freddie Mac is in the process of investigating the use of third party data sources to validate occupancy during loan file reviews as well as part of data analysis of servicer data.

SIGTARP Recommendation 20:
Additional anti-fraud protections should be adopted to verify the identity of the participants in the transaction and to address the potential for servicers to steal from individuals by receiving Government subsidies without applying them for the benefit of the homeowner. Closing-like procedure conducted would include (1) a closing warning sheet that would warn the applicant of the consequences of fraud; (2) the notarized signature and thumbprint of each participant; (3) mandatory collection, copying, and retention of copies of identification documents of all participants in the transaction; (4) verbal and written warnings regarding hidden fees and payments so that applicants are made fully aware of; (5) the benefits to which they are entitled under the program (to prevent a corrupt servicer from collecting payments from the Government and not passing the full amount of the subsidies to the homeowners); and (6) the fact that no fee should be charged for the modification.

Treasury's Response

Treasury has implemented standard guidelines for the HAMP program to ensure the program achieves its goals of stemming foreclosures without causing undue burden to borrowers or excessive costs to servicers. The program provides awareness, information, and education to borrowers regarding, for instance:

- Warnings of hidden fees,
- Reduction of monthly payments, and
- Principal reduction incentive.

Borrower education is provided both verbally and in written form through:

- Published marketing materials and program guidelines on MakingHomeAffordable.gov website,
- Call center counselors, and
- Outreach programs.

Treasury is currently drafting standard language that highlights these warnings and borrower incentives that will be used as part of the application process. One such standard employed presently to borrowers in the hardship affidavit is the disclosure of the penalties associated with fraud.

In addition, Treasury will implement additional anti-fraud protections to verify that borrower incentives are appropriately paid. Freddie Mac will verify that incentives are applied to borrowers and investors, as appropriate, as part of the compliance reviews of servicers. Freddie Mac will also employ testing procedures and data mining techniques, including the use of third-party anti-fraud tools, to help identify and report non-compliance as well as potential fraudulent practices by services.

Other procedures recommended by SIGTARP, such as obtaining notarized signatures and thumbprints, are not part of the current standard practice for mortgage modifications, and would cause undue burdens on borrowers and servicers, thereby defeating the objectives of the program.

SIGTARP Recommendation 21:
Treasury should require that verifiable, third-party information be obtained to confirm an applicant's income before any modification payments are made. Treasury should require servicers to (1) compare the income reported on their initial mortgage application with the income reported on the modification application, and, if they differ significantly, require an

explanation and verifiable documentation of the change in income; and (2) require third-party verification of employment.

Treasury's Response

Servicers are required to verify borrower income using tax returns, credit reports and other third party data sources. This verification must be retained by the servicer in the case file and provided to Treasury or its agent upon request or during a compliance audit. In many cases, the initial loan applications will not be in the servicer's files, particularly if servicing was transferred. The post-modification compliance procedures developed by Treasury and Freddie Mac also include validation of applicant's income using third-party sources where available.

SIGTARP Recommendation 22:
Treasury should defer payment of the $1,000 incentive to the servicer until after the homeowner has verifiably made a minimum number of payments under the mortgage modification program.

Treasury's Response

This is consistent with how Treasury has designed the HAMP program. Under the HAMP program, servicers are not eligible to receive the $1,000 upfront incentive until the borrower has made three full payments under the modification. Freddie Mac will include, in servicer compliance reviews, procedures to verify that borrowers have made the required number of payments under the trial modification.

SIGTARP Recommendation 23:
Treasury should proactively educate homeowners about the nature of the program, warn them about these predators, and publicize that no fee is necessary to participate in the program.

Treasury's Response

Treasury is taking important actions to educate homeowners about the Making Home Affordable (MHA) Program. First, the MHA website prominently features a 'Beware of Foreclosure Rescue Scams' warning on its homepage which highlights that there is no fee associated with getting help through MHA and includes a link to more in-depth guidance for homeowners to avoid scams. In addition, the website is updated frequently with new marketing materials, guidelines, FAQs, events and resources for those seeking 24/7 help.

On June 25, 2009, a press conference in Miami kicked off a nationwide campaign promoting the MHA Program to borrowers seeking eligibility information and empowering local partners to connect with these borrowers to prepare them for the interaction with their servicer. The Treasury Secretary and the Secretary of the Department of Housing and Urban Development were quoted in the press release on the need for the outreach effort to educate homeowners on foreclosure prevention and the importance of the trusted advisors in the communities. The outreach plan focuses on 40 markets hardest hit by foreclosure in large metropolitan areas across the country using national and local partners to launch several days of activities in each market geared to circulate foreclosure prevention messaging. Typically, each market will hold a series of events, with varying degrees of intensity, such as: 1) national partners and local officials to kick off the events with a press release and organize neighborhood canvassing to promote the HOPE hotline, MHA and consumer outreach events; 2) partners to facilitate round-table discussions with local officials, borrowers and media; 3) partners and Treasury to hold "Train-the-Trainer" events for servicers, counselors and local officials; and 4) partners to use MHA materials and "Take Action" folders to drive borrowers to consumer outreach events. The success of each market campaign will be measured by the number of borrowers who attended the outreach event and the number of borrowers who eventually entered into a modification. Measurements will also include exit surveys about how borrowers learned of the event, increased calls to the hotline, and increased hits to the MHA website from that particular market.

Homeownership Preservation Office's (HPO) goal is to ensure a consistent, repetitive message from trusted sources to build and strengthen awareness among homeowners on how to prevent foreclosure or to transition to an alternate solution if they are not eligible for modification. Treasury's HPO is the liaison for all of Treasury to all outreach partners such as: Fannie Mae, Freddie Mac, White House Office of Public Engagement, HUD, Federal Trade Commission, Department of Justice, Federal Housing Finance Agency, NeighborWorks America, HOPE Now Alliance, Homeownership Preservation Foundation, and local partners, e.g. Neighborhood Assistance Corporation of America, National Urban League, National Council of La Raza. HPO is partnering with NeighborWorks and Fannie Mae to complete an AdCouncil campaign in September.

SIGTARP Recommendation 24:
Treasury should require its agents to keep track of the names and identifying information for each participant in each mortgage modification transaction and to maintain a database of such information. Not only would such a database assist law enforcement in the detection and apprehension of fraudsters, but it could also assist in fraud prevention.

Treasury's Response

Treasury requires the names and identifying information of borrowers, co-borrowers, servicers, and investors who participate in each mortgage modification transaction. Treasury does not, however, obtain the names of individual employees involved in each mortgage modification transaction because of feasibility, costs, and privacy issues. The names and identifying information of appraisers, mortgage brokers, and attorneys are not collected because these entities do not play a significant role in the mortgage modification process.

The information collected will be retained in a repository that facilitates analysis and allows for customized searches. Treasury and Freddie Mac are developing trending and risk analyses as well as protocols to notify appropriate parties when suspicious activity is identified.

As program enhancements are implemented, Treasury will consider expanding the scope to ensure all relevant program participants are included.