

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

November 25, 2009

The Department of the Treasury (Treasury) welcomes the recommendations on the Troubled Assets Relief Program (TARP) from the Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP). This summary response serves as a status report on SIGTARP's Recommendations.

Treasury has given careful consideration to the 14 recommendations in SIGTARP's prior quarterly reports when taking actions to stabilize the financial system and restore the flow of credit. Treasury's policies and programs currently address many of the issues raised in your recommendations, and in many cases, Treasury has taken specific actions to implement your recommendations. When we believe a particular recommendation would not help carry out Treasury's statutory duties under the Emergency Economic Stabilization Act (EESA), we have developed alternative ways to address the underlying concerns SIGTARP has raised and have explained the measures we are employing to do so in our summary responses to SIGTARP and to Congress. Finally, SIGTARP Recommendations 2, 5, 8, 9, 10 11, 12 should be closed because Treasury has implemented the substance of the recommendation, and believes that no further action is necessary or appropriate.

Recommendations from the October 21, 2009 Quarterly Report

SIGTARP Recommendation 1:

Treasury should include language in new TARP agreements to facilitate compliance and oversight. Specifically, each program participant should (1) acknowledge 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, (2) establish internal controls with respect to that condition, (3) report periodically to the Compliance department of the Office of Financial Stability ("OFS-Compliance") regarding the implementation of those controls and its compliance with the condition, and (4) provide a signed certification from an appropriate senior official to OFS-Compliance that such report is accurate.

Treasury's Response

Treasury will implement this recommendation with respect to new TARP programs going forward, as appropriate.

Treasury has determined that it would not be appropriate to implement this recommendation with respect to the SBA Securities Purchase Program within the Unlocking Credit for Small Businesses Initiative for the following reasons. Treasury has included appropriate fraud controls in designing the program. Specifically, Treasury will not identify itself in the market until the

material terms of the trade, including price, have been settled. Treasury will use a robust procedure to verify that the price offered is in accordance with reasonable market prices and will not buy securities that have previously been traded in the secondary market. Although pool assemblers are vetted by the SBA, Treasury will independently screen pool assemblers, perform background checks on key personnel and perform on-site due diligence prior to entering into trades with any pool assembler. Additionally, in light of the nature of the government-guaranteed securities purchased under this program and the contractual visibility Treasury has regarding its financial agent, it is Treasury's view that substantial and appropriate protections for the taxpayer are in place. Additionally, it is Treasury's view, based on discussions with market participants as well as Treasury's financial agents, that the implementation of SIGTARP's recommendation for this program would likely result in little to no participation from pool assemblers.

Provisions in the servicer participation agreements were drafted to encourage broad participation by servicers in the Making Home Affordable (MHA) Program. The MHA servicer participation agreements contain a provision in which servicers expressly agree that parties designated by Treasury, including SIGTARP, or by applicable law shall have access to the books and records of the servicers. This general access-for-audit provision was considered more appropriate than specifically listing every oversight body that will have access to their books and records because such a specific list might have to be updated through a contract amendment with every servicer any time there is a change in law relating to audit requirements. Under the supplemental directives that are a part of the servicer participation agreements, the servicer must develop a quality control function to ensure compliance with Home Affordable Modification Program (HAMP) guidelines. Compliance with these guidelines is reviewed by Freddie Mac, Treasury's compliance agent. The servicer is required to cooperate with any request from our compliance agent and to send an annual certification regarding compliance with HAMP guidelines.

SIGTARP Recommendation 2:

All existing TARP agreements, as well as those governing new transactions, should be posted on the Treasury website as soon as possible.

Treasury's Response

All existing TARP agreements, including the previously identified CPP agreements have been posted to www.FinancialStability.gov as of November 4, 2009.

SIGTARP Recommendation 3:

Treasury should require TARP recipients to report on the actual use of TARP funds.

