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Testimony

Before the Committee on Financial  
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# TROUBLED ASSET RELIEF PROGRAM

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

Statement of Gene L. Dodaro  
Acting Comptroller General of the United States



**GAO**

Accountability \* Integrity \* Reliability

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Mr. Chairman, Ranking Member Bachus, and members of the committee:

I am pleased to be here today to discuss our first report on the newly created Troubled Asset Relief Program (TARP), which gave the Department of Treasury the authority to purchase and insure up to \$700 billion in troubled assets held by financial institutions through the Office of Financial Stability (OFS).<sup>1</sup> Treasury was granted this authority in response to the recent financial crisis that has threatened the stability of the U.S. banking system and the solvency of numerous financial institutions. Among other things, the Emergency Economic Stabilization Act (the act) that authorized TARP on October 3, 2008, requires GAO to report at least every 60 days on findings resulting from our oversight of the status of actions taken under the program.<sup>2</sup> My statement today is based on our December 2, 2008, report. This report is the first under the act's mandate and covers the actions taken as part of TARP through November 25, 2008.<sup>3</sup> Our oversight work under the act is ongoing, and our next report will be issued by January 31, 2009.

Like the report, this statement focuses on (1) the nature and purpose of activities that were 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.

To do this work, we reviewed documents related to TARP, including contracts, agreements, guidance, and rules. We also met with OFS, contractors, federal agencies, and officials from the eight large institutions that had received disbursements. Going forward, we plan to continue to monitor the issues highlighted in the report, as well as future and ongoing capital purchases, other more recent transactions undertaken as part of

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<sup>1</sup>GAO, *Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency*, [GAO-09-161](#) (Washington D.C.: Dec. 2, 2008).

<sup>2</sup>The Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343 (Oct. 3, 2008). 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 act's purposes; the financial condition and internal controls of TARP, its representatives, and agents; the characteristics of asset purchases and the disposition of acquired assets, including any related commitments entered into; TARP's efficiency in using the funds appropriated for its operations; its compliance with applicable laws and regulations; and its efforts to prevent, identify, and minimize conflicts of interest among those involved in its operations.

<sup>3</sup>Selected transaction information in this statement has been updated through December 5, 2008.

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TARP (e.g., capital purchases in Citigroup and American International Group), and the status of other aspects of TARP. 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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## Summary

Treasury has taken a number of steps to try to stabilize the U.S. financial markets and banking system, including injecting billions of dollars into financial institutions. Although Treasury initially planned to buy mortgages and mortgage-related assets through TARP, Treasury shifted its focus to a preferred stock and warrant purchase program, known as the Capital Purchase Program (CPP). Treasury has provided more than \$155 billion in capital to 87 institutions through CPP as of December 5, 2008. It has also established a Systemically Significant Failing Institution (SSFI) program, through which Treasury may invest in any financial instrument, including debt, equity, or warrants determined to be a troubled asset, and continues to explore other programs, including those focused on insurance, foreclosure mitigation, and consumer lending.<sup>4</sup> As of December 5, 2008, Treasury had allocated a total of \$335 billion of TARP funds and disbursed \$195 billion to institutions under the various programs.<sup>5</sup> While we recognize that TARP has existed for a short time and that a new program of such magnitude faces many challenges, especially in this current uncertain economic climate, we found that Treasury has yet to address a number of critical issues. These include determining how it will ensure that CPP is achieving its intended goals and monitoring compliance with limitations on executive compensation, dividend payments, and stock repurchases. Moreover, it has yet to formalize transition planning efforts

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<sup>4</sup>The Secretary of the Treasury is to make the determination that the asset is a troubled asset, after consultation with the Chairman of the Board of Governors of the Federal Reserve System and notice to Congress.

