

December 2008

# TROUBLED ASSET RELIEF PROGRAM

## Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency



GAO

Accountability \* Integrity \* Reliability



Highlights of [GAO-09-161](#), a report to congressional committees

## Why GAO Did This Study

On October 3, 2008, the Emergency Economic Stabilization Act was signed into law. The act established the Office of Financial Stability (OFS) within the Department of the Treasury (Treasury) and authorized the Troubled Asset Relief Program (TARP). Every 60 days, the U.S. Comptroller General is required to report on a variety of areas associated with oversight of TARP. This report reviews (1) the activities that have been undertaken through TARP as of November 25, 2008; (2) the structure of OFS, its use of contractors, and its system of internal controls; and (3) preliminary indicators of TARP's performance. GAO reviewed documents related to TARP, including contracts, agreements, guidance, and rules. GAO also met with OFS, contractors, federal agencies, and officials from some participating institutions. GAO plans to continue to monitor these and other issues including future and ongoing capital purchases, other transactions undertaken as part of TARP (e.g., capital purchases in Citigroup and American International Group), and the status of other aspects of TARP.

## What GAO Recommends

Treasury generally agreed with GAO's recommendations, but had a different perspective on the need to monitor how participating institutions are spending CPP funds. GAO believes that monitoring aggregate information across the participants would help ensure an appropriate level of transparency and accountability.

To view the full product, including the scope and methodology, click on [GAO-09-161](#). For more information, contact Thomas McCool (202)512-2642.

# TROUBLED ASSET RELIEF PROGRAM

## Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency

### What GAO Found

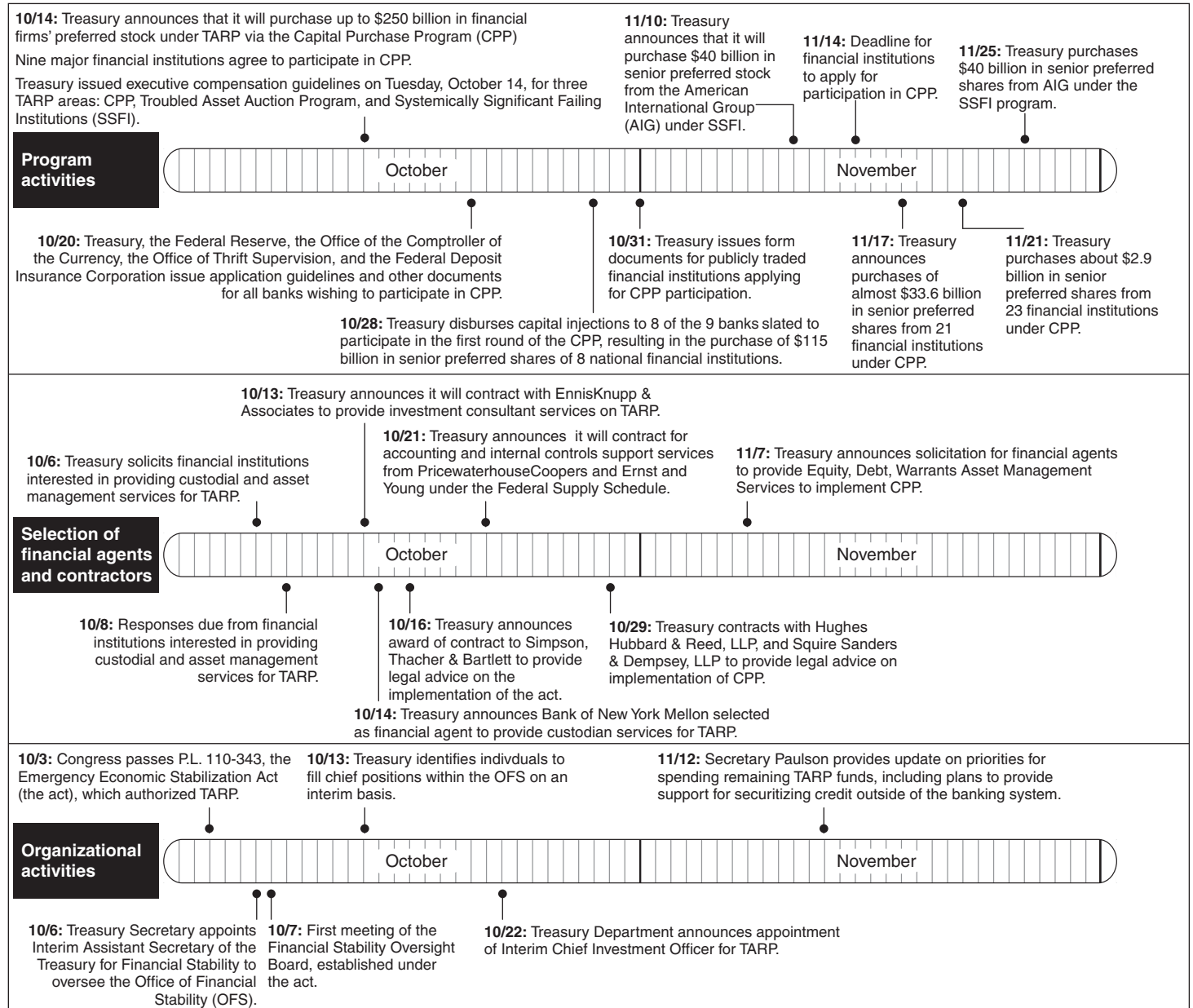
Treasury has taken a number of steps to stabilize U.S. financial markets and the banking system, including injecting billions of dollars in financial institutions. Through the capital purchase program (CPP)—a preferred stock and warrant purchase program—Treasury provided more than \$150 billion in capital to 52 institutions as of November 25, 2008. GAO recognizes that TARP has existed for less than 60 days and that a new program of such magnitude faces many challenges, especially in this current uncertain economic climate. However, Treasury has yet to address a number of critical issues, including determining how it will ensure that CPP is achieving its intended goals and monitoring compliance with limitations on executive compensation and dividend payments. Moreover, further actions are needed to formalize transition planning efforts and establish an effective management structure and an essential system of internal control. To help ensure the program's integrity, accountability, and transparency, GAO recommends that Treasury

- work with the bank regulators to establish a systematic means of determining and reporting in a timely manner whether financial institutions' activities are generally consistent with the purposes of CPP and help ensure an appropriate level of accountability and transparency;
- develop a means to ensure that institutions participating in CPP comply with key program requirements (e.g., executive compensation, dividend payments, and the repurchase of stock);
- formalize the existing communication strategy to ensure that external stakeholders, including Congress, are informed about the program's current strategy and activities and understand the rationale for changes in this strategy to avoid information gaps and surprises;
- facilitate a smooth transition to the new administration by building on and formalizing ongoing activities, including ensuring that key OFS leadership positions are filled during and after the transition;
- expedite OFS's hiring efforts to ensure that Treasury has the personnel needed to carry out and oversee TARP;
- ensure that sufficient personnel are assigned and properly trained to oversee the performance of all contractors, especially for Contracts priced on a time and materials basis, and move toward fixed-price arrangements whenever possible;
- continue to develop a comprehensive system of internal control over TARP, including policies, procedures, and guidance that are robust enough to protect taxpayers interests and ensure that the program objectives are being met;
- issue final regulations on conflicts of interest quickly and review and renegotiate mitigation plans to enhance specificity and compliance; and
- institute a system to effectively manage and monitor the mitigation of conflicts of interest.

It is too soon to determine whether the program is having the intended effect on credit and financial markets. Moreover, given that U.S. regulators as well as foreign governments are continuing to take a variety of actions aimed at stabilizing markets and the economy, separately evaluating the impact of Treasury's efforts under TARP will be difficult. Nevertheless, GAO has identified a number of preliminary indicators that when viewed collectively should signal whether TARP as well as other related programs may be functioning as intended. Among these preliminary indicators are trends in interest rate spreads, mortgage rates, mortgage originations, and foreclosures.

Treasury has operated on parallel tracks in implementing the act. The following timeline highlights key actions associated with program implementation to date.

**Timeline of Key Treasury Activities (Program Activities, Selection of Financial Agents and Contractors, and Organizational Activities), as of November 25, 2008**



Source: GAO.

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**Abbreviations**

ABS	asset-backed security
AIG	American International Group
CBO	Congressional Budget Office
CBOE	Chicago Board of Options Exchange
CDFI	Community Development Financial Institutions Fund
CFO	chief financial officer
COO	chief operating officer
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CPP	Capital Purchase Program
FAR	Federal Acquisition Regulation
FDIC	Federal Deposit Insurance Corporation
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
GSA	General Services Administration
HUD	Department of Housing and Urban Development
IMF	International Monetary Fund
LIBOR	London Interbank Offered Rate
MBS	mortgage-backed security
OCC	Office of the Comptroller of Currency
OFS	Office of Financial Stability
OTS	Office of Thrift Supervision
QFI	qualified financial institution
SAS	Statement of Accounting Standards
SEC	Securities and Exchange Commission
SSFI	Systemically Significant Failing Institution
TALF	Term Asset-backed Securities Loan Facility
TARP	Troubled Asset Relief Program

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United States Government Accountability Office  
Washington, DC 20548

December 2, 2008

Congressional Committees:

The current financial crisis has threatened the stability of the U.S. banking system and the solvency of numerous financial institutions at home and abroad. On October 3, 2008, Congress passed and the President signed the Emergency Economic Stabilization Act of 2008 (the act), which established the Office of Financial Stability (OFS) within the Department of the Treasury (Treasury) and authorized the Troubled Asset Relief Program (TARP). Among other things, the act provides Treasury with broad, flexible authorities to buy up to \$700 billion in “troubled assets” and allows Treasury to purchase and insure mortgages and securities based on mortgages and, in consultation with the Chairman of the Board of Governors of the Federal Reserve System (Federal Reserve), purchase any other financial instrument (e.g., equities) deemed necessary to stabilize financial markets.<sup>1</sup>

Before the bill was passed, TARP’s primary focus was expected to be the purchase of mortgage-backed securities (MBS) and whole loans. Within 2 weeks of enactment, however, following similar action by several foreign governments and central banks, Treasury announced that it would make \$250 billion of the \$700 billion available to U.S. financial institutions through purchases of preferred stock. The Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) also announced concurrent coordinated actions that were intended to increase confidence in the U.S. financial system. FDIC announced that it would temporarily guarantee certain senior debt of all FDIC-insured institutions and certain holding companies, as well as deposits in noninterest bearing deposit transaction

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<sup>1</sup>Pub. L. No. 110-343, sec. 3(9)(Oct. 3, 2008). The act requires that the appropriate committees of Congress be notified in writing that the Secretary of the Treasury, after consultation with the Federal Reserve Chairman, has determined that purchase of other financial instruments is necessary to promote financial market stability.

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accounts at insured depository institutions.<sup>2</sup> The Federal Reserve announced the details of its Commercial Paper Funding Facility program, which provides a broad backstop to the commercial paper market by funding purchases of 3-month commercial paper from high-quality issuers.<sup>3</sup> The Federal Reserve and FDIC, among others, have also announced a variety of other initiatives aimed at addressing the current crisis, including the Federal Reserve's creation of a funding facility to support a private-sector initiative designed to provide liquidity to U.S. money market investors and the temporary increase in FDIC deposit insurance coverage.<sup>4</sup>

The act requires the U.S. Comptroller General to report at least every 60 days, as appropriate, on findings resulting from oversight of TARP's performance in meeting the purposes of the act; the financial condition and internal controls of TARP, its representatives, and agents; the characteristics of both asset purchases and the disposition of assets acquired, including any related commitments that are entered into; TARP's efficiency in using the funds appropriated for the program's operation; TARP's compliance with applicable laws and regulations; and TARP's

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<sup>2</sup>The FDIC established the two guarantee programs after a determination of systemic risk by the Secretary of the Treasury. FDIC may bypass the least cost method of resolving banks in extraordinary circumstances if the least cost method would have "serious adverse effects on economic conditions and financial stability" and if bypassing the least cost method would "avoid or mitigate such adverse effects." The systemic risk exception requires the approval of the FDIC Board of Directors, the Federal Reserve Board and the Secretary of the Treasury in consultation with the President. 12 U.S.C. §1823(c)(4)(G). FDIC believes that the guarantee programs promote financial stability by preserving confidence in the banking system and encourage liquidity in order to ease lending to creditworthy businesses and consumers. GAO is required to review the systemic risk determination and report to Congress on (1) the basis for the determination; (2) the purpose for the action; and (3) the likely effect of the determination and the action on the incentives and conduct of insured depository institutions and uninsured depositors. GAO's work on this mandate is ongoing.

<sup>3</sup>Commercial paper is an unsecured, short-term debt instrument issued by a corporation, typically for the financing of accounts receivable, inventories, and meeting short-term liabilities. Maturities on commercial paper rarely range any longer than 270 days.

<sup>4</sup>The Federal Reserve Bank of New York will provide senior secured funding to a series of special purpose vehicles to facilitate an industry-supported private sector initiative to finance the purchase of eligible assets from eligible investors. Eligible assets are to include U.S. dollar-denominated certificates of deposit, bank notes, and commercial paper issued by highly rated financial institutions and having remaining maturities of 90 days or less. Eligible investors include U.S. money market mutual funds and over time may include other U.S. money market investors. Congress has also temporarily increased FDIC deposit insurance from \$100,000 to \$250,000 per depositor through December 31, 2009.

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efforts to prevent, identify, and minimize conflicts of interest of those involved in its operations. In response to this mandate, this report addresses (1) the nature and purpose of activities that have been initiated under TARP as of November 25, 2008; (2) the structure of OFS, its use of contractors, and its system of internal controls; and (3) preliminary indicators of TARP performance.

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## Scope and Methodology

To determine the nature and purpose of TARP activities since the passage of the act on October 3, 2008, through November 25, 2008, we reviewed documents from OFS that described the amounts, types, and terms of Treasury's purchases of preferred stocks and equity warrants under the Capital Purchase Program (CPP).<sup>5</sup> We reviewed documentation and interviewed officials from OFS and the four primary banking regulators that are responsible for reviewing CPP applications—FDIC, Federal Reserve, Office of the Comptroller of Currency (OCC), and Office of Thrift Supervision (OTS)—on the process for selecting financial institutions to participate in CPP. We compared the evaluation criteria used by each of the regulators to determine that they were consistent with the criteria approved by Treasury and reviewed additional guidelines provided by the banking regulators to their regional offices. For the first eight institutions that received CPP funds, we reviewed the individual case memorandums documenting Treasury's decision to invest in these institutions.<sup>6</sup> We are in the process of reviewing the regulators' and Treasury's guidance. To understand the requirements of CPP, we reviewed the standard agreements signed by the participating institutions and interviewed senior officials from OFS and the banking regulators. In addition, we reviewed documentation from and interviewed senior officials at the eight participating institutions on how their participation in the program would affect their operations, including how they planned to use the capital injection and whether they intended to report separately on their activities associated with capital investments. Specifically, the institutions included in this review are the Bank of America Corp.; Bank of New York Mellon Corp.; Citigroup, Inc.; Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; State Street Corp.; and Wells Fargo & Co. We also met with OFS and regulatory officials to discuss their plans for ensuring

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<sup>5</sup>An equity warrant is an option to buy the common stock of the debt issuer at a predetermined price on or before a specified expiration date.

<sup>6</sup>Treasury has announced a \$10 billion capital purchase for Merrill Lynch & Co., pending completion of its merger with Bank of America.



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compliance with the requirements of the agreements between Treasury and participants, including those limiting executive compensation and restricting CPP participants from increasing dividend payments or repurchasing common stock. We also reviewed Treasury's interim final rule and notices implementing the act's executive compensation rules. To determine the status of OFS's progress in establishing a program to insure troubled assets—a program that Treasury chose to implement through OFS in conjunction with TARP—we reviewed OFS's request for public comments on potential program design and the comments Treasury received, and met with OFS officials. For other approaches that Treasury was considering and had not fully implemented, we met with officials from OFS and reviewed public statements by Treasury officials to determine the status of their efforts to address TARP requirements.

To determine how Treasury had structured OFS, we reviewed a draft organizational chart and other planning documents to understand the number and types of positions OFS was planning to fill. We also met with Treasury and OFS officials regularly to discuss their approach to staffing the office in the near and long terms. We also discussed with them Treasury's plan for the transition to the next administration. As part of our responsibility for monitoring internal controls for TARP and its agents and representatives, we began regular meetings with OFS officials to learn what the office was doing to develop such controls for the office's operations and for programs such as CPP. We also reviewed information provided by PricewaterhouseCoopers, the firm that Treasury retained to help develop a system of internal control, and met with PricewaterhouseCoopers officials to learn about the approach they are taking. We also met with Ernst & Young officials who are helping OFS develop accounting procedures for TARP. Because CPP is the first TARP program to disburse funds, we reviewed documentation provided by OFS and PricewaterhouseCoopers that described the controls established for the initial disbursements and steps taken to implement these controls. We also met with officials from the Bank of New York Mellon to discuss the system of internal control for functions related to services the bank plans to provide for TARP, as well as to review the bank's internal audit process and recent reports. Our review included a report by the Bank of New York Mellon's external auditor on the internal controls over the Bank of New

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York Mellon's trust and custodial services and selected internal audit reports on key functions that will support TARP services.<sup>7</sup>

To assess Treasury's approaches to acquiring services in support of TARP, we reviewed the financial agency agreement Treasury entered into and the contracts that Treasury awarded between October 3, 2008, and November 25, 2008.<sup>8</sup> We also reviewed Treasury's procurement strategy, solicitations, and other agency documents related to those agreements and contracts, as well as the statutes, regulations, and guidance governing the award of financial agency agreements and contracts. As part of this review, we examined documentation outlining the steps Treasury had taken to promote the use of small business concerns—including those owned and controlled by women, minorities, veterans, and socially and economically disadvantaged individuals—in carrying out TARP, such as Treasury guidance on small business participation in procurements under the act. We reviewed the proposals submitted by the firms that signed the financial agency agreement or were awarded contracts in order to identify the approaches those firms proposed for using small businesses. In addition, we examined documentation outlining actual and potential conflicts of interest identified by the financial agents and contractors, as well as their proposed plans for mitigation of those conflicts. We also reviewed Treasury's interim guidelines for conflicts of interest related to the authorities granted under the act and the statutes and regulations related to organizational and personal conflicts of interest, postemployment restrictions, and standards of ethical conduct.