Treasury's Response

Treasury is committed to transparency with respect to programs established under EESA and will issue reports that we believe will adequately address the transparency issues raised by

SIGTARP. Specifically, our expanded CPP quarterly report will cover, on both an aggregate basis and for each bank participating in CPP, all of the significant categories of uses reported in SIGTARP's Use of Capital Survey Responses, including lending, investments, capital cushion, repayment of debt and acquisitions. Moreover, our report will be based upon detailed financial information collected by bank regulators, and will specify the actual levels and changes of assets and liabilities related to each use of funds rather than simply identifying categories. Further, our report will be updated and published on the Financial Stability web site each quarter and will show how uses of capital by each CPP bank and by all CPP banks in the aggregate are changing over time. Treasury plans to post the expanded CPP quarterly report on the Financial Stability web site by November 30, 2009.

Separately, Treasury will create and publish a summary of certain data based on the categories provided in the overall CPP Quarterly Report, which will describe in quantitative terms the changes in assets, liabilities and capital accounts as well as key performance ratios for each participating institution. These summaries will be based on each financial institution's call reports and/or Y-9C data submitted to its primary banking regulator.

Additionally, Treasury plans to gauge the effectiveness of CPP by collecting and analyzing information from financial institutions that have participated in this program. Treasury has discussed with SIGTARP the format and content of a use of capital survey and plans to present a revised version of the survey in response to comments received from SIGTARP next week.

The survey will request CPP recipients to complete a set of questions asking what actions institutions took, or were able to avoid taking, because of the CPP funding. The electronic survey questions will request institutions provide qualitative information on all specific uses of CPP capital, refer to quantitative evidence as necessary and appropriate, and maintain all supporting documentation used to complete the survey. The scope of the survey will cover how each financial institution has employed the capital infusion of CPP funds from the date they initially received the funds until the end of the third quarter 2009.

Treasury plans to send the survey to CPP recipients in the near future, and would request survey responses from financial institutions within 30 days of the request. Treasury would publish the survey responses on the Financial Stability web site as soon as practicable, and would also publish the names of the financial institutions that failed to submit a survey response to Treasury.

SIGTARP Recommendation 4:

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

Treasury's Response

Treasury is in process of implementing this recommendation. Treasury agrees with SIGTARP that it is in the public interest to provide periodic disclosure of the estimated value of the TARP

portfolio so that the public knows the value of the investments that Treasury has made. A valuation of the portfolio was previously provided as part of the President's 2010 Budget. Under Federal law, Treasury is required to provide a valuation of its investments in connection with the preparation of its annual financial statements. On or about December 15, 2009, Treasury will publish the financial statements for the fiscal year ended September 30, 2009. The methodology used for such valuation is governed by Federal accounting principles and the financial statements and the methodology are being audited by the GAO.

Updated valuations will be published from time to time in accordance with the existing schedule for federal budget and accounting reporting. This means that we expect to publish such valuations at the time of the President's budget and the President's midsession budget review.

Further, we are tentatively planning to complete an additional valuation in the late spring (probably May) so that, taken together, we will be providing quarterly valuations.

SIGTARP Recommendation 5:

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

Treasury's hiring for oversight, reporting, conflicts, and executive compensation are substantially complete. Treasury continues to hire staff for OFS-Compliance with several new additions for anti-fraud and audit experience. When fully staffed, the compliance department will have senior compliance professionals and supporting teams overseeing each TARP program.

The compliance staff continues to receive 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 investment agreements. In addition, Treasury is using Freddie Mac with regards to HAMP and contractors to provide substantive expertise and program monitoring services under the direction of the compliance staff. Most notably, Treasury has hired a compliance contractor to help with monitoring activities for the PPIP.

SIGTARP Recommendation 6:

Treasury should periodically disclose trading activity and require PPIF managers to disclose to SIGTARP, within seven days of the close of the quarter, all trading activity, holdings, and valuations so that SIGTARP may disclose such information, subject to reasonable protections, in its quarterly reports.

Treasury's Response

Treasury agrees with the need for transparency and each PPIF fund manager will be required to make a quarterly report to the Secretary of the Treasury that discloses the 10 largest positions of the PPIF and these reports will be publicly released.

With respect to timing, Treasury believes that delivery of reports within 15 calendar days after the end of each month is reasonable and consistent with industry practices for investment funds. Per the PPIF Loan Agreement, each fund manager will participate in a formal valuation process for determining the market value of portfolio investments at the end of each month. The valuation process includes multiple steps, involves multiple parties and takes six business days to complete following the end of each month. Following the completion of the valuation process, a draft Collateral Administration Report is delivered to each fund manager no later than 7 business days after month end. The fund managers then review the draft report and are able to correct any errors. A final Collateral Administration Report is delivered to Treasury and SIGTARP 15 calendar days after month end. This timing should not prevent SIGTARP from including the data from the prior month-end (which is more recent than the quarterly information provided under certain other OFS programs) as well as in its quarterly reports.

Treasury agrees with SIGTARP that the information on Eligible Assets should be delivered in the monthly reports (including CUSIP or ISIN, date of purchase, security description, par value, cost, fair market value and accrued income) and has updated its definitive agreements accordingly. Additionally, documents will be retained for as long as the PPIF is in existence and three years beyond the termination of the PPIF.

SIGTARP Recommendation 7:

Treasury should have appropriate metrics defined and an evaluation should be in place to monitor the effectiveness of the PPIF managers, both to ensure that they are fulfilling the terms of their agreements and to measure their performance against pre-established benchmarks and against each other.

Treasury's Response

Treasury is continuing the process of developing appropriate metrics to monitor the effectiveness of the PPIF fund managers as well as the Legacy Securities PPIF in general. Performance metrics will be evaluated across three principal areas:

- Effectiveness of achieving policy goals for programs for Legacy Assets – Metrics to measure price discovery and restarting the markets for Eligible Assets are expected to include trading volume and pricing for Eligible Assets.
- Financial performance of a PPIF – Metrics are expected to include PPIF returns. Given the heterogeneous pool of pre-qualified PPIF fund managers (e.g., CMBS vs. RMBS,

participation in different levels of the capital structure, etc.); it is difficult to compare PPIP fund managers' returns directly.

- Adherence to compliance regime – Metrics are expected to include timeliness of delivery of reports and compliance with the Rules, etc.

Treasury has the ability to end the investment period after 12 months in its sole discretion, and to the extent a certain PPIP fund manager is underperforming, Treasury and the private investors will have the ability to replace the General Partner of the PPIF. In addition, material violations of the Compliance Rules will be included as Events of Cause in the Partnership Agreements governing each PPIF.

SIGTARP Recommendation 8:

The conditions that give Treasury “cause” to remove a PPIP fund manager should be expanded to include a manager’s performance below a certain standard benchmark, or if Treasury concludes that the manager has materially violated compliance or ethical rules.

Treasury's Response

Treasury believes that this recommendation should be closed and no further action is necessary. Removal rights are stipulated in definitive legal documentation, available after each initial closing is conducted. To date, seven closings have taken place as of November 10, 2009.

SIGTARP Recommendation 9:

Treasury should require PPIF managers to obtain and maintain information about the beneficial ownership of all the private equity interests, and Treasury should have the unilateral ability to prohibit participation of private equity investors.

Treasury's Response

Treasury believes that this recommendation should be closed and no further action is necessary. Access to fund managers' books and records is stipulated in definitive legal documentation and available after each initial closing is conducted. To date, seven closings have taken place as of November 10, 2009.

SIGTARP Recommendation 10:

Treasury should require the imposition of strict information barriers or “walls” between the PPIF managers making investment decisions on behalf of the PPIF and those employees of the fund management company who manage non-PPIF funds.

Treasury's Response

Treasury believes that this recommendation should be closed and no further action is necessary.

As previously noted, Treasury's policies and procedures incorporate nearly all of SIGTARP's recommendations. The one substantial recommendation Treasury has declined to accept is the requirement that PPIP fund managers provide an investment team that is exclusively devoted to the PPIF and walled off from other employees of the fund manager. This is a procedure that the FRBNY has required in certain of its programs. After careful assessment of this option 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 has decided it would not be in the taxpayers' interest to impose such requirements.

While using a segregated team to manage the PPIF might reduce the possibility that non-PPIF investors could benefit at the expense of taxpayers, such an arrangement is impractical in the context of PPIP. The goal of the PPIP is to restart legacy securities markets by providing capital for investment and promoting price discovery. The PPIP will 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. Conflicts of interest will be adequately addressed through the alternative procedures that Treasury has developed, including the ability of SIGTARP and Treasury to monitor all relevant trades across each manager's entire fund complex on a daily basis.