Finally, to identify a preliminary set of indicators on the state of credit and financial markets that might be suggestive of the performance and effectiveness of TARP, we consulted Treasury officials and other experts and analyzed available data sources and the academic literature. We selected a set of preliminary indicators that offered perspectives on different facets of credit and financial markets, including perceptions of

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<sup>7</sup>"Reports on the Processing of Transactions by Service Organizations" (Statement of Auditing Standards [SAS 70]) provides guidance on the factors an independent auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions.

<sup>8</sup>A financial agency agreement is the document that establishes and governs the relationship between Treasury and its financial agent. A financial agent is a financial institution that has authority to hold deposits of public money and perform related services. See 31 U.S.C. pt. 202. A financial agent has a principal-agent relationship with Treasury and owes a fiduciary duty of loyalty and fair dealing to the United States.

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risk, cost of credit, and flows of credit to businesses and consumers.<sup>9</sup> We assessed the reliability of the preliminary indicators presented and found that despite certain limitations and the fact that others could interpret these indicators differently, they were sufficiently reliable for our purposes. The data used to construct the indicators in this report came largely from the Federal Reserve. As these data are widely used, including by GAO and the Federal Reserve, and are considered to be a reliable and often definitive source for banking sector data, we conducted only a limited review of the data but ensured that the trends we found were consistent with other research. We also relied on data from the Chicago Board Options Exchange (CBOE), *Inside Mortgage Finance*, and Global Insight. We have relied on CBOE and Global Insight data for past reports, and we determined that considered together, these auxiliary data were sufficiently reliable for the purpose of presenting and analyzing trends in financial markets.

We conducted this performance audit in October 2008 and November 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Results in Brief

As of November 25, 2008, Treasury's focus in implementing TARP has been on investing directly in regulated financial institutions through CPP, which is intended to provide financial institutions with additional capital through purchases of senior preferred stock. Treasury stated that it chose to implement CPP because it concluded that the worsening conditions in the financial market required a more immediate response than would have been possible through the purchase of mortgage-related assets. This shift in the direction of the program heightened the need for Treasury to proactively provide sufficient information to external stakeholders about not only the change in strategy but also the rationale for the new focus. As of November 25, 2008, Treasury had allocated \$250 billion to CPP and purchased \$115 billion in senior preferred shares of 8 national financial

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<sup>9</sup>No indicator on its own provides a definitive perspective on the state of markets; collectively, the indicators should provide a broad sense of stability and liquidity in the financial system and could be suggestive of the program's impact. However, it is difficult to draw conclusions about actual causality.

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institutions and almost \$36.5 billion in senior preferred shares of 44 financial institutions.<sup>10</sup> Treasury has stated that by building capital, CPP should help increase the flow of financing to U.S. businesses and consumers and support the U.S. economy. Treasury also has indicated that it intends to use CPP to encourage financial institutions to work to modify the terms of existing residential mortgages. Treasury has not yet determined if it will impose reporting requirements on the participating financial institutions. Such requirements would enable Treasury to monitor, to some extent, how the infusions were being used. Treasury and the banking regulators have taken important steps to ensure consistency in evaluating applications, but the extent to which regulators have provided guidance to their staff concerning denials of applications has varied. Institutions participating in CPP must comply with certain requirements regarding executive compensation—for example certain senior executives must repay any incentive or bonus compensation that was based on materially inaccurate financial statements. Treasury has not yet determined how it will monitor compliance with this or other requirements such as limitations on dividend payments and stock repurchases. It is also unclear what other approaches Treasury will pursue to meet the purposes of the act, including insuring mortgage-related assets. Treasury recently stated that it intends to purchase mortgage-related assets only on a targeted basis. In addition, Treasury has taken initial steps to gather comments on ways of using its authority to insure troubled assets and is exploring approaches to supporting loan modification efforts. Without a strong oversight and monitoring function, Treasury's ability to help ensure an appropriate level of accountability and transparency will be limited. Moreover, a strengthened communication strategy could help avoid information gaps as market conditions and TARP continue to evolve.

Treasury quickly established an overall organizational structure for OFS, filled key leadership roles, and contracted for support services. Currently, it is working to hire the full complement (perhaps as many as 200 full-time-equivalent positions) of staff, and OFS officials said that about 48 employees were assigned to TARP as of November 21, 2008, including those from other Treasury offices, federal agencies, and organizations who were providing assistance on a temporary basis and 5 permanent hires. Identifying and hiring the numbers and types of staff needed to successfully operate TARP will be challenging because of the evolving

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<sup>10</sup>One additional purchase of \$10 billion is pending until a merger is complete.

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nature of the program and the transition to a new administration. While Treasury has filled key positions on an interim basis, these same issues may limit its ability to ensure that key leadership positions at OFS remain filled both during and after the transition, potentially creating uncertainty about the direction of the program and impeding efforts to effectively implement TARP. In addition to using permanent staff, OFS plans to rely on contractors and financial agents in several key areas. Treasury used expedited solicitation procedures and structured the agreements to allow for flexibility in procuring the required services. For the most part, the contracts awarded as of November 25, 2008, are priced on a time-and-materials basis, which provides for payments to the contractors based on a set labor rate for hours billed plus the cost of any materials. This type of pricing arrangement requires enhanced oversight. Treasury has also taken steps to help promote the use of small businesses in carrying out TARP and issued interim guidelines to address potential and actual conflicts of interest. As required by Treasury, the financial agent and contractors selected have identified a variety of potential and actual conflicts of interest and proposed a variety of solutions to mitigate identified conflicts. However, the agent and contractors have provided few written details on how they intend to implement mitigation plans or communicate related issues to OFS, and OFS has not yet developed a process for monitoring conflicts of interest. Recognizing the importance of internal controls, Treasury awarded one of the first contracts to PricewaterhouseCoopers to assist OFS in developing and implementing a comprehensive system of internal controls over TARP activities, including a risk-assessment framework. However, the rapid pace of implementation and evolving nature of the program have hampered efforts to put a comprehensive system of internal control in place. Instead OFS has focused on specific transaction controls as programs such as CPP are implemented. While OFS and PricewaterhouseCoopers are working to implement a comprehensive system of internal control, until such a system is fully developed and implemented, there is heightened risk that the interests of the government and taxpayers may not be adequately protected and that the program objectives may not be achieved in an efficient and effective manner.

It is too soon to determine whether the program is having the intended effect on credit and other markets. While TARP's CPP could improve confidence in participating financial institutions and may have beneficial effects on credit markets, attributing any such improvement solely to TARP is problematic because of the range of actions that have been and are being taken to address the current crisis. These include coordinated efforts by the global community and U.S. regulators—namely, FDIC, the Federal Reserve, and the Federal

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Housing Finance Agency (FHFA)—as well as actions by financial institutions to mitigate foreclosures. We have identified a set of preliminary indicators that we will monitor for indications of improvements in credit and financial markets, such as the narrowing of various interest rate spreads that signal perceptions about the level of risk associated with lending among banks, in corporate debt markets, and throughout the general economy and reductions in the cost of credit for banks, businesses, and consumers. Over time, additional effects might be apparent in credit flows that capture key developments in mortgage markets and the level of defaults and foreclosures. While these indicators may be suggestive of TARP's ongoing impact, which we will be monitoring, no single indicator or set of indicators will provide a definitive determination of the program's impact. Moreover, we plan to report on additional indicators as more data become available and as economic and credit conditions evolve.

We recognize that less than 60 days has passed since the program was created and the inherent difficulty of setting up any new program, especially during turbulent economic conditions. However, we have identified a number of areas that warrant Treasury's ongoing attention. Therefore, we are recommending that Treasury take a number of actions aimed at improving the integrity, accountability, and transparency of TARP. Specifically, Treasury should

- work with the bank regulators to establish a systematic means of determining and reporting in a timely manner whether financial institutions' activities are generally consistent with the purposes of CPP;
- develop a means to ensure that institutions participating in CPP comply with key requirements of their agreements with Treasury, including those covering limitations on executive compensation, dividend payments, and the repurchase of stock;
- formalize the existing communication strategy to ensure that external stakeholders, including Congress and the public, are informed about the program's current strategy and activities as well as the rationale for changes in this strategy to avoid information gaps and surprises;
- develop a definitive transition plan by building on and formalizing ongoing activities to facilitate a smooth transition to the new administration, including ensuring that key OFS leadership positions are filled during and after the transition to the new administration;

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- continue OFS hiring efforts in an expeditious manner to ensure that Treasury has the personnel needed to carry out and oversee TARP;
  - ensure that sufficient numbers of personnel are assigned and appropriately trained to oversee the performance of all contractors, especially those performing under contracts priced on a time and materials basis, and move toward greater reliance on fixed-price arrangements whenever possible as program requirements are better defined over time;
  - continue to develop a comprehensive system of internal controls over TARP including policies, procedures, and guidance for program activities that are robust enough to ensure that government's and taxpayers' interests are protected and that the program objectives and requirements are being met;
  - issue final regulations on conflicts of interest concerning its contractors and financial agents as expeditiously as possible and review and renegotiate mitigation plans as necessary to enhance specificity and compliance with the new regulations once they are issued; and
  - institute a system to effectively manage and monitor the mitigation of conflicts of interest.

We provided a draft of this report to Treasury for review and comment. We also provided excerpts of the draft report to the Federal Reserve, FDIC, OCC and OTS for review and comment. In written comments, Treasury generally agreed with the report and eight of the nine recommendations (see app. I). Treasury had a different perspective on what should be done to evaluate how institutions were using funds received under CPP, opting for development of general metrics for evaluating the overall success of CPP rather than working with bank regulators to establish a systematic means for determining whether financial institutions' uses of CPP funds were consistent with the purposes of the program, as we recommended. In technical comments, the Federal Reserve also expressed concern about whether Treasury needed to monitor individual institutions' use of CPP funds. As discussed in the draft, we agree that it will be important to develop a range of metrics to evaluate the overall success of CPP and we welcome continued discussions with Treasury and the bank regulators on general metrics to achieve this purpose. However, given the magnitude of funds provided to this program, these types of metrics alone will not provide the necessary transparency and accountability needed to ensure

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that participating institutions are using the funds in a manner that is consistent with the purposes of the act. As stated in the report, Treasury should build on the existing oversight mechanisms of the banking regulators to minimize any additional regulatory burden and develop a means of reviewing and reporting on planned and actual actions taken by participating financial institutions resulting from the additional funding received through CPP. Obtaining such information could help Treasury better monitor participating institutions' activities and provide an appropriate level of accountability and transparency. Moreover, such information aggregated across the participants would also provide an alternative basis to assess the effect of TARP in restoring liquidity and stability to the financial system. Treasury, the Federal Reserve, FDIC, OCC, and OTS also provided technical comments that we incorporated in the report, as appropriate.

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## Background

The dramatic correction in the U.S. housing market precipitated a decline in the price of financial assets that were associated with housing, in particular mortgage assets based on subprime loans that lost value as the housing boom ended and the market underwent a dramatic correction. Some institutions found themselves so exposed that they were threatened with failure—and some failed—because they were unable to raise the necessary capital as the value of their portfolios declined. Other institutions, ranging from government-sponsored enterprises such as Fannie Mae and Freddie Mac to Wall Street firms, were left holding “toxic” mortgages that became increasingly difficult to value, were illiquid, and potentially had little worth. Moreover, investors not only stopped buying securities backed by mortgages but also became reluctant to buy securities backed by many types of assets. Because of uncertainty about the financial condition and solvency of financial entities, the prices banks charged each other for funds rose dramatically, and interbank lending effectively came to a halt. The resulting credit crunch made the financing on which businesses and individuals depend increasingly difficult to obtain as cash-strapped banks held onto their assets. By late summer of 2008, the potential ramifications of the financial crisis ranged from the continued failure of financial institutions to increased losses of individual savings and corporate investments and further tightening of credit that would exacerbate the emerging global economic slowdown that was beginning to take shape.

In September 2008, the Secretary of the Treasury announced that he was working with the chairmen of the Federal Reserve and the Securities and Exchange Commission (SEC) and congressional leaders to develop a



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comprehensive approach to the crisis facing financial institutions and markets. Until that time, the administration had responded to the ongoing problems in the financial sector on a case-by-case basis, facilitating JPMorgan Chase's purchase of Bear Stearns, addressing problems at Fannie Mae and Freddie Mac, working with market participants to prepare for the failure of Lehman Brothers, and lending to American International Group (AIG) to allow it to sell some of its assets in an orderly manner. Although Treasury had begun to take a number of broader steps, including establishing a temporary guarantee program for money market funds in the United States, it decided that additional and comprehensive action was needed to address the root cause of the financial system's stresses. On September 20, 2008, Treasury proposed draft legislation to allow it to purchase up to \$700 billion in troubled mortgage-related assets. Although the legislation was initially rejected by the House of Representatives on September 29, the Senate passed an expanded version of the legislation on October 1, and on October 3, the act was passed by the House of Representatives and signed into law by the President.

The act, as it relates to TARP, provides Treasury with the authority to purchase and insure certain types of troubled assets for the purposes of providing stability to and preventing disruptions in the economy and financial system and protecting taxpayers. The purposes of the act are to immediately provide authority and facilities that Treasury can use to restore liquidity and stability to the U.S. financial system and to ensure that these activities are consistent with protecting home values, college funds, retirement accounts, and life savings; preserving homeownership and promoting jobs and economic growth; maximizing overall returns to U.S. taxpayers; and providing public accountability for the exercise of authority under the act.

In exercising its authorities, the act further states that Treasury must consider a variety of additional factors, including the following:

- minimizing the impact on the national debt;
- providing stability for and preventing disruption to financial markets;
- considering the long-term viability of financial institution in determining whether a direct purchase represents the most efficient use of funds under the act;
- ensuring that all financial institutions are eligible to participate in the program, regardless of size, geographic location, form of organization, or amount of assets eligible for purchase under the act;

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- providing financial assistance to financial institutions—including those serving low- and moderate-income populations and other underserved communities, and that have assets of less than \$1 billion; that were well or adequately capitalized as of June 30, 2008; and that as a result of the devaluation of the preferred government-sponsored enterprises, will see their stock drop one or more capital levels—in a manner sufficient to restore the financial institutions to at least an adequately capitalized level;
  - ensuring stability for U.S. public instrumentalities, such as counties and cities, that may have suffered significant increased costs or losses in the current market turmoil;
  - considering the retirement security of Americans by purchasing troubled assets held by or on behalf of an eligible retirement plan;<sup>11</sup> and
  - considering the utility of purchasing other real estate owned and instruments backed by mortgages on multifamily properties.

The act also requires several new and existing entities, in addition to the U.S. Comptroller General, to oversee the activities of OFS and TARP. For example, the legislation created the Financial Stability Oversight Board, which includes the Chairman of the Federal Reserve; the Secretary of the Treasury; the Director of FHFA; the Chairman of SEC, and the Secretary of Housing and Urban Development (HUD).<sup>12</sup> Moreover, it created a

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<sup>11</sup>As described in clause (iii), (iv), (v), or (vi) of section 402(c)(8)(B) of the Internal Revenue Code of 1986 (IRC), except that such authority shall not extend to any compensation arrangements subject to section 409A of the IRC.

<sup>12</sup>The Chairman of the Federal Reserve was selected as the Chairman of the Oversight Board.

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Special Inspector General for the program as well as a Congressional Oversight Panel.<sup>13</sup>

Treasury and federal and state regulators all play a role in regulating and monitoring the financial system. Historically, Treasury's mission has been to act as steward of U.S. economic and financial systems and to participate in and influence the global economy. As such, Treasury is responsible for a wide range of activities, helping to frame economic and financial policies and encourage sustainable economic growth. Among its many activities is working to predict and prevent economic and financial crises, positioning Treasury to take a leading role in addressing underlying issues such as those currently facing the U.S. financial system. The key federal banking regulators include the following:

- Federal Reserve, which is responsible for (among other things) conducting the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates; supervising and regulating bank holding companies and banks that are members of the Federal Reserve System; and maintaining the stability of the financial system and containing systemic risk that may arise in financial markets;
- FDIC, an independent agency created to help maintain stability and public confidence in the nation's financial system by insuring deposits, examining and supervising state-chartered banks that are not members of the Federal Reserve System, and managing receiverships;
- OCC, which charters and supervises national banks; and
- OTS, which supervises savings associations (thrifts) and savings association holding companies.

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<sup>13</sup>The Congressional Oversight Panel consists of five members, with the Speaker of the House, the House Republican Leader, the Senate Majority Leader, and the Senate Republican Leader each selecting one member. The fifth member is a joint selection by the Speaker of the House and the Senate Majority Leader. Its members are Richard H. Neiman, Superintendent of Banks in New York (appointed by the Speaker of the House); Representative Jeb Hensarling (appointed by the House Republican Leader); Elizabeth Warren, Harvard Law School (appointed by the Senate Majority Leader); Senator Judd Gregg (appointed by the Senate Republican Leader); and Damon Silvers, of the AFL-CIO Associate General Counsel, (jointly appointed by the Speaker of the House and the Senate Majority Leader). Others with oversight responsibilities include the Congressional Budget Office and the Office of Management and Budget.

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As discussed in the next section of this report, these bank regulators have a role in reviewing the applications of financial institutions applying for CPP.

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## Treasury Has Moved Quickly to Establish CPP, but Plans for Other Approaches for Strengthening Financial Markets Are Ongoing

Treasury's focus on implementing TARP thus far has been on directly investing in regulated financial institutions through CPP, with federal banking regulators playing a role in evaluating potential participants. Treasury had purchased more than \$150 billion in senior preferred shares of 52 financial institutions as of November 25, 2008. Treasury has stated that it intends to use CPP to encourage U.S. financial institutions to increase the flow of financing to U.S. businesses and consumers and to support the U.S. economy. Treasury has also indicated that it intends to use CPP to encourage financial institutions to work to modify the terms of existing residential mortgages. OFS has not yet determined if it will impose reporting requirements on the participating financial institutions that could enable OFS to monitor, to some extent, how the financial institutions are using capital infusions. Institutions participating in CPP have agreed to comply with certain requirements, such as limitations on executive compensation, dividend payments, and repurchases of stock. However, Treasury has not yet determined how it will ensure compliance with these requirements. The extent to which Treasury will pursue other approaches to strengthening financial markets, including insuring troubled assets, to meet the purposes of the act also remains uncertain. But without effective oversight, Treasury cannot ensure that those receiving funds are complying with CPP requirements.

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## Treasury's Focus Has Shifted Away from the Purchase of Mortgage-related Assets

The act authorized the Secretary of the Treasury to purchase mortgages and MBS, and, in consultation with the Chairman of the Federal Reserve, to purchase other financial instruments if such purchases were deemed necessary to promote financial market stability. On October 13, 2008, consistent with conditions prescribed by the act, Treasury notified Congress that Treasury officials had determined that it would be necessary under TARP to purchase preferred stocks and warrants issued by certain financial institutions.<sup>14</sup> On October 14, Treasury announced that it would make direct capital investments in financial institutions in exchange for

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<sup>14</sup>See Section 3(9)(B) of the act. Treasury transmitted its determination to the appropriate committees of Congress on October 13, 2008.

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preferred stocks and warrants through CPP.<sup>15</sup> Treasury stated that strengthening capital via investments under this program was the swiftest mechanism to stabilize the financial markets, encourage interbank lending, and increase confidence in lenders and investors. Further, at the time Treasury stated that it planned to continue developing a program to purchase mortgages and MBS and would seek public comments on structuring a program to insure these assets. On November 12, Treasury announced that it would move away from purchasing mortgages and MBS as originally planned because it believed that such purchases were not the best use of TARP funds, although targeted purchases of such assets were still under consideration. Instead, Treasury planned to focus on extending capital investments to nonbank financial institutions and providing federal financing to investors of highly rated asset-backed securities (ABS) to lower the cost of and increase the availability of credit for consumers. The ABS market provides liquidity to financial institutions that provide small business loans and consumer lending such as auto loans, student loans, and credit cards. In addition, Treasury stated that it would develop strategies to stabilize the real estate market by encouraging loan modifications. While Treasury has used a variety of mechanisms to make sure the program is transparent, the shift in the direction of the program to CPP highlighted the need for Treasury to more actively provide sufficient information to external stakeholders (e.g., Congress and the public) about changes in its planned strategy and activities as well as the rationale for any shift to avoid future information gaps and surprises.

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## Treasury Has Invested More than \$150 Billion in 52 Financial Institutions

Treasury had made more than \$150 billion in capital investments in 52 financial institutions as of November 25, 2008. On October 14, 2008, in conjunction with similar actions by foreign governments and coordinated actions by the Federal Reserve and FDIC, Treasury announced that it planned to use \$250 billion to purchase senior preferred shares in a broad array of qualifying financial institutions.<sup>16</sup> Treasury approved \$125 billion in capital purchases for nine of the largest public financial institutions considered by the federal banking regulators and Treasury to be

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<sup>15</sup>Generally, financial institutions include qualifying U.S.-controlled banks, savings associations, and certain bank and savings and loan holding companies.

<sup>16</sup>The act authorized Treasury to draw up to \$250 billion for immediate use and provided for an additional \$100 billion if the President certifies that the additional funds are needed. A written certification that the additional \$100 billion was necessary has been submitted. A final \$350 billion is available under the act but is subject to congressional review.

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systemically significant to the operation of the financial system. Together, these institutions hold about 55 percent of U.S. banking assets. These nine institutions provide a variety of services, including retail and wholesale banking, investment banking, and custodial/processing services. According to Treasury officials, the nine financial institutions agreed to participate in part to signal the importance of the program to the stability of the financial system. On October 28, 2008, Treasury settled the capital purchase transactions with eight of these institutions for a total of \$115 billion.<sup>17</sup> According to Treasury, the remaining \$10 billion will be settled when the merger of Bank of America Corporation and Merrill Lynch & Co., Inc. is complete, sometime before January 31, 2009. Table 1 provides information about the first eight institutions selected for capital investment as well as other investments.<sup>18</sup>

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<sup>17</sup>In its October 2008 Monthly Treasury Statement of Receipts and Outlays of the United States Government, Treasury reported the \$115 billion it paid for the senior preferred shares as cash outlays. The Congressional Budget Office (CBO), in its Monthly Budget Review dated November 7, 2008, reported that, in its view, these stock purchases “should not be recorded on a cash basis but on a net present value basis, accounting for market risk, as specified in the Emergency Economic Stabilization Act.” CBO’s preliminary estimate for the present value cost of the stock purchases is \$17 billion as compared to the \$115 billion cash basis amount reported by Treasury. This cost reflects the estimated net amount of payments made and received by Treasury under the agreements, discounted for market risk and for interest in future years. The treatment of these stock purchases is being reviewed as part of our ongoing work.

<sup>18</sup>As required under the act, Treasury publicly disclosed a description of the assets purchased, and the amounts and pricing of those assets for the capital purchases within 2 business days of completion. See section 114(a) of the act.

**Table 1: Amount of Capital Investment and Characteristics of the Qualified Financial Institutions Participating in the Capital Purchase Program, as of November 25, 2008**

<b>Name of qualified financial institution (Location of qualified financial institution)</b>	<b>Capital purchased by Treasury (in millions)</b>	<b>Total company assets as of September 2008 (in millions)</b>
<b>Purchases on October 28, 2008</b>		
Bank of America Corp. (Charlotte, N.C.)	\$15,000	\$1,831,000
Bank of New York Mellon Corp. (New York City, N.Y.)	3,000	268,000
Citigroup, Inc. (New York City, N.Y.)	25,000 <sup>a</sup>	2,050,000
Goldman Sachs Group, Inc. (New York City, N.Y.)	10,000	1,082,000 <sup>b</sup>
JPMorgan Chase & Co. (New York City, N.Y.)	25,000	2,251,000
Morgan Stanley (New York City, N.Y.)	10,000	987,000 <sup>c</sup>
State Street Corp. (Boston, Mass.)	2,000	286,000
Wells Fargo & Co. (San Francisco, Calif.)	25,000	1,371,000 <sup>d</sup>
<b>Subtotal</b>	<b>\$115,000</b>	<b>\$10,126,000</b>
<b>Purchases on November 14, 2008</b>		
Bank of Commerce Holdings (Redding, Calif.)	\$17	\$651
1st FS Corporation (Hendersonville, N.C.)	16	670
UCBH Holdings, Inc. (San Francisco, Calif.)	299	13,044
Northern Trust Corporation (Chicago, Ill.)	1,576	79,244
SunTrust Banks, Inc. (Atlanta, Ga.)	3,500	174,777
Broadway Financial Corporation (Los Angeles, Calif.)	9	404
Washington Federal Inc. (Seattle, Wash.)	200	11,795
BB&T Corp. (Winston-Salem, N.C.)	3,134	137
Provident Bancshares Corp. (Baltimore, Md.)	152	6,410
Umpqua Holdings Corp. (Portland, Ore.)	214	8,328
Comerica Inc. (Dallas, Tex.)	2,250	65,153
Regions Financial Corp. (Birmingham, Ala.)	3,500	144,292

<b>Name of qualified financial institution (Location of qualified financial institution)</b>	<b>Capital purchased by Treasury (in millions)</b>	<b>Total company assets as of September 2008 (in millions)</b>
Capital One Financial Corporation (McLean, Va.)	3,555	154,803
First Horizon National Corporation (Memphis, Tenn.)	867	32,804
Huntington Bancshares (Columbus, Ohio)	1,398	54,661
KeyCorp (Cleveland, Ohio)	2,500	101,290
Valley National Bancorp (Wayne, N.J.)	300	14,288
Zions Bancorporation (Salt Lake City, Utah)	1,400	53,974
Marshall & Ilsley Corporation (Milwaukee, Wisc.)	1,715	63,501
U.S. Bancorp (Minneapolis, Minn.)	6,599	247,055
TCF Financial Corporation (Wayzata, Minn.)	361	16,511
<b>Subtotal</b>	<b>33,562</b>	<b>1,235,464</b>
<b>Purchases on November 21, 2008</b>		
Ameris Bancorp (Moultrie, Ga.)	52	2,258
Associated Banc-Corp (Green Bay, Wisc.)	525	22,487
Banner Corporation/Banner Bank (Walla Walla, Wash)	124	4,650
Boston Private Financial (Boston, Mass.)	154	7,022
Cascade Financial Corporation (Everett, Wash.)	39	1,552
Centerstate Banks Of Florida Inc. (Davenport, Fla.)	28	1,235
City National Corporation (Beverly Hills, Calif.)	400	16,331
Columbia Banking System, Inc. (Tacoma, Wash.)	77	3,105
First Community Bancshares Inc. (Bluefield, Va.)	42	1,967
First Community Corporation (Lexington, S.C.)	11	634
First Niagra Financial Group (Rockport, N.Y.)	184	9,008
First Pctrust Bancorp, Inc. (Chula Vista, Calif.)	19	846
Heritage Commerce Corp (San Jose, Calif.)	40	1,512



<b>Name of qualified financial institution (Location of qualified financial institution)</b>	<b>Capital purchased by Treasury (in millions)</b>	<b>Total company assets as of September 2008 (in millions)</b>
Heritage Financial Corporation (Olympia, Wash.)	24	905
Hf Financial Corp. (Sioux Falls, S. Dak.)	25	1,128
Nara Bancorp, Inc. (Los Angeles, Calif.)	67	2,598
Pacific Capital Bancorp (Santa Barbara, Calif.)	181	7,689
Porter Bancorp Inc (Louisville, Ky.)	35	1,596
Severn Bancorp, Inc. (Annapolis, Md.)	23	964
Taylor Capital Group (Rosemont, Ill.)	105	4,075
Trustmark Corporation (Jackson, Miss.)	215	9,086
Webster Financial Corporation (Waterbury, Conn.)	400	17,516
Western Alliance Bancorporation (Las Vegas, Nev.)	140	5,229
<b>Subtotal</b>	<b>\$2,910</b>	<b>\$123,393</b>
<b>Grand Total</b>	<b>\$151,472</b>	<b>\$11,484,857</b>

Sources: Treasury and SEC (Form 10-Q).

Note: Table does not include the \$10 billion purchase of Merrill Lynch & Co. preferred stock because the settlement of this purchase is pending completion of its merger with Bank of America.

<sup>a</sup>On November 23, 2008, Treasury announced that it was purchasing an additional \$20 billion in preferred shares from Citigroup, Inc. TARP funds were used, but this additional purchase was not part of CPP.

<sup>b</sup>Data as of August 29, 2008.

<sup>c</sup>Data as of August 31, 2008.

<sup>d</sup>Based on estimated 12-31-08 Pro Forma financial statements to reflect the purchase of Wachovia Corporation.

Treasury made the remaining \$125 billion available for additional qualified financial institutions. The period for public financial institutions to apply for the capital purchase ended on November 14, 2008. As shown in table 1, Treasury purchased almost \$33.6 billion of senior preferred stock in 21 financial institutions on November 14, 2008 and an additional \$2.9 billion in 23 financial institutions on November 21, 2008. The institutions varied in size, and purchases ranged from \$9 million to \$6.6 billion per institution. According to Treasury, it intends to make final eligibility and purchase decisions for qualifying financial institutions by the end of 2008.

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## Terms of the Capital Purchase Program Agreements

Under CPP, a qualified financial institution can receive a minimum investment of 1 percent of its risk-weighted assets, up to the lesser of \$25 billion or 3 percent of those risk-weighted assets.<sup>19</sup> In exchange for the investment, Treasury receives shares of senior preferred stock that will pay dividends at a rate of 5 percent annually for the first 5 years and 9 percent annually thereafter. Such shares are nonvoting, except with respect to protecting investors' rights. The financial institutions can redeem their shares at their face value after 3 years. At any time before that time, however, the shares can be redeemed if the financial institution has received a minimum amount from "qualified equity offerings" of any Tier 1 perpetual preferred or common stock.<sup>20</sup> Treasury may also transfer the senior preferred shares to a third party at any time.

Treasury will also receive warrants to purchase a number of shares of common stock with a total market value equal to 15 percent of the senior preferred investment for publicly traded securities and 5 percent for privately held securities. The exercise price on the warrants will generally be based on the market price of the participating institution's common stock at the date of the Treasury's acceptance of the financial institution's application to participate in CPP. The exercise price is reduced by 15 percent of the original exercise price on each 6-month anniversary of the issue date of the warrants if certain shareholder approvals are not obtained, subject to a maximum reduction of 45 percent of the original exercise price.<sup>21</sup> In addition, the number of shares of common stock underlying the warrant held by Treasury are reduced by half if the qualified financial institution completes one or more "qualified equity offerings" and receives proceeds equal to the amount of the preferred

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<sup>19</sup>Risk-weighted assets are the total of all assets held by the bank that are weighted for credit risk according to a formula established in regulation by the Federal Reserve.

<sup>20</sup>Tier 1 capital is the core measure of a bank's financial strength from a regulator's point of view. It consists of the types of capital considered the most reliable and liquid, primarily common stock and preferred stock. A "qualified offering" is the sale and issuance of Tier 1 qualifying perpetual preferred stock, common stock, or a combination of such stock for cash. Senior preferred may only be redeemed prior to 3 years from the date of investment if the proceeds of "qualified equity offerings" result in aggregate gross proceeds to the financial institution of not less than 25 percent of the issue price of the senior preferred. Banks are required to hold 8 percent capital for regulatory purposes and historically, on average hold closer to 10 percent. Therefore, in terms of total capital, Treasury's capital infusions could equal about one-quarter to one-third of an institution's capital.

<sup>21</sup>The issue date is the date that Treasury made the capital purchase of preferred stocks and warrants. In the case of the initial eight financial institutions that have reached settlement, this date is October 28, 2008.

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shares prior to December 31, 2009. Bank officials we spoke with said that the option to reduce the number of shares underlying the warrants provided a powerful incentive to replace public capital with private capital before this date.

The standardized terms require that dividends on the senior preferred stock be payable quarterly in arrears. According to a Treasury official, the first dividend payments will be due in December 2008 for some financial institutions, with the dividend accrual period beginning on October 28, 2008. These institutions are expected to pay a rate of 5 percent of the capital investment per annum. As custodian, the Bank of New York Mellon will receive the dividends and wire the proceeds to the general fund of Treasury.<sup>22</sup>

Treasury also plans to make capital investments in privately held financial institutions and on November 17, 2008, issued new program terms for investing in these institutions. The deadline for privately held institutions to submit applications is December 8, 2008. Treasury is also developing program terms for S Corporations and mutual organizations (mutuals) but OFS officials noted that there were a number of challenges associated with structuring terms for these types of organizations.<sup>23</sup> As of November 21, 2008, no final decisions had been made about the timing of any such program.

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### Treasury Is Relying on Recommendations from the Bank Regulators to Select Qualified Financial Institutions for CPP

Treasury officials stated that they were relying extensively on the primary federal banking regulators in determining which institutions would be allowed to participate in CPP. Because the program is intended to provide capital to those institutions that can demonstrate their overall financial strength and long-term viability, OFS is relying on the banking regulators' examinations and experience with these institutions when it makes a final determination regarding their financial condition. The final decision

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<sup>22</sup>Bank of New York Mellon is also a participant in CPP. We plan to review how OFS intends to mitigate and manage the conflict between Bank of New York Mellon's role as custodian and its participation in the program.

<sup>23</sup>An S Corporation is a corporation that makes a valid election to be taxed under Subchapter S of Chapter 1 of the Internal Revenue Code and thus does not pay any income taxes. Instead, the corporation's income or losses are divided among and passed through to its shareholders. A mutual organization is a company that is owned by its customers rather than by a separate group of stockholders. Many thrifts and insurance companies (for example, Metropolitan and Prudential) are mutual companies.

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regarding the selection of institutions to participate in CPP is made by OFS. Qualified financial institutions seeking capital to participate in the program were to send their applications directly to their primary federal banking regulators.<sup>24</sup>

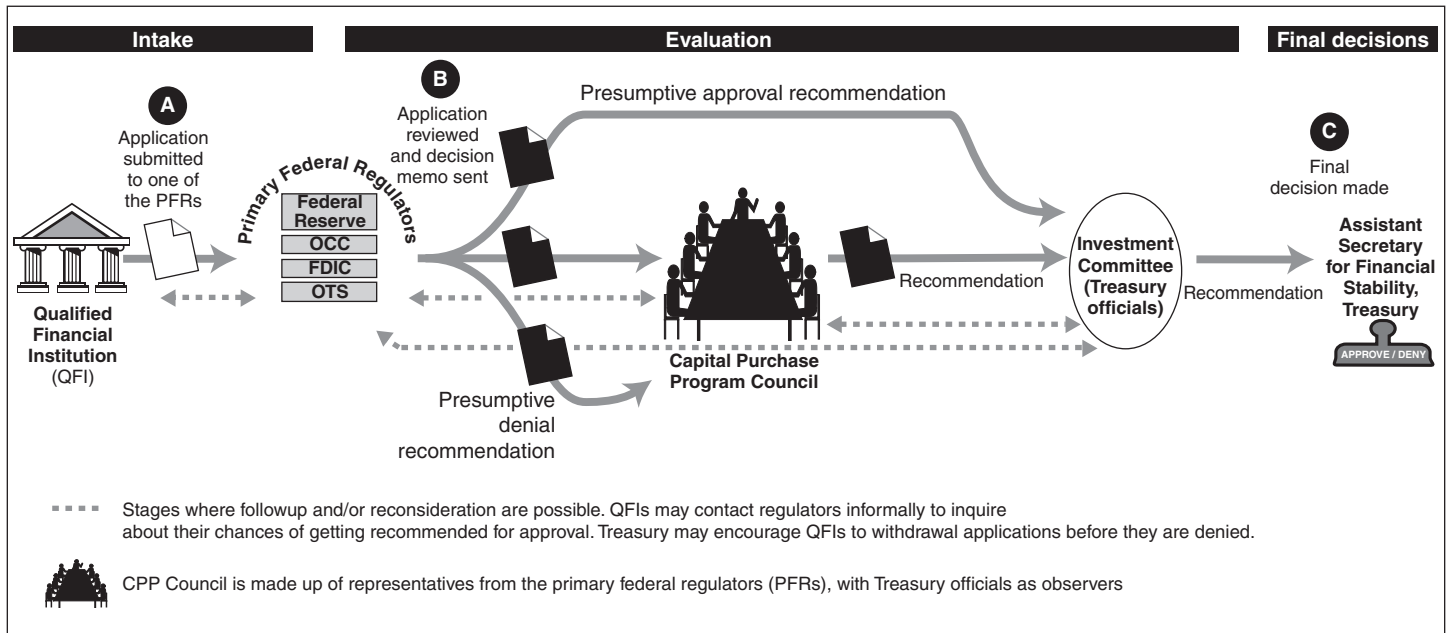
Treasury, in consultation with the banking regulators, has developed a standardized process for evaluating the financial strength and viability of applicants. Specifically, financial institutions are encouraged to consult with their primary regulators for help about deciding whether to apply. For those institutions that decide to apply, the federal banking regulators evaluate applications based on certain factors, such as examination ratings, selected performance ratios. Federal banking regulators may also consider information on the intended deployment of capital injections, although guidance on this possibility varied across regulators. Institutions with the highest examination ratings are to receive presumptive approval from the banking regulators, and the regulators' recommendations are to be forwarded to OFS's Investment Committee for its advice and recommendation.<sup>25</sup> Institutions with lower examination ratings or other considerations require further review and are to be referred to the CPP Council, which is made up of representatives from the four federal banking regulators, with Treasury officials as observers. Regulators and the CPP Council may consider other factors, such as the existence of a signed merger agreement involving the institution, confirmed private equity investment in the institution, and other factors that may offset the effect of lower examination ratings. Finally, those institutions with the lowest examination ratings are to receive a presumptive denial recommendation from the banking regulators. In these instances, the primary bank regulators may have further discussions with the applicants and encourage the institution to withdraw its application. The banking regulator or the CPP Council is to forward approval recommendations to OFS's Investment Committee, which further reviews the applications and may request additional analysis or information from the regulators or the CPP Council. Figure 1 provides an overview of the process for assessing and approving applications for capital purchases.