SIGTARP Recommendations 11:

Treasury should unambiguously commit to give SIGTARP notice of and an opportunity to comment upon any change to the PPIP compliance rules.

Treasury's Response

Treasury believes that this recommendation should be closed and no further action is necessary. We confirm that we will continue to consult with SIGTARP before making any material changes to the Compliance Rules.

SIGTARP Recommendation 12

Treasury should give SIGTARP explicit contractual access to all of the fund manager's and affiliate's information to which Treasury has access, including books and records for the fund managers' affiliates.

Treasury's Response

Treasury believes that this recommendation should be closed and no further action is necessary. SIGTARP will have access on the same basis as Treasury to daily trading records for all transactions in eligible assets by any member of the manager's fund complex. These records go to the heart of the potential conflict concerns SIGTARP has identified to Treasury, because they

allow SIGTARP and Treasury to detect quickly any trades by affiliates that may indicate activity in conflict with the interests of PPIP investors.

SIGTARP Recommendation 13:

Additional anti-fraud protections should be adopted in MHA 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.

Treasury's Response

Incentive payments to servicers include servicer incentives, investor payments, and borrower incentives. Payments represent (i) incentive payments to the servicer at the successful conclusion of the trial loan modification period (90-120 days) and (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. After one year (and annually thereafter, and for up to five years) payments to servicers also include borrower incentives, assuming the borrower is current, which would be applied to reduce the principal amount of the residential mortgage loan for the borrower.

Freddie Mac, Treasury's compliance agent for HAMP, is in the process of refining procedures to verify that incentives paid to servicers are accurately applied to the respective borrower participating in HAMP, and to investors. These compliance procedures will be performed by Freddie Mac on HAMP participating servicers by reviewing a sample of serviced mortgage loans, starting in November. Through this sampling, Freddie Mac's procedures will look to verify that the servicers have appropriate controls to ensure that borrower incentives paid to servicers are properly applied to reduce the outstanding principle balance of the related borrower's residential mortgage loan by tracing the incentives allocated to such loan. Freddie Mac will also look to verify that the investor incentives have been passed through to the related investors. Additional procedures include loan file reviews performed by Freddie Mac to verify that the loan exists, and that the data submitted by the servicer to the HAMP system of record is accurate.

Treasury believes that the existing anti-fraud protections to identify borrowers and/or co-borrowers involved in HAMP are sufficient. In addition, controls are in place to ensure that borrowers can receive benefit for only one modification to a first lien loan and, if applicable, only one modification to a second lien loan. However, Treasury's Financial Agent Fannie Mae is currently investigating potential automated methods to validate both home occupancy and the reported Social Security numbers for borrowers. Treasury anticipates the results of these investigations by January.

Treasury believes the existing anti-fraud protections to identify incentives paid to investors are sufficient. Freddie Mac will, as part of its servicer compliance reviews, reconcile on a sample basis the investor payments remitted to the servicer to verify that servicers are not retaining these incentives.

SIGTARP Recommendation 14:

Treasury should require servicers in MHA to submit third-party verified evidence that each applicant is residing in the subject property before funding a mortgage modification.

Treasury's Response

Treasury agrees that obtaining verifiable third-party information about an applicant's residency is an effective control. Treasury ensures that borrowers reside in their HAMP-modified property in three ways. Two of these mechanisms occur prior to the funding of the modification.

During evaluation for HAMP, servicers must obtain a credit report from an independent credit reporting agency for every borrower and joint-borrower. Servicers use this credit report to confirm that the property securing the mortgage loan is the borrower's principal residence. If the credit report is inconsistent with other information provided by the borrower, the servicer must reconcile the inconsistency.

Secondly, Fannie Mae is establishing a fraud detection surveillance procedure using reported trial period data that specifically focuses on verifying borrower residency. When occupancy discrepancies or potential misrepresentations are identified, servicers will be notified during the trial period and will be required to take appropriate action to resolve the discrepancy prior to executing a final modification. This procedure should be in place by January, 2010.

Finally, Treasury's compliance agent, Freddie Mac, conducts loan file reviews of participating servicers. Servicers are required to submit borrower files for review by Freddie Mac in order to identify non-compliance, including cases where borrowers' residency has not been adequately verified.