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<sup>24</sup>The primary federal regulator is generally the regulator overseeing the lead bank of the institution. Where the institution is a bank holding company, the primary federal regulator also consults with the Federal Reserve.

<sup>25</sup>The committee membership includes the OFS's Chief Investment Officer (committee chair) and the assistant secretaries for Financial Markets, Economic Policy, Financial Institutions, and Financial Stability at Treasury.

**Figure 1: Process for Accepting and Approving CPP Applications, as of November 21, 2008**



Sources: GAO analysis; Treasury; Art Explosion (images).

Once its review is complete, the Investment Committee is to make recommendations to the Assistant Secretary for Financial Stability for final approval. According to OFS officials, denied applicants will not be publicly announced, and as of November 21, 2008, the primary regulators also told us that they had not recommended denial for any financial institutions. However, regulatory officials stated that institutions could withdraw their applications at any point in the process if it was unlikely that their applications would be approved. And according to bank regulators, some institutions have withdrawn their applications. The extent to which regulators provided additional internal guidance on processing applications that might not be approved varied. For example, three bank regulators provided additional written guidance to staff on how to handle applications that were not likely to be recommended for approval, while one bank regulator did not provide any additional guidance. We are also examining the reasonableness of steps taken to ensure that CPP and regulators' procedures are being consistently followed and will report our results in subsequent reports.

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## OFS and the Regulators Have Not Decided How to Monitor Banks' Use of CPP Funds or How to Ensure Compliance with Purchase Agreements

It is unclear how OFS and the regulators will monitor participating institutions' use of the capital investments. The standard agreement between Treasury and the participating institutions includes a number of provisions, some in the "recitals" section at the beginning of the agreement and others that are detailed in the body of the agreement. The recitals refer to the participating institutions' future actions in general terms—for example, that "the Company agrees to expand the flow of credit to U.S. consumers and businesses on competitive terms" and "agrees to work diligently, under existing programs, to modify the terms of residential mortgages." Treasury and the regulators have publicly stated that they expect these institutions to use the funds in a manner consistent with the goals of the program, which include both the expansion of the flow of credit and the modification of the terms of residential mortgages. But it is unclear how OFS and the banking regulators will monitor how participating institutions are using the capital investments and whether these goals are being met. The standard agreement between Treasury and the participating institutions does not require that these institutions track or report how they plan to use, or do use, their capital investments.

We spoke with representatives of the eight large institutions that initially received funds under CPP, and they told us that their institutions intended to use the funds in a manner consistent with the goals of CPP. Generally, the institutions stated that CPP capital would not be viewed any differently from their other capital—that is, the additional capital would be used to strengthen their capital bases, make business investments and acquisitions, and lend to individuals and businesses. With the exception of two institutions, institution officials noted that money is fungible and that they did not intend to track or report CPP capital separately. We will continue to monitor the activities of these institutions as well as the plans of others in future reports as well as any oversight provided by Treasury and its agents or the regulators. The banking regulators indicated that they had not yet developed any additional supervisory steps, such as requiring more frequent provision of certain call report data for participating institutions, to monitor participating institutions' activities.<sup>26</sup> For example, it is unclear whether Treasury plans to leverage bank regulators, which in the case of the largest institutions have bank examiners on site, to conduct any oversight or monitoring related to CPP requirements. However, unless Treasury does additional monitoring and regular reporting, Treasury's

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<sup>26</sup>A call report is a bank/thrift regulatory quarterly report that allows a regulator to monitor institution's financial condition.

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ability to help ensure an appropriate level of accountability and transparency will be limited.

In addition to the general recitals, the standard terms of the securities purchase agreements include specific requirements. Participating institutions' dividend payments are restricted for as long as Treasury's senior preferred shares are outstanding, and the institutions cannot redeem these senior preferred shares for 3 years except with proceeds from new capital obtained from the market. Treasury is in the early stages of determining how it plans to monitor compliance with these requirements. The agreements require that the financial institutions' benefit plans comply with the requirements for executive compensation contained in the act and guidance issued by Treasury before the date of Treasury's purchase of the preferred shares. On October 20, 2008, Treasury published in the *Federal Register* an interim final rule to provide guidance on the executive compensation provisions in the act applicable to participants in CPP. The interim final rule outlines four executive compensation requirements that apply to senior executive officers of institutions while Treasury holds equity or debt in the institution. Senior executive officers are generally the chief executive officer, the chief financial officer, and the three most highly compensated officers. A participating financial institution must meet the following requirements:

- The institution's compensation committee must (1) review the senior executive officers' incentive and bonus compensation arrangements within 90 days of the CPP purchase to ensure the arrangements do not encourage unnecessary or excessive risk taking, (2) the compensation committee must meet at least annually with senior risk officers to review the relationship between the institutions' risk-management policies and the senior executive officer incentive arrangements, and (3) certify that it has completed the reviews.
- Payments of bonus or incentive compensation that are made based on materially inaccurate earnings must be refunded to the institution by the senior executive officers.

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- No golden parachute payments will be made.<sup>27</sup>
  - The institution must agree not to deduct for tax purposes executive compensation in excess of \$500,000 per executive.

Treasury officials said that they intended to develop a plan to ensure that participating institutions adhere to these requirements, including having Treasury's equity asset managers (yet to be selected) monitor financial institutions' compliance with certain requirements such as executive compensation and dividend restrictions. As discussed later in this report, internal controls are a major part of efficiently and effectively managing a program, and developing a process for monitoring participating financial institutions will be critical to identifying and addressing any potential problems in these institutions' compliance with program requirements. Treasury officials noted that once they have examined all public comments, they might add clauses or other components to the executive compensation rules to strengthen oversight of the executive compensation requirements. But at this point, the officials have not determined how Treasury will monitor executive compensation compliance. Bank regulators varied in their views about their oversight responsibilities related to compliance with executive compensation requirements and other required terms of CPP. For example, one regulator noted that it would rely on the institution's board of directors to assess compliance, and another regulator stated that it was Treasury's responsibility to provide such oversight. Without a consistent process for monitoring participating institutions, Treasury's ability to identify and address any potential problems in these institutions' compliance with program requirements will be limited.

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### The Extent to Which Treasury Will Pursue Other Programs under TARP Remains Uncertain

The TARP legislation provides Treasury with broad authorities to establish programs that can purchase or insure "troubled assets." As previously mentioned, these assets can include mortgage-related assets and other financial instruments that Treasury, after consultation with the Federal Reserve, determines to be necessary to promote financial stability. Treasury has established a Systemically Significant Failing Institutions

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<sup>27</sup>A golden parachute is defined as any payment in the nature of compensation to a senior executive officer made on account of involuntary termination or in connection with any bankruptcy filing, receivership, or insolvency of the institution to the extent that the present value of the payment equals or exceeds three times the executive's average annual compensation over the preceding 5 years.



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(SSFI) program under TARP. According to Treasury, unlike CPP, which is broad-based, a financial institution's participation in SSFI will be considered on a case-by-case basis. Moreover, there is no deadline for participation in this program. For example, on November 10, 2008, Treasury announced that it would purchase \$40 billion in senior preferred stock from AIG as part of a comprehensive plan to restructure federal assistance to this company, which Treasury views as systemically significant.<sup>28</sup> These funds were disbursed on November 25, 2008.

Treasury has also taken other targeted action. On November 23, Treasury announced that it would invest an additional \$20 billion in Citigroup from TARP in exchange for preferred stock, with an 8 percent dividend to Treasury. Citigroup is to comply with enhanced executive compensation restrictions and implement FDIC's mortgage modification program. Treasury and FDIC will provide protection against unusually large losses on a pool of loans and securities on the books of Citigroup. The Federal Reserve will backstop residual risk in the asset pool through a nonrecourse loan.

We plan to continue to monitor activities associated with both of these transactions in future reports.

### Treasury Decided Not to Pursue Further Development of the Mortgage-related Assets Purchase Programs

On November 12, 2008, Treasury announced that it had examined the benefits of purchasing troubled mortgage-related assets, including mortgage-backed securities and whole loans, and concluded that this approach would not be the best use of TARP funds at this time. Prior to this announcement, despite the creation of CPP, purchases of these assets were considered a key part of Treasury's planned strategy for stabilizing financial markets. Treasury had worked with the financial agent it had selected to provide custodian services to TARP (Bank of New York Mellon), bank regulators, and others to develop mechanisms for identifying and pricing mortgage-backed securities and whole loans. In addition, OFS started to identify asset managers to oversee acquired mortgage-backed securities and whole loans, but given that it would not be purchasing these mortgage-related assets, OFS officials said that it would not be seeking the services of these asset managers at this time.

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<sup>28</sup>The restructuring plan also includes actions by the Federal Reserve aimed at restructuring the terms of its previous agreement.

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Treasury Has Taken Preliminary Steps to Establish a Program to Insure Troubled Assets

Under the act, Treasury is required to establish a program that insures troubled assets and protects investors from losses.<sup>29</sup> On October 16, 2008, Treasury published in the *Federal Register* a request for public comment to identify potential approaches to structuring such an insurance program.<sup>30</sup> In the notice, Treasury solicited comments on how to structure the program, identify institutions and assets for inclusion, and calculate premiums. In addition, Treasury requested comments on the types of events that should lead to an insurance payout and on approaches to setting a value for the payout. When the comment period closed, on October 28, Treasury had received 66 comment letters from, among others, holding companies and financial services firms, consulting firms, and trade industry groups on how to structure the program. Treasury, as of November 21, 2008, had made no final decision regarding the design of the program. The comments suggested a range of program options. Recommendations focused on insuring asset-backed securities, in particular securities backed by consumer loans; providing insurance for guarantors' losses on their portfolios; and insuring loans to small businesses to facilitate lending. Many comments targeted securitized assets, and some comments indicated that the program should encompass a variety of assets and not just those related to mortgages.

Treasury Is Examining Strategies to Mitigate Mortgage Foreclosures

Having decided against large purchases of troubled mortgage assets under TARP, Treasury stated that the agency was considering other ways to meet Congress' expectation that Treasury would work with lenders "to achieve aggressive loan modification standards" to mitigate foreclosures. As of November 25, 2008, it had not yet announced any specific programs. OFS has established and hired a chief for the Office of the Chief of Homeownership Preservation within OFS. The Director of Treasury's Community Development Financial Institutions Fund (CDFI) is serving as the interim chief for homeownership until a permanent chief is hired. According to OFS officials, the effort to staff this office with housing policy, community development, and economic research experts is ongoing. As of November 21, 2008, seven positions had been filled with federal government detailees, according to the Chief, and the recruitment and hiring process had begun for permanent positions. OFS has stated that it is working with other federal agencies, including FDIC, HUD, and FHFA,

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<sup>29</sup>The act specifies that the program would insure only troubled assets originated or issued prior to March 14, 2008.

<sup>30</sup>73 Fed. Reg. 61452 (Oct. 16, 2008), Department of the Treasury: Development of a Guarantee Program for Troubled Assets (Notice and Request for Comments).

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to explore alternatives to help homeowners under TARP. As OFS reviews foreclosure mitigation program options, it is considering a number of factors, including the cost of the program, the extent to which the program minimizes the recidivism of borrowers helped out of default, and the number of homeowners the program has helped or is projected to help remain in their homes, according to a senior official. A senior OFS official stated that the agency had considered loan modification strategies such as the program FDIC developed to convert nonperforming mortgages owned or serviced by IndyMac Federal Bank into affordable loans. Possible loan modification measures under such programs include interest rate reductions, extended loan terms, and deferred principal.

Other similar programs under review, according to OFS, include strategies to guarantee loan modifications by private lenders. The HOPE for Homeowners program at the Federal Housing Administration (FHA) is one such program.<sup>31</sup> According to FHA, lenders benefit by turning failing mortgages into performing loans. Other loan modification programs include those announced by FHFA in partnership with Treasury, such as a streamlined loan modification program for at-risk borrowers, to prevent foreclosures and mitigate losses. According to an OFS official, OFS is also considering what policy actions might be taken under CPP to encourage participating institutions to modify mortgages that are at risk of or in default. Although OFS has stated that it is contemplating these and other foreclosure mitigation strategies, including strategies that involve TARP funds and strategies that do not involve TARP funds, it has not announced a specific program structure.

### Treasury's Strategy Continues to Evolve and Will Focus More on Consumer Credit

In addition to CPP, the insurance program, and potential foreclosure mitigation programs, Treasury is considering additional strategies under TARP. According to the Treasury Secretary, the agency is evaluating a program to leverage TARP funds with matching capital from private investors. This type of program could address the needs of nonbank financial institutions that are not eligible to participate in CPP. However, OFS acknowledged that many nonbank credit providers were not directly regulated, possibly making taxpayer protection, a key goal of the act, more difficult to achieve. OFS is also considering strategies to increase the

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<sup>31</sup>Under the new FHA program, lenders can have loans in their portfolios refinanced into FHA-insured 40-year loans with fixed interest rates. The new insured mortgages cannot exceed 96.5 percent of the current appraised value of the homes, a provision that could require lenders to write down the existing mortgage amounts. Borrowers must also share a portion of the equity resulting from the new mortgage and the value of future appreciation.

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availability of consumer financing by improving the liquidity of the asset-backed securitization market. According to Treasury, a freezing of credit in this market has limited financing options for consumers for car loans, student loans, and credit card borrowing. According to the Secretary, Treasury has been looking for strategies to use its authority and funds under TARP to encourage private investors to purchase highly rated ABS to expand the flow of consumer credit. Treasury and the Federal Reserve Bank of New York announced on November 25, 2008, the creation of the Term Asset-Backed Securities Loan Facility (TALF), under which the Federal Reserve Bank of New York will lend up to \$200 billion to holders of newly issued ABS for a term of at least 1-year. This credit facility is intended to create consumer credit by providing liquidity to ABS holders to issue new consumer credit-driven bonds. Using the funds available under TARP, Treasury will provide \$20 billion in credit protection to the Federal Reserve for loans. This credit facility may expand to include other asset classes, such as commercial and certain residential mortgage-backed assets.

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## Efforts to Establish the Office of Financial Stability Are Ongoing

Treasury has taken a number of major steps to set up OFS, including (1) establishing an organizational structure and filling key leadership positions and a number of staff positions within that structure, (2) selecting contractors and a financial agent to support TARP activities, and (3) beginning to develop an overall system of internal control for the program. However, OFS faces a number of challenges in completing its organizational activities. First, hiring the number and type of staff needed to successfully operate TARP, as well as ensuring that key leadership positions remain filled, will be challenging due to the rapid evolution of program activities and the fact that the office will soon be transitioning to a new administration. Further, Treasury has used contractors and a financial agent to play key roles in supporting the program, and it is taking initial steps to address conflicts of interest posed by their roles. But Treasury is still developing an oversight process for conflicts of interest involving its contractors and financial agents. These and other gaps in internal controls have resulted from the need to begin program activities before policies and procedures have been fully developed and implemented. While OFS recognizes the need to quickly develop and implement a comprehensive system of internal control for all TARP activities, these efforts have also been challenged by recent changes in the strategic direction of the program and uncertainties about further changes that may result once the new administration is in place. Successfully meeting all of these challenges is key to ensuring the efficient and effective operation of TARP now and in the future.

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## An Organizational Structure Has Been Established for OFS

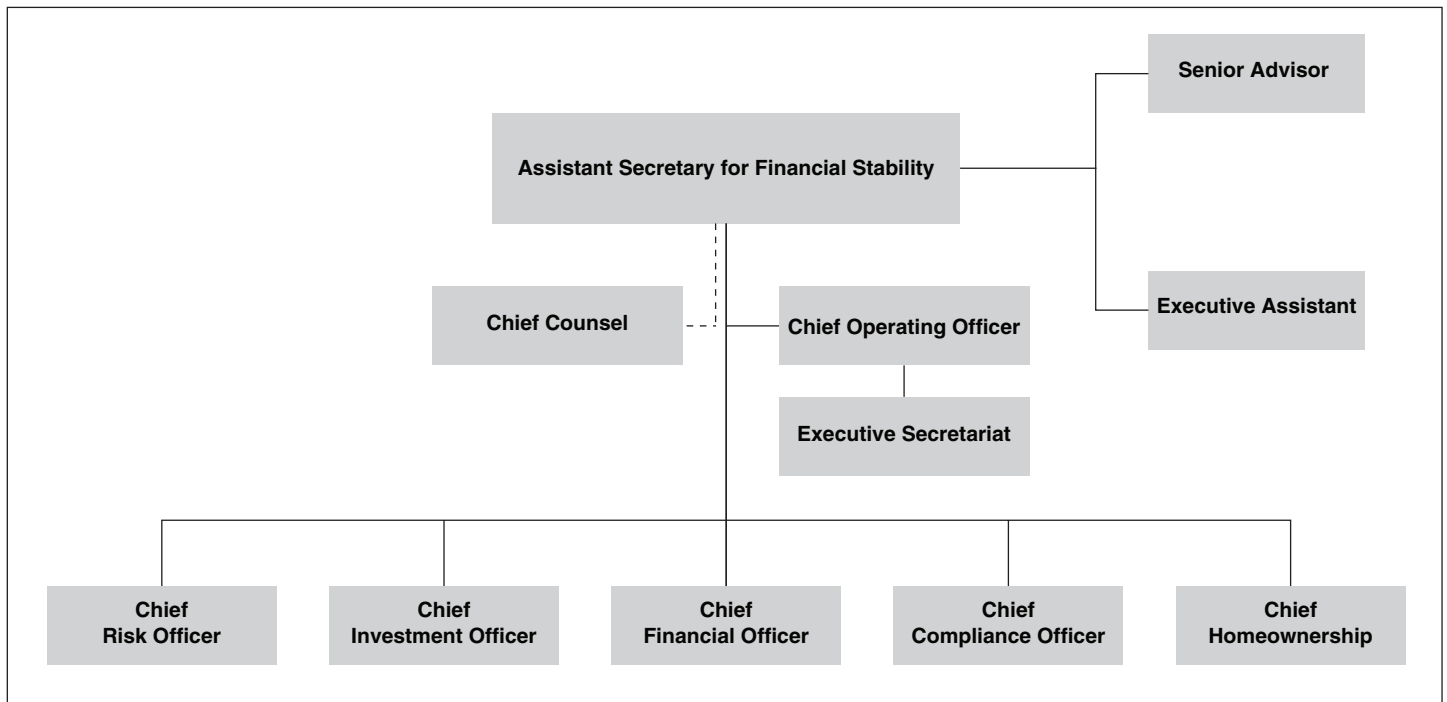
On October 6, 2008, in order to implement TARP and address growing concerns about the stability of the financial markets and the functioning of credit markets, Treasury established OFS and appointed an Interim Assistant Secretary of Financial Stability as its head. OFS is organized within Treasury's Office of Domestic Finance and reports to the Under Secretary for Domestic Finance. Soon after establishing OFS, Treasury created several functional areas within the office and hired interim chiefs to manage each of the major OFS functions (fig. 2). According to OFS's current organizational outline, these interim chiefs and their major areas of responsibility are as follows:

- *Chief Investment Officer* is responsible for administering TARP programs, such as CPP, and approving and managing all TARP investments.
- *Chief Risk Officer* is responsible for identifying and assessing risks that TARP faces and for tracking and reporting measurements of those risks.
- *Chief Financial Officer (CFO)* is responsible for the budget, financial statement reporting, accounting, and internal controls.
- *Chief Compliance Officer* is responsible for ensuring program compliance with laws and regulations, including the executive compensation and conflicts of interest requirements under TARP.
- *Chief of Homeownership Preservation* is responsible for overseeing efforts to reduce foreclosures and identify opportunities to help homeowners keep and protect their homes while also protecting taxpayers.

In addition, OFS has a Chief Operating Officer (COO), who is responsible for helping to develop the infrastructure to support TARP, coordinating communications among the various units, and working with Treasury's administrative resources unit to ensure efficient and effective TARP operations. In addition, the COO is responsible for working with the CFO

to manage the TARP budget.<sup>32</sup> The OFS organizational structure also includes a Chief Counsel who is responsible for providing legal and policy advice to OFS on implementing TARP and complying with the provisions of the act, and a Senior Advisor, who provides direct support to the Assistant Secretary for Financial Stability in overseeing the implementation of TARP.

**Figure 2: Organization of the Office of Financial Stability, as of November 21, 2008**



Source: Treasury.

Note: The Chief Counsel reports directly to Treasury's Office of General Counsel.

<sup>32</sup>In our prior work, we have reported that top leadership must set the direction, pace, and tone for agencies undergoing significant transformation and that the appointment of a chief operating officer is among the key practices available to help elevate attention on management issues and transformational change. See GAO, *Results-Oriented Cultures: Implementation Steps to Assist Mergers and Organizational Transformations*, [GAO-03-669](#) (Washington, D.C.: July 2, 2003).

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Treasury recognized that it needed to move quickly to fill the interim chief positions, for several reasons. First, the escalating financial crisis called for TARP to become operational as soon as Congress passed legislation to establish the program. Second, even before OFS was established, Treasury had contemplated engaging in various strategies to address the credit crisis and conducting a large number of financial transactions. Third, Treasury anticipated that a variety of factors could affect the timing, nature, and extent of the activities that OFS would administer. According to Treasury, its short-term strategy for staffing high-level OFS positions was to identify government employees inside Treasury and other federal agencies with the necessary skills and knowledge who could fill leadership positions on a temporary basis and establish a structure for administering the program going forward. The five interim chiefs have come from across government and beyond, including from OCC, the Federal Reserve, CDFI, the Export-Import Bank, and the International Monetary Fund (IMF), an international organization whose mission is to foster global monetary cooperation and secure financial stability. According to Treasury officials, the overall structure of OFS will remain appropriate for continuing to administer TARP regardless of the program's overall strategic direction.

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### Effective Implementation of OFS's Organizational Structure Depends on Timely Hiring and Well-Coordinated Transition Planning Efforts

Treasury is in the process of recruiting and hiring well-qualified career staff who will be able to stay on in their positions on a long-term basis. OFS officials said that it had about 48 employees assigned to TARP as of November 21, 2008, including those from other Treasury offices, federal agencies, and organizations, who are providing assistance on a temporary basis. OFS's interim chiefs have each developed a needs assessment for their areas and have submitted these assessments to the COO, who is working with Treasury's human resources department to meet those needs. The chiefs identified about 130 positions, although OFS officials have said that the office may require more (up to 200 full time equivalent employees) or less staff depending on the type and complexity of the various activities that OFS initiates under TARP and that hiring could be adjusted accordingly. Treasury is making efforts to meet the current estimate of needed staff by the end of December and is prioritizing its hiring process by filling senior career positions first. Consistent with the need to fill a large number of positions, Treasury officials said that they were reviewing a number of résumés from within and outside of the federal government to staff the organization as quickly as possible. As of November 21, 2008, Treasury had filled five permanent positions.

OFS is also taking steps to help ensure that the key positions remain filled during and after the transition to the new administration. While Treasury

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officials said that some interim chiefs might be asked to stay to serve under the new administration, at present it is unclear how many of them ultimately will continue in their existing roles or for how long. Consequently, the interim chiefs have been tasked with developing a description of their current roles and responsibilities and helping identify their potential replacements. While Treasury expects that there will be many qualified candidates interested in chief officer positions, uncertainty over leadership and the strategic direction of the program may inhibit some of OFS's efforts to fill these key positions. OFS officials said that they planned to meet frequently with the incoming administration's transition team and that they planned to hire senior career staff who could effectively manage TARP activities during and after the transition. Filling needed positions will be a key step in the successful transition of the program to the new administration, and we plan to continue to monitor these activities as the transition to the new administration continues.

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### Contractors and Financial Agents Will Provide Key Services for TARP

Treasury has used a financial agency agreement and a variety of contracts to acquire a range of services in support of TARP. To promote a timely and flexible approach to implementing the program, Treasury used expedited procedures to enter into the agreement and award the contracts and structured these arrangements to allow for flexibility in ordering the services required. Treasury has also taken steps to help promote the inclusion of small businesses in carrying out TARP.

### Contracts and Other Agreements Entered into by Treasury Provide for a Range of Services to Support TARP

Treasury has used two approaches to acquire the necessary services to support TARP. First, Treasury exercised its authority under the act to retain financial agents to provide services on its behalf. Treasury said that it would use financial agents when the required services involved managing public assets. Second, Treasury has entered into a variety of contracts and blanket purchase agreements under the Federal Acquisition Regulation (FAR) for legal, investment consulting, accounting, and other services that are generally available in the commercial sector. While the financial agency agreement and certain contracts were awarded primarily to assist with the purchase of troubled assets, Treasury officials explained that they were redirecting requirements within the scope of the contracts to support TARP's shift to CPP and made similar modifications to the financial agency agreement.

Between October 3 and November 25, 2008, Treasury entered into one financial agent agreement and seven contractual arrangements in support of TARP, the details of which are summarized in table 2. In addition, we



have preliminary information on three other contracts ranging from about \$8,500 to \$2.2 million for a budget model, legal services, and leased office space. We are continuing to review all contracts and agreements, including these three additional contracts.

**Table 2: Financial Agency Agreement and Contracts Awarded, as of November 25, 2008**

Purpose	Date signed	Value	Agreement structure	Pricing structure	Competition	
<b>Financial Agency Agreement</b>						
Bank of New York Mellon	To provide custodian and cash management services	10/14/2008	To be calculated based on percentage of value of assets managed	Financial agency agreement	Percentage of value of assets managed	Open competition: Submissions received: 70 Submissions meeting qualifications: 10 Responses considered: 3
<b>Contracts</b>						
Simpson, Thacher & Bartlett, LLP	To serve as a legal adviser for implementing the Emergency Economic Stabilization Act	10/10/2008	\$5,000-\$500,000	Indefinite delivery/ indefinite quantity contract	Time and materials or firm-fixed price task orders	Other than full and open based on unusual and compelling urgency exception. Offerors solicited: 6 Offers received: 2
EnnisKnupp & Associates, Inc.	To support development and maintenance of investment policies and guidelines and assist with the oversight of asset managers	10/11/2008	\$25,000 - \$2,500,000	Indefinite delivery/ indefinite quantity contract	Firm-fixed price task orders	Other than full and open based on unusual and compelling urgency exception. Offerors solicited: 6 Offers received: 3
Pricewaterhouse Coopers, LLP	To help establish internal controls	10/16/2008	Total amount of services ordered to date: \$191,469	Blanket purchase agreement	Time and materials or firm-fixed price task orders	Request for quotes from 6 firms on the General Services Administration's (GSA) Federal Supply Schedules (the Schedule) Quotes received: 6
Ernst & Young, LLP	To provide general accounting support and expert accounting advice	10/18/2008	Total amount of services ordered to date: \$492,007	Blanket purchase agreement	Time and materials or firm-fixed price task orders	Request for quotes from 7 firms on the GSA Schedule Quotes received: 6
Hughes Hubbard & Reed, LLP	To provide legal services in connection with the capital purchase program	10/29/2008	Total amount of services ordered to date: \$1,411,300	Blanket purchase agreement	Time and materials or firm-fixed price task orders	Request for quotes from 5 firms on the GSA Schedule Quotes received: 4

	<b>Purpose</b>	<b>Date signed</b>	<b>Value</b>	<b>Agreement structure</b>	<b>Pricing structure</b>	<b>Competition</b>
Squire Sanders & Dempsey, LLP	To provide legal services in connection with the capital purchase program	10/29/2008	Total amount of services ordered to date: \$1,380,000	Blanket purchase agreement	Time & materials or firm-fixed price task orders	Request for quotes from 5 firms on the GSA Schedule Quotes received: 4
Lindholm & Associates	To provide Human Resources Support	10/31/2008	\$174,720 for base period of 6 months. Total value of base period plus all options is \$710,528.	Order under the GSA Schedule	Time and materials task orders	Quotes sought and received from 3 small businesses

Source: GAO analysis of Treasury documents.

## Treasury Used Expedited Procedures to Award the Agreement and Contracts

Treasury used a variety of methods to expedite the process for entering into its agreement and awarding contracts for TARP. For the financial agency agreement, Treasury posted notices on its Web site on October 6 seeking proposals to provide asset management and custodian services. Proposals were due by October 8. Although Treasury had not selected asset managers as of November 21, it moved quickly to complete the custodian agreement. Treasury said that of the 70 custodian proposals it received, 10 met minimum eligibility requirements, and 3 institutions were invited to submit formal proposals and make face-to-face presentations. Treasury evaluated the three proposals and on October 14, 2008, selected Bank of New York Mellon to be the custodian for the asset purchase program for a term of 3 years. The parties later amended the agreement to provide for services under CPP.

Treasury also used other than full and open competition to expedite the award of two contracts for services. To obtain legal services and the expertise of an investment consultant firm, Treasury used existing statutory authority as the basis to award contracts using other than full and open competition procedures. The specific exception Treasury used under this authority was unusual and compelling urgency.<sup>33</sup> Using market research that it had conducted, Treasury invited several firms to submit

<sup>33</sup>The Competition in Contracting Act authorizes agencies to limit competition when an unusual and compelling urgency precludes the use of full and open competition and delaying the contract would result in serious financial or other harm to the government. 41 U.S.C. § 253(c)

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Contracts Have Been  
Structured to Accommodate  
Treasury's Need for Flexibility

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proposals on an expedited basis. Treasury received two proposals for legal services and three for investment services and was able to make awards in accordance with its announced criteria. Treasury also made five awards under schedules maintained by the General Services Administration (GSA). In all cases, Treasury solicited and awarded the contracts within a matter of days.

Treasury used contract structures and pricing arrangements designed to allow for flexibility in ordering the services required. Specifically, Treasury established blanket purchase agreements with several firms based on contracts previously awarded to those firms by the GSA. These blanket purchase agreements contain the basic terms and conditions governing the types of services the firms will provide to Treasury in support of TARP. As specific needs arise, the blanket purchase agreements allow Treasury to issue task orders to the firms describing the specific services required, establishing time frames, and setting pricing arrangements. Treasury established two 3-year agreements; other agreements were established for periods ranging from 6 to 24 months. In other instances, Treasury awarded new indefinite delivery/indefinite quantity contracts that, like the blanket purchase agreements, contain all necessary contract terms and conditions. As specific needs arise, Treasury issues a task order under the indefinite delivery/indefinite quantity contract. These contracts were established for 1 year or less. In general, the task orders under these contracts were awarded for periods of performance ranging from 2 weeks to 6 months.

For the most part, the contracts and task orders awarded as of November 25, 2008, including the blanket purchase agreements, are priced on a time and materials basis. This pricing mechanism provides for payments to the contractors based on set labor rates and the number of hours worked, plus the cost of any materials. Our prior work on such contracts recognized both the inherent flexibility of such arrangements and the highlighted need for close government supervision to ensure that costs are contained. Specifically, time and materials contracts are considered high risk for the government because they provide no positive incentive to the contractor for cost control or labor efficiency. Thus, the onus is on the government to monitor contractors to ensure that they are performing the work efficiently and controlling costs.<sup>34</sup>

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<sup>34</sup>GAO, *Defense Contracting: Improved Insight and Controls Needed over DOD's Time-and-Materials Contracts*, GAO-07-273 (Washington, D.C.: Sept. 17, 2007).

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Treasury Has Taken Some Steps to Promote the Use of Small Businesses in TARP Activities

A Treasury procurement official stated that time and materials pricing for its task orders had been necessary because of the uncertain nature of the work that would be required. As TARP requirements become more established, Treasury may award future task orders using fixed-price arrangements. Furthermore, the official outlined several steps his office was taking to ensure appropriate management and oversight of the time and materials contracts awarded as of November 25, 2008, including assigning additional oversight personnel to TARP procurements, ensuring that training requirements were met, and providing specific training on the tracking of billable costs. However, Treasury has not yet established a specific timetable for completing these steps.

In a memo issued through its Web site, Treasury provided guidelines to small businesses for pursuing procurement opportunities. Treasury noted that while there were no requirements under its financial agent authority to set aside work for various designations of small businesses—including small business concerns owned and controlled by women, minorities, veterans, and socially and economically disadvantaged individuals—use of these groups was an evaluation factor during the selection process. Treasury further noted that any small businesses that did not meet the minimum requirements for award of the financial agency agreement could participate as subcontractors.

For services obtained through procurement contracts, Treasury considered offerors' efforts to promote small business participation as part of its selection criteria. Specifically, for three of the contractual agreements it has awarded, Treasury evaluated the proposals received based in part on the offerors' approach to ensuring that small businesses had opportunities to participate. One of the contracted firms is a small business, while other awardees offered the following approaches to using small businesses:

- One vendor has teamed with a minority small business firm as a subcontractor.
- Another vendor plans to utilize two subcontractors: one woman-owned small business and one other small business. However, Treasury noted that the subcontractors' combined participation would amount to less than 1 percent of the contract's total value.

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- One other company stated that it intends to use a minority- and woman-owned small business enterprise as a subcontractor.

Three contract proposals did not contain a plan for utilizing small businesses.

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### Treasury Has Taken Initial Steps to Address Conflicts of Interest but Specific Policies and Procedures Have Yet to Be Established

Treasury's reliance on private sector resources to assist with implementing TARP has underscored the importance of addressing conflicts of interest issues. Treasury has taken some steps to address actual and potential conflicts of interest involving its financial agent and contractors, such as issuing interim guidelines and requiring that all those responding to solicitations provide a plan to mitigate any actual or potential conflicts of interest they or their proposed subcontractors may have. The financial agent and contractors that Treasury selected identified a variety of potential or actual conflicts of interest and proposed a variety of solutions to mitigate these conflicts. We plan to monitor closely the implementation of these mitigation plans.

### Treasury Has Issued Interim Guidelines and Plans to Issue Regulations on Conflicts of Interest

On October 6, 2008, Treasury issued interim conflict of interest guidelines. The guidelines identify conflict of interest issues for contractors to consider when submitting their proposals to assist with the act's implementation. Treasury's interim guidelines

- contemplate that Treasury could obtain nondisclosure and conflict of interest agreements before supplying an offeror with a solicitation;
- encourage contractors to disclose all actual or potential conflicts of interest and develop mitigation plans;
- note that Treasury's solicitations could include evaluation factors and criteria to assess contractors' conflict of interest mitigation plans;
- restate Treasury's statutory authority and duty to oversee, evaluate, waive, negotiate, and mitigate conflicts of interest related to its contracts; and
- provide that a mitigation plan submitted in a proposal will become a binding contractual obligation.

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The guidelines will remain in effect until Treasury issues the regulations that are currently being drafted.

Employees of Treasury's contractors and financial agents are not subject to the conflict of interest laws and regulations that govern the conduct of government employees. In prior work on defense contracting, GAO recommended that the Department of Defense contractually require its contractors to impose conflict of interest restrictions similar to those for federal employees on employees who were providing advice or assistance in mission-critical or in certain contracting matters.<sup>35</sup>

Treasury officials said that the agency intended to use existing statutory and regulatory postemployment restrictions to guide the actions of Treasury employees who might leave the agency. In addition, because these rules do not apply to employees of Treasury's contractors, Treasury's contracts awarded under TARP provide some postemployment limitations for contractors and their employees. For example, one solicitation for legal services prohibits attorneys assigned to work on the contract from representing other parties on issues related to the services performed both during the term of the contract and for 6 months thereafter.

### Contractors and Agents Have Identified Potential and Actual Conflicts of Interest

For each solicitation, Treasury required respondents to identify any actual or potential conflicts of interest that they would encounter in providing the services described and to explain how they would avoid, mitigate, or neutralize any conflicts concerning the company, its corporate parents, subsidiaries, affiliates, and proposed subcontractors. Among other situations, Treasury identified areas of possible conflict for respondents to consider, including personal, business, or financial interests related to the requested services and participation in TARP. In their responses to Treasury's requirements, six of the eight service providers selected as of November 25, 2008, identified potential or actual sources of conflict. According to our review, the identified conflicts generally involve organizational conflicts of interest, though some also involve personal conflicts of interest:

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<sup>35</sup>GAO, *Defense Contracting: Additional Personal Conflicts of Interest Safeguards Needed for Certain DOD Contractor Employees*, GAO-08-169 (Washington, D.C.: Mar. 7, 2008).

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Contractors and Agents Have Proposed Plans to Mitigate Conflicts of Interest but Have Provided Few Details on Implementing Them

- Five contractors indicated that they either already had clients or could have clients who were receiving TARP assistance.
- One contractor indicated that a potential conflict of interest would arise if it received information proprietary to multiple clients with competing investment interests.
- One company identified conflicts regarding troubled assets owned either directly by the company or by clients that were eligible for assistance under TARP.

The financial agent and contractors have proposed various approaches to mitigating any actual or potential conflicts of interest. Awardees indicated that they would use their codes of conduct, company policies and procedures, senior executive meetings, confidentiality agreements, specialized information security methods, and open communication with Treasury to mitigate conflicts of interest. For example, two contractors indicated that their companies would create a secure information environment, provide training to relevant employees, and monitor their compliance with requirements. Another contractor said that it would execute nondisclosure agreements, develop a mitigation plan, provide oversight and training, and conduct regular monitoring of compliance for any conflicts of interest involving its personnel. One company proposed using a third-party agent to facilitate the sale of its troubled assets and an independent accounting firm to oversee the transfer of those assets.

The submitted plans provided few details, however, on how the companies would notify and communicate with Treasury if conflicts were identified during the course of performance.<sup>36</sup>

- Two firms' plans indicated that they would either maintain an "open dialog" or would "work in good faith" with Treasury should conflicts of interest emerge.
- Two other plans did not describe how the firms would address conflicts of interest or how they would notify Treasury.

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<sup>36</sup>A recent FAR amendment, effective December 12, 2008, will require contractors to disclose promptly credible evidence of fraud and conflicts of interest to the appropriate inspector general and contracting officer. 73 Fed. Reg. 67064 (Nov. 12 2008) (to be codified at 41 C.F.R. §52-203-13(b)(3)).

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By comparison, one plan indicated that the company would provide information on conflicts of interest to Treasury in its weekly reports and offer recommendations for addressing each issue.

Treasury relies on its financial agents and contractors to disclose conflicts of interest. Treasury officials stated that while under current procedures, they might not know if an agent or contractor did not disclose a conflict, they believed that the consequences for nondisclosure were sufficiently severe to deter such behavior. Finally, Treasury has noted in its solicitations that it intends to oversee and enforce compliance with conflict of interest mitigation plans. For example, Treasury noted in one of its solicitations for legal services that it would incorporate the offeror's final negotiated conflict of interest mitigation plan into the contract and then oversee and enforce the contractor's compliance with the plan. At the time we conducted our work, however, Treasury was still in the process of developing an oversight mechanism for enforcing financial agents' and contractors' mitigation plans.

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## OFS's Internal Control Structure Is Evolving As Program Activities Are Implemented

A key challenge facing OFS is the need to develop a comprehensive system of internal controls at the same time that it must react quickly to financial market events. Effective internal control is a major part of managing any organization to achieve desired outcomes and manage risk. As shown in table 3, GAO's Standards for Internal Control include five key elements.<sup>37</sup> Internal controls include the program's policies, procedures, and guidance that help management ensure effective and efficient use of resources; compliance with laws and regulations; prevention and detection of fraud, waste, and abuse; and the reliability of financial reporting. OFS has hired PricewaterhouseCoopers to assist in the design and implementation of a system of internal control for TARP.<sup>38</sup> Because of the rapid evolution of TARP, controls are being developed as various aspects of the program become operational. For example, once CPP became active, OFS and PricewaterhouseCoopers focused on developing and implementing internal

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<sup>37</sup>GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999).

<sup>38</sup>According to PricewaterhouseCoopers, it plans to use the *Committee of Sponsoring Organizations of the Treadway Commission's (COSO)–Enterprise Risk Management–Integrated Framework* as the basis for providing assistance in developing the internal control model. COSO is a voluntary private sector organization whose purpose is to help businesses and other entities assess and enhance their internal control systems. This framework is consistent with GAO's Standards for Internal Control.



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controls related to the capital purchase transactions and documenting the control activities as they occurred. However, many key controls remain to be developed. Specific examples, which we noted earlier, are that OFS has not yet developed sufficient policies and processes for overseeing its contractors or overseeing whether participating institutions are adhering to the executive compensation requirements under CPP.

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**Table 3: GAO’s Standards for Internal Control in the Federal Government**

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(1) *Control environment*—creating a culture of accountability by establishing a positive and supportive attitude toward improvement and the achievement of established program outcomes.

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(2) *Risk assessment*—performing comprehensive reviews and analyses of program operations to determine if risks exist and the nature and extent of risks have been identified.

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(3) *Control activities*—taking actions to address identified risk areas and help ensure that management’s decisions and plans are carried out and program objectives met.

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(4) *Information and communication*—using and sharing relevant, reliable, and timely financial and nonfinancial information in managing programs.

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(5) *Monitoring*—tracking improvement initiatives over time and identifying additional actions needed to further improve program efficiency and effectiveness.

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Source: GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999).

Going forward, it will be essential that OFS continue developing a comprehensive internal control structure that addresses all five standards.

- A strong *control environment* will depend on OFS’s management’s ability to set and maintain an environment based on integrity and core values and on the competence of staff hired to manage and perform program operations. As noted earlier, OFS has taken the first steps by developing an organizational structure that defines lines of authority and has begun to hire permanent staff, but OFS may need to adjust these initial steps as the focus of TARP evolves.
- A *risk assessment* for TARP will include consideration of all significant interactions between OFS and other parties, including banks receiving funds under CPP and the custodian for TARP activities, as well as internal factors that increase risk. This assessment is important, but again OFS will be challenged as the strategies developed to achieve TARP’s objectives continue to evolve, a fact that could also affect the risks facing the program. Because TARP is a new and unique program dealing with unusual circumstances, the program will likely be faced with unique and complex risks.

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- *Control activities* for TARP will consist of the policies, procedures, and guidance that enforce management's directives and achieve effective internal control over specific program activities. Examples of such policies and procedures particularly relevant to TARP are (1) proper execution and accurate and timely recording of transactions and events, (2) controls to ensure compliance with program requirements, (3) establishment and review of performance measures and indicators, and (4) management reviews of performance and agency achievements. As noted earlier, the development of policies and procedures is occurring concurrently with program execution, thereby increasing the risk that the programs will not be implemented as intended or that transactions will not be processed properly. Further, documented policies, procedures and guidance will be critical tools for OFS staff, many of whom have yet to be hired and were not involved in the initial transactions.
  - *Information and communication* will be important to OFS managers in helping them achieve their responsibilities and goals within an effective internal control structure. Communication is particularly important because of the dynamic environment in which OFS is currently operating. OFS has begun to address external communication issues by posting information on Treasury's Web site as it becomes available, holding press conferences, speaking at industry events, and testifying at congressional hearings.
  - *Monitoring activities* include the systemic process of reviewing the effectiveness of the operation of the internal control system. These activities are conducted by management, oversight boards and entities, and internal and external auditors. *Monitoring* enables stakeholders to determine whether the internal control system continues to operate effectively over time. It also improves the organization's overall effectiveness and efficiency by providing timely evidence of changes that have occurred, or might need to occur, in the way the internal control system addresses evolving or changing risks.

A robust system of internal control specifically designed to deal with the unique and complex aspects of TARP will be key to helping OFS management achieve the desired results from TARP. While OFS plans to implement such a system, there is heightened risk that without it the interests of the government and taxpayers may not be adequately protected and that the programs' objectives may not be achieved in an efficient and effective manner. Our ongoing monitoring efforts will continue to focus on the steps OFS is taking to develop and implement an effective internal control structure.

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## Measuring the Impact of TARP on Credit Markets and the Economy Will Be Challenging

TARP's activities could improve market confidence in banks that choose to participate and have beneficial effects on credit markets, but several factors will complicate efforts to measure any impact. If TARP is having its intended effect, a number of developments might be observed in credit and other markets over time, such as reduced risk spreads, declining borrowing costs, and increased lending. However, several factors will make isolating and measuring the impact of TARP challenging, including simultaneous changes in economic conditions, changes in monetary and fiscal policy, and other programs introduced by the Treasury, the Federal Reserve, FDIC, and FHFA to support banks, credit markets, and other struggling institutions. As a result, any improvement in capital markets cannot be attributed solely to TARP nor will a slow recovery necessarily reflect its failure because of the effects of market forces and economic conditions outside of the control of TARP. Nevertheless, we have preliminarily identified some indicators that may be suggestive of TARP's impact over time. These indicators include measures of the perception of risk in interbank lending, consumer lending, corporate debt markets, and the overall economy. We have also identified a number of other indicators that we are also monitoring and may include in future reports.

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## TARP Could Have a Number of Effects on Credit Markets and the Economy, but Several Factors Complicate Measuring the Impact

TARP activities as of November 25, 2008—specifically CPP—could improve market confidence in participating banks by improving their balance sheet, cash flow, and capital positions; reducing their perceived risk; and allowing them to borrow and raise capital at more favorable rates. To the extent that confidence in participating banks improves, the banks should be able to increase lending at lower rates and pass on some of their lower funding costs to their own customers. Moreover, the capital infusions could also increase the confidence of participating banks so that the banks increase business, interbank, and consumer lending rather than hoarding the capital or using it to purchase low-risk assets. However, some tension exists between the goals of improving banks' capital position and promoting lending—that is, the more capital banks use for lending, the less their overall capital position will improve.

If TARP does have its intended impact, a number of these effects should appear in credit and other markets over time. Since the first eight banks received capital injections on October 28, 2008, it may well be too early to expect noticeable changes. However, if confidence in banks improves, the perceived risk of lending to banks should decline, and this development would be observed in declining risk premiums (the difference between risky and risk-free interest rates, such as rates on U.S. Treasury securities) for interbank lending and bank debt. With an improved capital position

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and lower funding costs, over time banks should be able to increase lending and pass some of their lower borrowing costs on to their customers. Further, improved market conditions may permit some borrowers to avoid foreclosures by enhancing the capacity and willingness of banks to refinance certain loans or modify others.<sup>39</sup> Potentially, this development would lower risk premiums for and raise volumes of consumer and business lending. Because bank financing and capital markets are close substitutes for large businesses, declines in borrowing costs from banks could also reduce borrowing costs in capital markets.<sup>40</sup> Over the long term, improvements in credit markets should have effects on real economic activity as lower borrowing costs boost demand for goods and services. Asset prices, such as stock prices, and risk premiums, although imperfect, are also important leading indicators of real economic activity.<sup>41</sup>

Changes in credit market conditions may not provide conclusive evidence of TARP's effectiveness, however, as other important policies and interventions can influence these markets. A number of government agencies, including FHFA, FDIC, Treasury (through approaches other than TARP), and the Federal Reserve have worked in a collaborative manner to attempt to restore financial stability. For example, FDIC announced that it would temporarily guarantee the senior debt of all FDIC-insured institutions and their holding companies. This guarantee may affect the interest rates on bank-issued debt and improve confidence in banks. In addition to lowering the federal funds rate and providing liquidity facilities for a range of assets and institutions, the Federal Reserve has begun intervening in the market for commercial paper, a move that is also intended to reduce the cost of borrowing in those markets. Moreover, as of November 21, the Federal Reserve had almost \$900 billion in loans outstanding to financial institutions. FHFA placed Fannie Mae and Freddie Mac in conservatorship in response to their deteriorating financial condition.

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<sup>39</sup>In an interagency statement, Treasury, FDIC, and the Federal Reserve encouraged banks and their regulators to work collectively to meet the needs of creditworthy borrowers and work with existing borrowers to avoid preventable foreclosures.

<sup>40</sup>Capital markets are a larger source of business borrowing than banks, but consumers and small businesses do not generally have access to capital markets.

<sup>41</sup>Real economic activity generally refers to measures of national income and the production of goods and services, such as gross domestic product and industrial production.

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In addition, Treasury announced that, under authority provided by the Housing and Economic Recovery Act of 2008, it planned to purchase mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac on the open market. As of September 30, 2008, Treasury reported that it had purchased about \$3.3 billion in Fannie and Freddie MBS and intended to purchase additional securities.<sup>42</sup> Moreover, on November 25, 2008, the Federal Reserve announced that it was initiating a program to purchase up to \$500 billion in mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae and up to \$100 billion in direct obligations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. According to the Federal Reserve, the action was intended to support housing markets and foster improved conditions in financial markets more generally. Because banks hold a significant amount of securities guaranteed by these institutions, which are central to liquid secondary mortgage markets, these actions may also affect investor and bank confidence and interest rates. Moreover, FHFA, in partnership with Treasury, has implemented a supplemental loan modification program for at-risk borrowers to prevent foreclosures and mitigate losses.

General market forces will also complicate a determination of TARP's effectiveness. For example:

- Recent and expected declines in general economic activity are likely to reduce lending and heighten perceived credit risk despite a host of U.S. government interventions.
- Further declines in housing prices are possible as values fall to levels consistent with incomes and rents in local areas, possibly leading to additional foreclosures, asset write-downs, and an increase in the perceived risk of banks and other financial institutions with exposure to mortgage assets.<sup>43</sup>
- In the face of increased risk, banks may not raise interest rates much (if at all) but instead ration credit so that only borrowers with pristine

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<sup>42</sup>Treasury agreed to commit only up to \$100 billion per government-sponsored enterprise to cover the enterprises' negative net worth.

<sup>43</sup>Some changes in financial markets could occur because market participants may alter their behavior based on the announcement of a program in anticipation that specific action will be taken. In other words, if market participants believe risk will decline in the future, they will charge less for that risk in the present, assuming that the announcement is credible and the program is viewed as effective.

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credit receive loans. Furthermore, changes in both the supply of and demand for credit can influence interest rates, and interest rates charged by banks may also reflect the customers they choose rather than the cost of bank credit for all borrowers.

Finally, any changes attributed to TARP may well be changes that (1) would have occurred anyway, (2) are enhanced or counteracted by other market fundamentals, or (3) can be attributed to other policy interventions, such as the actions of FDIC, the Federal Reserve, or other financial regulators. For these and other reasons, we will not know what would have happened in the absence of TARP. As a result, determining the effect of TARP as it is being implemented will be a challenge.

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### Changes in Select Indicators over Time May Provide Insights about CPP's Impact

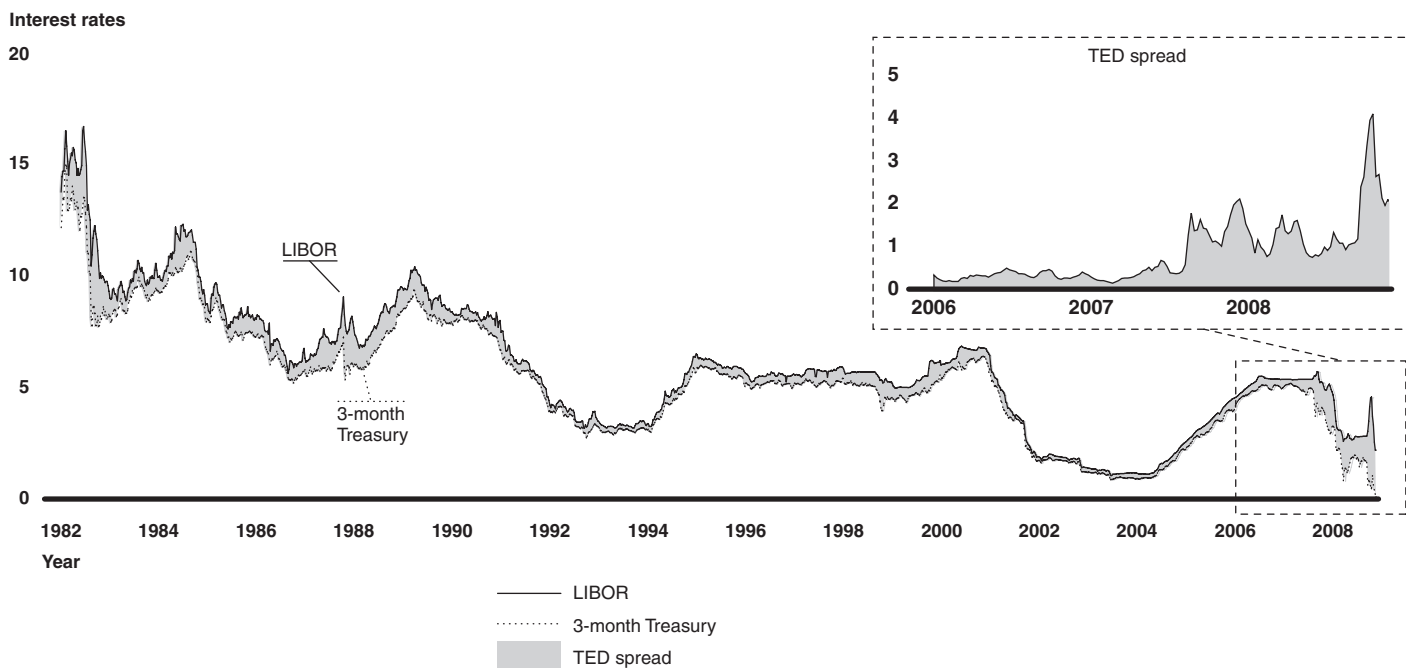
We considered a number of indicators that, although imperfect, may be suggestive of TARP's impact on credit and other markets. Currently, we have identified a number of preliminary indicators that are likely to capture interbank, mortgage, and nonbank lending activity as well as financial market risk perceptions and variables that are predictive of future real economic activity. At the very least, improvements in these measures would indicate improving conditions in credit markets. Further, given that CPP's goal is to improve the capital position of banks and promote lending, going forward we expect to monitor indicators that can provide some insight into the potential effects of the plan on capital ratios, the structure of liabilities, and net changes in lending at participating institutions. We continue to consider a variety of additional indicators, and as more data become available and as economic and credit conditions evolve, we plan to include them in future reports.

### Treasury-London Interbank Offered Rate (LIBOR) Spread (TED Spread)

The TED Spread is the difference between an average of interest rates offered in the London interbank market for 3-month, dollar-denominated loans (known as LIBOR) and the interest rate on U.S Treasury bills with the same maturity. It is considered a key indicator of credit risk that gauges the willingness of banks to lend to other banks. Increases in the TED spread imply a bigger aversion to risk. That is, investors have a preference for safe investments (e.g., Treasuries) and charge a higher premium for loans to other institutions to compensate for greater perceived default risk. Figure 3 shows both the historical TED spread as well as an inset that focuses on the TED spread since 2006. The figure shows that the weekly TED spread increased to roughly 2 percentage points (or 200 basis points) in early December 2007 and

peaked at over 400 basis points for the week including October 17, 2008.<sup>44</sup> Between the announcement of the creation of CPP the week of October 14 and the week before Treasury disbursed capital injections to the eight banks initially participating in CPP (week of October 20), the spread declined 146 basis points. Decreases in the TED spread could reflect the fact that banks are more willing to lend to other banks on terms that reflect greater confidence in the banking system (i.e., without demanding a large interest rate premium). From the date of the initial capital injections on October 28 to November 14, the TED spread declined by about 60 basis points. The LIBOR itself has declined, but so has the Treasury yield. However, during the week ending November 21, 2008, the LIBOR rate and the TED spread began to rise.

**Figure 3: Three-Month LIBOR and 3-Month Treasury Bill Yield, as of November 21, 2008**



Source: Global Insight and Federal Reserve Bank of St. Louis.

Note: Rates and yields are weekly percentages. Area between LIBOR and Treasury yield is the TED spread.

<sup>44</sup>A basis point is a common measure used in quoting yield on bills, notes, and bonds and represents 1/100 of a percent of yield. It should be noted that while the spread is large, the actual LIBOR rate is lower than the average rate for 2005 through mid-2007.

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## Corporate Spreads

The economywide risk premium is measured in a number of ways, most commonly as the difference (spread) between Moody's Investors Service (Moody's) Baa bond rate and Moody's Aaa rate or between these rates and the relevant government bond yield.<sup>45</sup> These spreads represent a premium lenders demand for taking on risk—that is, when spreads are high, market participants perceive more risk, warranting a higher rate of return. When credit market conditions improve, some narrowing of these spreads would be expected.<sup>46</sup> Moody's describes Aaa bonds as “of the highest quality, with minimal credit risk” and Baa bonds as “subject to moderate credit risk” that “may possess certain speculative characteristics.” As shown in figure 4, the various interest rate spreads show a common pattern—an increase in negative perceptions about risk, resulting in increasing spreads as seen over the past year (as shown in the inset) and at various points in the past 25 years, including the mid-1980s and early 2000s. Declines in these spreads would be indicative of improving credit conditions, but because these spreads may have been too narrow during the period leading up to the credit market turmoil (risk was underpriced), it is not clear how much these premiums should decline. Treasury has noted that although interbank lending rates have improved, U.S. companies continue to experience difficulties in issuing long-term debt at attractive rates. As of November 21, 2008, both corporate spreads were higher than they were the week prior to the initial capital injections.

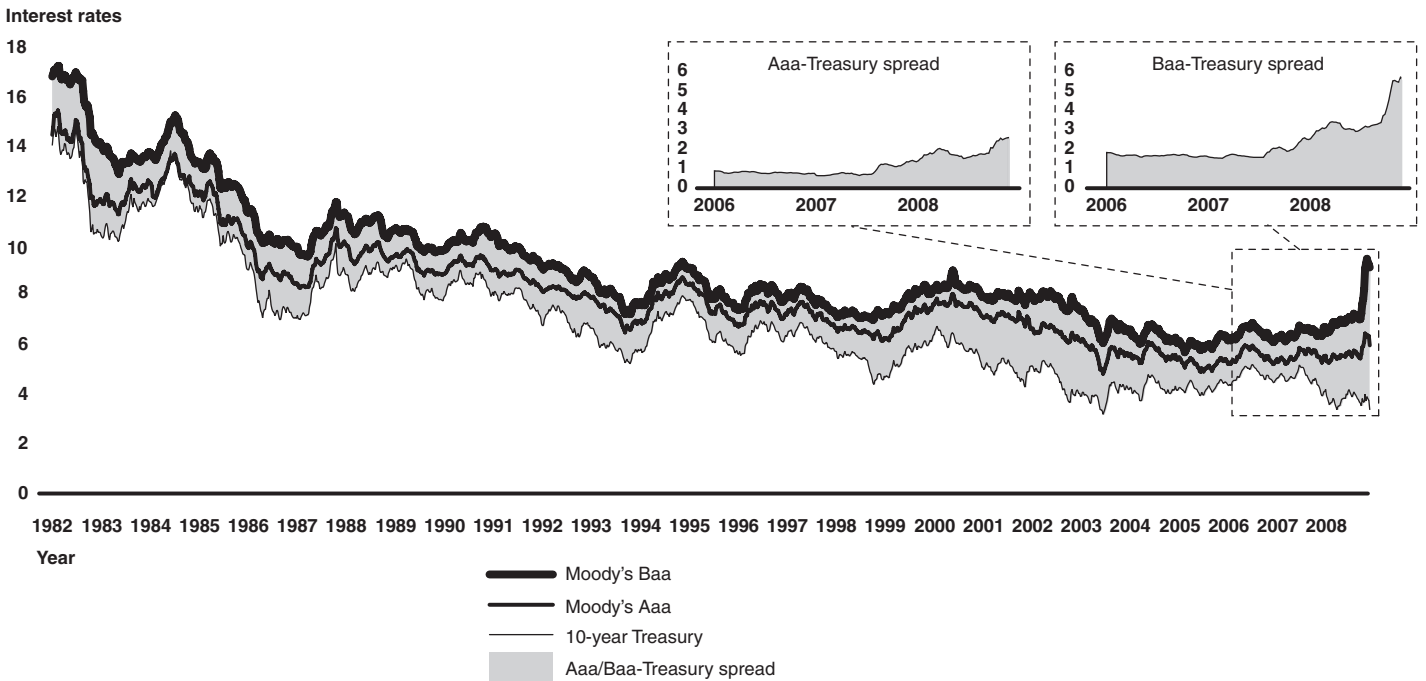
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<sup>45</sup>Moody's Investors Service performs financial research and analysis on commercial and government entities. It also ranks the creditworthiness of borrowers using a standardized ratings scale. These spreads can also reflect a liquidity and/or prepayment premium. Moreover, some economic research also suggests that such interest rate spreads have predictive power for the real economy, although the inferences to be drawn vary across time and instruments and may send false signals.

<sup>46</sup>Moreover, economic research also suggests that such interest rate spreads have predictive power for several real economy variables, such as industrial production, durable orders, the unemployment rate, personal income, capacity utilization, and consumption.



**Figure 4: Yields on Corporate Bonds (Aaa and Baa) Relative to 10-year Treasury**



Source: Federal Reserve Bank of St. Louis.

Note: Rates and yields are weekly percentages. The average for the week of November 21, 2008, is a midweek estimate.

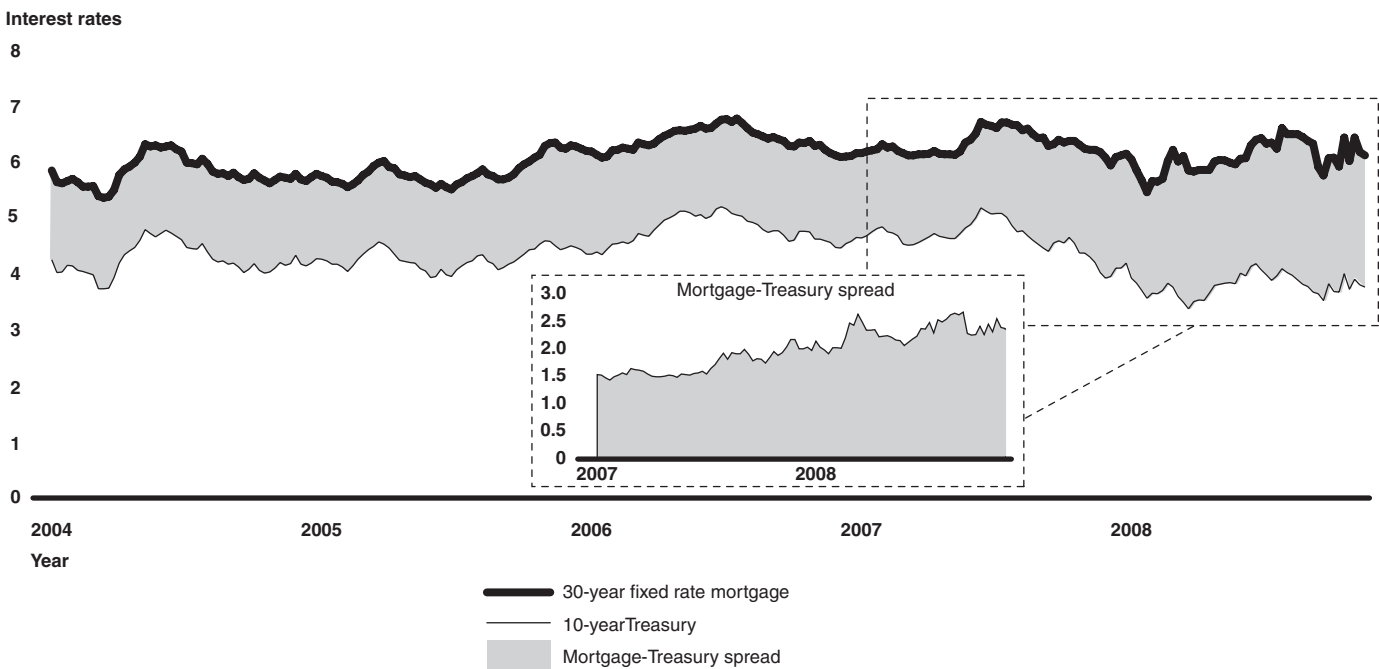
## Mortgage Rates

The credit turmoil has raised concern about consumers' abilities to obtain funds, including mortgages, at rates consistent with economic fundamentals and individual risk characteristics. One of TARP's explicit goals is to enhance liquidity and promote lending to consumers, but high spreads between mortgage rates and Treasury yields indicate relatively high risk and low liquidity. Therefore, to the extent that credit and economic conditions improve, these spreads would narrow. Figure 5 shows that the weekly spread between conforming mortgage rates and Treasuries has widened significantly since 2004.<sup>47</sup> As shown in the inset to the figure, from October 2007 through October 2008, there was some

<sup>47</sup>Conforming mortgages are mortgage loans that can be purchased by Fannie Mae and Freddie Mac.

improvement in this measure since peaking in early September 2008, however, the spread increased for the week ending November 21.

**Figure 5: Mortgage Rates (30-Year Fixed Rate, Conforming) and Treasury Yields, as of November 20, 2008**



Source: Federal Reserve Bank of St. Louis.

Note: Rates and yields are weekly percentages.

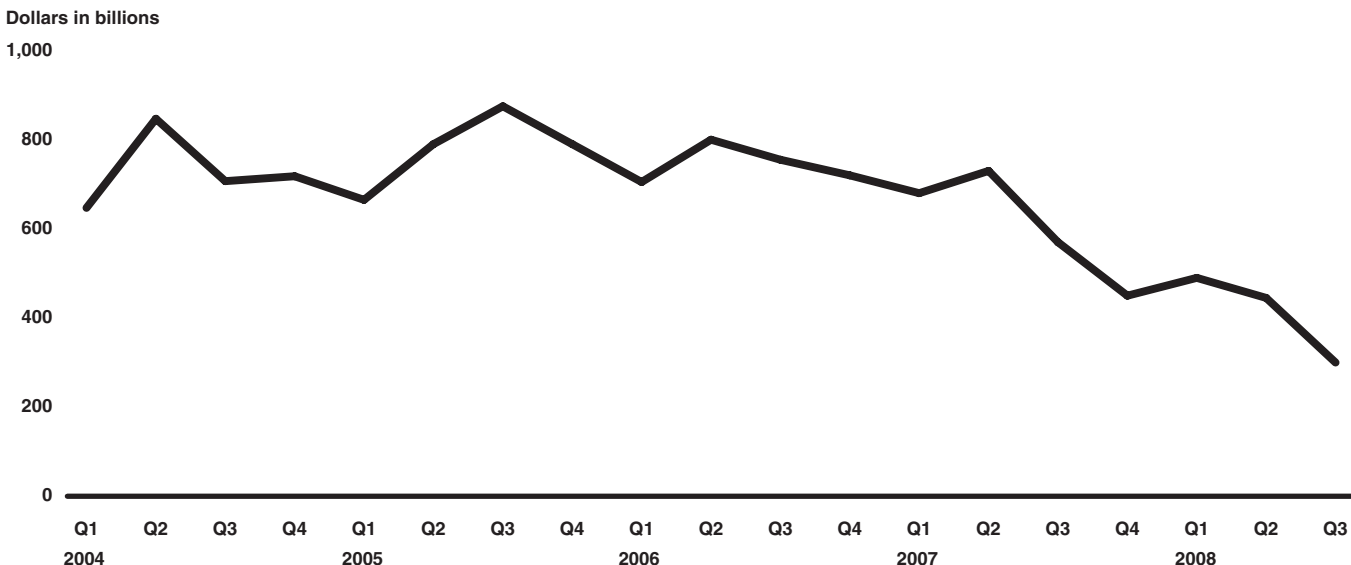
## Mortgage Originations

Like other bank interest rates, mortgage rates may reflect the customers banks choose to lend to rather than the cost of credit for all potential customers. As such, the volume of new mortgage lending may also indicate the availability of credit, changes in credit risk, or demand for credit. As shown in figure 6, quarterly mortgage originations in the United States have fallen by over 50 percent since 2005.<sup>48</sup> While increases in mortgage interest rates have remained moderate, mortgage lending has decreased. To the extent that credit and economic conditions improve over time and interest rates remain stable, we would expect mortgage

<sup>48</sup>This dropoff is consistent with the change in household mortgage debt as measured by the Federal Reserve's flow of funds data.

originations to stop declining and eventually rise, although it is not clear that this measure would or should return to the level seen in the period leading up to the credit market turmoil.

**Figure 6: Mortgage Originations, as of September 2008**



Source: Inside Mortgage Finance estimates.

Note: Estimates of originations are based on information from FHA, VA, mortgage-backed securities and lenders and include refinances.

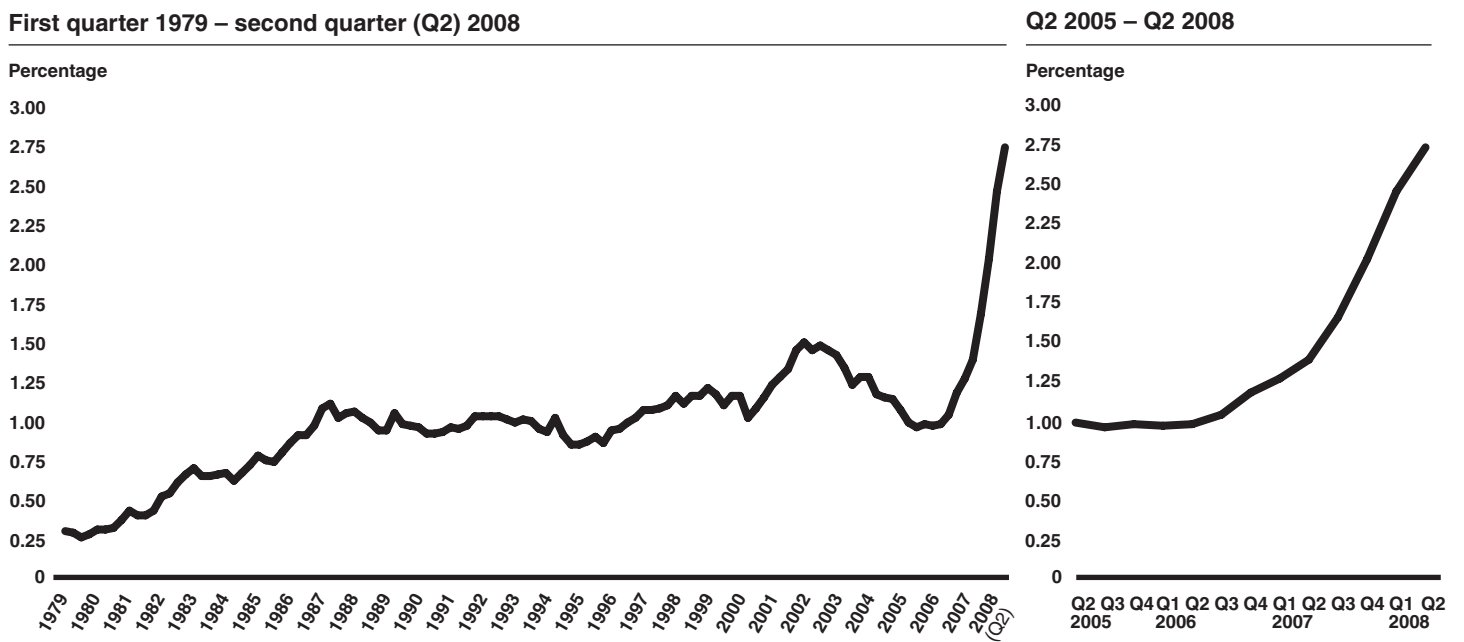
## Mortgage Foreclosures and Defaults

Going forward, we also plan to report on trends in foreclosures and delinquencies. Treasury officials have urged banks to work to modify and restructure loans whenever reasonable to avoid preventable foreclosures.<sup>49</sup> Moreover, if CPP is effective, banks may be more able to refinance mortgage loans for creditworthy borrowers to keep monthly payments affordable. While it is too early to expect material changes in foreclosures and the most recent data preclude an assessment of trends since September 30, figure 7 establishes the historical context for continued monitoring. As the figure shows, the percentage of total loans foreclosures

<sup>49</sup>FDIC, Treasury, and the Federal Reserve have stated that lenders and servicers should (1) determine whether a loan modification would enhance the net present value of the loan before proceeding to foreclosure and (2) ensure that loans currently in foreclosure have been subject to such analysis.

has reached 2.75—a level unseen in recent history. As noted earlier, outside of TARP a variety of parties are taking a number of actions to address the rising foreclosure rate.

**Figure 7: Percentage of Loans in Foreclosure, as of June 30, 2008**



Source: GAO analysis of Global Insight data.

**Other Financial and Credit Market Indicators May Be Useful as TARP Evolves**

In addition to the preliminary indicators previously identified, we are evaluating the potential usefulness of a number of other indicators. This list is not definitive or exhaustive, and we expect to add new indicators and modify or drop others as we engage with Treasury, Federal Reserve, and other informed market participants. Moreover, some measures included may become more appropriate indicators as time progresses.

- *Prime lending rate (Federal Reserve).* The prime lending rate is an interest rate banks charge to their most creditworthy customers and usually moves with the target Fed funds rate—an overnight interbank lending rate. Many variable rate consumer loans such as credit cards are linked to the prime rate. Like mortgage rates, the prime lending rate does not necessarily indicate the cost of credit to all potential borrowers.

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- *Survey of lending standards (Federal Reserve)*. This survey asks senior loan officers at U.S. banks whether lending standards have tightened or eased. The most recent survey suggests a tightening in credit standards for approving applications for commercial and industrial loans. It also shows increased spreads of loan rates over banks' cost of funds, especially for riskier loans, in part because of the uncertain economic outlook, reduced tolerance for risk, and liquidity issues.
  - *Commercial paper interest rates (Federal Reserve)*. Interest rates on financial and nonfinancial commercial paper should be indicative of liquidity and perceptions of risk in short-term debt markets. The spread between financial commercial paper and nonfinancial commercial paper indicates the cost of raising capital for financial institutions relative to their nonfinancial counterparts.
  - *Changes in assets held by commercial banks (Call Report Data)*. Banks provide quarterly call report information to their regulators, including information on loan assets, among other things. This information could provide information about the quality and flow of credit.
  - *Changes in household and business debt (Federal Reserve)*. These are indicators of the quantity and flow of credit.
  - *Stock prices (Lexis Nexis Historical Quotes)*. Stock prices represent an important component of the cost of capital for publicly traded companies and impact the ability to secure loans. Stabilization of stock prices for banks participating in CPP and the financial sector in general would indicate a rebuilding of investor confidence and improve the ability of these companies to raise capital on the public market. Stock prices are also a leading indicator of real economic activity.
  - *House prices (S&P/Case-Shiller, Office of Federal Housing Enterprise Oversight)*. By increasing liquidity, rebuilding confidence, and lowering borrowing costs, CPP may lead to improvements in both housing prices and foreclosure rates.<sup>50</sup> The stabilization of housing markets is

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<sup>50</sup>While dominant causal effect may run from housing prices to foreclosures, foreclosures can also affect prices. To the extent that at-risk borrowers are able to refinance or restructure mortgages, prices may stabilize. Similarly, price stabilization can reduce foreclosure rates. However, independent of foreclosures, housing prices may simply be returning to their fundamental values after a long period of overvaluation.

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important to the valuation of MBS and other financial instruments central to current market conditions.

- *VIX (Chicago Board Options Exchange)*. The VIX is a measure of expected stock market volatility over the next 30 days, calculated as an index of the prices of options on the Standard & Poor's 500 Index. It is an indicator of uncertainty about the future price of stocks and general uncertainty about the economy.

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## Conclusions

TARP is a new program that involves taking a number of steps to help revive the U.S. and global economies as they struggle through the current economic crisis. Given changing market conditions and the need to coordinate efforts both domestically and globally, Treasury must continue to strengthen its communication with external stakeholders, including Congress and the public, to ensure that members and the public understand Treasury's rationale for shifts in OFS's strategic direction. Because TARP is relatively new, and because the crisis makes immediate action imperative, Treasury is operating on a number of fronts concurrently. It is setting up programs and establishing oversight policies and procedures at the same time. As a result, we are seeing some lag in administrative efforts—for example, in internal controls—as the programs proceed. Treasury and the banking regulators have publicly stated that they expect participating institutions to use CPP funds in a manner consistent with the goals of the program by working to expand the flow of credit to promote sustained economic growth and modifying the terms of residential mortgages to strengthen the housing market. But Treasury has not yet set up policies and procedures to help ensure that CPP funds are being used as intended. Similarly, institutions participating in CPP are subject to specific restrictions on dividend payments or repurchasing shares as long as Treasury has preferred shares outstanding. But Treasury also has no policies and procedures in place for ensuring that the institutions are complying with these requirements or that they are using the capital investments in a manner that helps meet the purposes of the act. Although Treasury has hired a third party to help establish a system of internal controls, until control are in place to ensure that specific program requirements are met, Treasury cannot effectively hold participating institutions accountable for how they use the capital injections or provide strong oversight of compliance with the requirements under the act.

Further, while Treasury has made progress in setting up OFS, it faces a number of ongoing challenges that must be addressed. First, timely completion of hiring efforts to bring OFS up to its full complement of

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staff, as well as effective succession planning for likely changes in key OFS leadership positions, is critical to ensuring the integrity of TARP both during and after the transition to the new administration. Second, Treasury has not yet finalized necessary oversight procedures for its growing number of contractors and financial agents, even though the use of time and materials contracts requires enhanced oversight of contractor performance. Third, while the financial agent and contractor arrangements will enhance Treasury's capabilities to administer TARP, the substantial reliance on the private sector raises issues related to the potential for conflicts of interest. Lacking a comprehensive and complete system to monitor conflicts of interest, Treasury runs the risk that it may not be able to ensure that conflicts are fully identified and appropriately addressed. This area is just one of several in which internal controls have yet to be established for TARP activities. While OFS is in the process of developing a comprehensive system of internal control, there is heightened risk that the interests of the government and taxpayers may not be adequately protected and that OFS may not achieve its mission in an effective and efficient manner.

Finally, evaluating the impact of Treasury's efforts under TARP, which are intended to improve conditions in credit and other markets, will be challenging for a number of reasons. As we have noted, little time has passed since the initial infusion of capital into the institutions, and a variety of other programs and efforts directed at bolstering the economy and helping homeowners are still being considered. Further, in addition to TARP, U.S. regulators as well as foreign governments continue to take a variety of actions, including many coordinated efforts, aimed at stabilizing markets and the economy. Moreover, a number of other interventions and market forces themselves will affect future developments and make it difficult to isolate the effects of any program or action, not just TARP. To facilitate our assessment of TARP's activities going forward, we have identified a number of preliminary indicators that, when viewed collectively, should signal whether TARP as well as other programs are functioning as intended. Among these preliminary indicators are interest rate spreads, mortgage rates, and mortgage originations. We also have identified other indicators that may prove useful as TARP evolves. Together, these indicators should provide additional information to policymakers and others on the overall stability of our financial markets.

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## Recommendations for Executive Action

We recognize that less than 60 days has passed since the program was created and the inherent difficulty of setting up any new program, especially during turbulent economic conditions. However, we have identified a number of areas that warrant Treasury's ongoing attention. Therefore, we are recommending that Treasury take a number of actions aimed at improving the integrity, accountability, and transparency of TARP. Specifically, Treasury should

- work with the bank regulators to establish a systematic means of monitoring and reporting on whether financial institutions' activities are consistent with the purposes of CPP and help ensure an appropriate level of accountability and transparency;
- develop a means to ensure that institutions participating in CPP comply with key requirements of program agreements, including those covering limitations on executive compensation, dividend payments, and the repurchase of stock;
- formalize the existing communication strategy to ensure that external stakeholders, including Congress and the public, are informed about the program's current strategy and activities as well as the rationale for changes in this strategy to avoid information gaps and shocks;
- develop a definitive transition plan by building on and formalizing ongoing activities to facilitate a smooth transition to the new administration, including ensuring that key OFS leadership positions are filled during and after the transition to the new administration;
- continue OFS hiring efforts in an expeditious manner to ensure that Treasury has the personnel needed to carry out and oversee TARP;
- ensure that sufficient personnel are assigned and appropriately trained to oversee the performance of all contractors, especially those performing under contracts priced on a time and materials basis, and move toward greater reliance on fixed-price arrangements, whenever possible, as program requirements are better defined over time;
- continue to develop a comprehensive system of internal control over TARP, including policies, procedures, and guidance for program activities that are robust enough to ensure that program's objectives and requirements are being met;
- issue final regulations on conflicts of interest involving Treasury's agents, contractors, and their employees and related entities as



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expeditiously as possible, and review and renegotiate mitigation plans, as necessary, to enhance specificity and compliance with the new regulations once they are issued; and

- institute a system to effectively manage and monitor the mitigation of conflicts of interest going forward.

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## Agency Comments and Our Analysis

We provided a draft of this report to the Department of the Treasury for review and comment. We also provided segments of the draft report to the Federal Reserve, FDIC, OCC and OTS for review and comment. In written comments, Treasury generally agreed with the report and eight of the nine recommendations (see app. I). Treasury stated that it had taken aggressive measures to stabilize credit markets, such as investing over \$150 billion in financial institutions through CPP. Treasury also said that it had made significant progress in building an infrastructure to carry out its ongoing responsibilities to develop other programs, measure risk, monitor compliance, and ensure robust internal financial controls and that our report's recommendations would be helpful in implementing the work that remained to be done in these areas. Treasury stated that it had made significant efforts to ensure transparency and good communication with external stakeholders but acknowledged that more could and would be done in these areas. Treasury agreed that it needed to develop procedures to determine whether financial institutions were complying with the requirements explicitly imposed on them in the CPP agreements and under the statute but had a different perspective from our recommendation on what should be done to evaluate how institutions were using funds received under CPP. Treasury said that it would welcome further discussion on general metrics for evaluating the overall success of CPP in addressing the purposes of the act. In technical comments, the Federal Reserve also expressed concern about whether Treasury needed to monitor individual institutions' use of CPP funds, because data from any single institution would not indicate that the program's goals had been achieved. Instead, achievement of the goals would be reflected in the level of functioning of the financial marketplace as a whole.

As discussed in the draft, we agree that it will be important to develop a range of metrics to evaluate the overall success of CPP, and we welcome continued discussions with Treasury and the regulators on general metrics to achieve this purpose. However, given the magnitude of funds provided to this program, these types of metrics alone will not provide the

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necessary transparency and accountability needed to ensure that participating institutions are using the funds in a manner that is consistent with the purposes of the act. As stated in the report, Treasury should build on the existing oversight mechanisms of the banking regulators to minimize any additional regulatory burden and develop a means for reviewing and reporting on planned and actual actions taken by participating financial institutions that result from the additional funding received through CPP. Obtaining such information could help Treasury better monitor participating institutions' activities and provide an appropriate level of accountability and transparency. Moreover, the information could also feed into an overall assessment of the effect of TARP in restoring liquidity and stability to the financial system. Treasury, the Federal Reserve, FDIC, OCC, and OTS also provided technical comments that we incorporated in the report, as appropriate.

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We are sending copies of this report to other interested congressional committees and members, Treasury, the federal banking regulators, and others. The report also is available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact Richard J. Hillman at (202) 512-8678 or [hillmanr@gao.gov](mailto:hillmanr@gao.gov), Thomas J. McCool at (202) 512-2642 or [mccoolt@gao.gov](mailto:mccoolt@gao.gov), or Orice M. Williams at (202) 512-8678 or [williamso@gao.gov](mailto:williamso@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix II.

A handwritten signature in black ink that reads "Gene L. Dodaro". The signature is written in a cursive style with a large, prominent "D" at the end.

Gene L. Dodaro  
Acting Comptroller General  
of the United States

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*List of Congressional Addresses*

The Honorable Robert C. Byrd  
Chairman

The Honorable Thad Cochran  
Ranking Member  
Committee on Appropriations  
United States Senate

The Honorable Christopher J. Dodd  
Chairman

The Honorable Richard C. Shelby  
Ranking Member  
Committee on Banking, Housing, and Urban Affairs  
United States Senate

The Honorable Kent Conrad  
Chairman

The Honorable Judd Gregg  
Ranking Member  
Committee on the Budget  
United States Senate

The Honorable Max Baucus  
Chairman

The Honorable Charles E. Grassley  
Ranking Member  
Committee on Finance  
United States Senate

The Honorable David R. Obey  
Chairman

The Honorable Jerry Lewis  
Ranking Member  
Committee on Appropriations  
House of Representatives

The Honorable John M. Spratt, Jr.  
Chairman

The Honorable Paul Ryan  
Ranking Member  
Committee on the Budget  
House of Representatives

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The Honorable Barney Frank  
Chairman  
The Honorable Spencer Bachus  
Ranking Member  
Committee on Financial Services  
House of Representatives

The Honorable Charles B. Rangel  
Chairman  
The Honorable Jim McCrery  
Ranking Member  
Committee on Ways and Means  
House of Representatives

# Appendix I: Comments from the Department of the Treasury



ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C.

November 28, 2008

Mr. Thomas J. McCool  
Director, Center for Economics,  
Applied Research and Methods  
U.S. Government Accountability Office  
441 G Street, N.W.  
Washington, D.C. 20548

Dear Mr. McCool:

Thank you for the opportunity to review the draft report entitled *Troubled Assets Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency*. The draft report fairly summarizes Treasury's progress in implementing the Emergency Economic Stabilization Act of 2008 (EESA), and we agree with the draft report's recommendations, except as noted below.

Less than 60 days have elapsed since Congress passed and the President signed EESA into law. During this short time, Treasury has taken aggressive measures to stabilize credit markets. We designed and implemented the Capital Purchase Program (CPP) to inject equity into healthy financial institutions, drawing upon the judgment and expertise of bank regulators. To date, we have invested over \$150 billion in financial institutions (banks and savings institutions and their holding companies). Treasury also instituted a program to address the risks posed by systemically significant failing institutions. At the same time, Treasury has made significant progress building an infrastructure that will carry out our ongoing responsibility to develop other programs, measure risk, monitor compliance, and ensure robust internal financial controls. The draft report acknowledges Treasury's progress in these areas and makes helpful recommendations about the work that remains to be done.

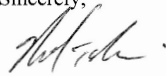
We agree with the recommendations directed at building an Office of Financial Stability that is well-staffed and well-trained. We also agree that Treasury must continue to develop its internal controls, procedures, and policies for program activities. We believe that Treasury has made significant efforts to ensure transparency and good communication with our external stakeholders, but more can and will be done in these areas.

Treasury also agrees with the recommendation that it should develop means to determine whether financial institutions are complying with the requirements explicitly imposed on them in our purchase agreements and under the statute. We have a different perspective, however, on what is needed to evaluate how individual institutions participating in the CPP are spending the funds they receive under the program. Treasury designed the capital purchase program to further the goals of EESA, which included a number of

requirements applicable to individual financial institutions. Treasury is developing compliance programs for these requirements, and welcomes further discussion on general metrics for evaluating the overall success of the capital purchase program in addressing the purposes of EESA.

Thank you again for the work that went into this draft report and the opportunity to comment on it. We appreciate the cooperation you have extended to us in implementing this important legislation.

Sincerely,



Neel Kashkari  
Interim Assistant Secretary  
Office of Financial Stability

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# Appendix II: GAO Contacts and Staff Acknowledgments

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## GAO Contacts

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## Staff Acknowledgments

In addition to the contacts named above, Linda Calbom, Mathew Scire, and William Woods (Lead Directors); Daniel Garcia-Diaz, Lawrence Evans, Jr., Kay Kuhlman, Harry Medina, and Carol Dawn Petersen (Lead Assistant Directors); and Allison Abrams, Marianne Anderson, Sonya Bensen, Patrick Breiding, Steven Brown, Angela Burriesci, Mason Calhoun, Timothy Carr, Tara Carter, Emily Chalmers, Rachel DeMarcus, Heather Digna, Lynda Downing, Matt Drerup, Abe Dymond, Katherine Eikel, Nancy Eibeck, Gary Engel, Paul Foderaro, Jeanette Franzel, Leon Gill, Daniel Gordon, Michael Hoffman, Joe Hunter, Ron Ito, Elizabeth Jimenez, John A. Krump, James Lager, Robert Lunsford, Stephanie May, Kimberly McGatlin, Jay R. McTigue, Marc Molino, Susan Offutt, Jose Oyola, Kenneth Patton, Jasmine Persaud, Susan Poling, Anthony Pordes, Barbara Roesmann, Susan Sawtelle, Jeremy Sebest, John Treanor, Karen Tremba, Katherine Trimble, Julie Trinder, and James Vitarello made contributions to this report.

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