<sup>5</sup>As of December 5, 2008, Treasury had allocated \$335 billion to various programs, including \$250 billion to CPP, \$40 billion to American International Group (AIG) under SSFI, \$20 billion to Citigroup, and \$20 billion to a Federal Reserve lending facility. To date, it had disbursed a total of \$195 million of the \$335 billion including \$155 billion under CPP (excludes \$10 billion committed to Merrill Lynch & Co., which has yet to be disbursed) and \$40 billion to AIG.

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given the upcoming shift to a new administration or to establish an effective management structure and an essential system of internal controls. In our report, we recommended that Treasury take nine actions to help ensure the program's integrity, accountability, and transparency. These would require 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 (for example, 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.

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In the short period covered by our report, Treasury has taken a number of important steps to set up TARP and to address the unfolding financial crisis. While immediate action is important, this urgency must be balanced against the need for strong management and oversight. Because Treasury is establishing oversight policies and procedures at the same time that it is setting up the program, we found some lag in its administrative efforts, which we have highlighted in this statement and discussed in detail in our report. Until these issues are resolved, 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. We are continuing to follow up on these issues and to oversee new developments in the program, such as the foreclosure mitigation and insurance programs, SSFI, and minority contracting issues, as we prepare for our next report.

We also have started to evaluate indicators that, when reviewed collectively, should provide information about the state of financial markets and credit flow. However, it is too soon to determine whether the program is having the intended effect on credit and financial markets. Further, isolating TARP's impact will be difficult because of the number of actions that have been taken by U.S. regulators and foreign governments to stabilize the markets and because we cannot say what would have happened in the absence of TARP and these other efforts. We will continue to monitor and report on these preliminary indicators, including trends in interest rate spreads, mortgage rates, mortgage originations, and foreclosures, and to identify additional indicators as the program evolves.

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

Treasury allocated \$250 billion to CPP and purchased \$115 billion in senior preferred shares of eight national financial institutions on October 28, 2008, and about \$40 billion in senior preferred shares of 79 additional financial institutions on November 14, 21 and December 5, 2008.<sup>6</sup> 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

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<sup>6</sup>One additional purchase of \$10 billion is pending until a merger is complete.

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institutions does not require that these institutions track or report how they use or plan to use their capital investments. Although Treasury has said that it expects the institutions to increase the flow of credit, Treasury has not yet determined whether it will impose reporting requirements on the participating financial institutions or whether it will leverage existing reporting requirements to the banking regulators to reduce the regulatory burden. While we understand that money is fungible, such monitoring and reporting requirements are critical to ensuring the transparency and accountability of CPP and would help Treasury to monitor how the infusions were being used in the aggregate across the participating institutions. We recommended 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. Treasury had a different perspective on what should be done to evaluate how institutions were using funds received under CPP, and is 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. While 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, 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 that participating institutions are using the funds in a manner that is consistent with the purposes of the act. Moreover, institution-level 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.

The standard terms of the securities purchase agreements also include certain requirements regarding executive compensation—for example, certain senior executives must repay any incentive or bonus compensation

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that was based on materially inaccurate financial statements.<sup>7</sup> However, Treasury has not yet determined how it will monitor compliance with this or other requirements, such as limitations on dividend payments and stock repurchases. Without a strong oversight and monitoring function, Treasury's ability to ensure an appropriate level of accountability and transparency will be limited. Our related recommendation in this area is intended to bolster the program's accountability and transparency.

The creation of CPP was a shift in the direction of TARP. Treasury's rationale for the shift was that purchasing troubled assets would not provide the immediate results that were needed, given the deepening crisis in financial markets. Treasury believed that purchasing preferred stocks and warrants from financial institutions would be the fastest way to stabilize the markets, encourage interbank lending, and increase confidence of lenders and investors.<sup>8</sup> While Treasury has provided information on its Web page about its activities, this shift in the direction of the program heightened the need for Treasury to provide sufficient information to external stakeholders, such as Congress and the public, about not only the change in strategy but also the rationale for the new focus. Consequently, we urged Treasury to strengthen its communication strategy about plans for the program in order to avoid information gaps as market conditions and TARP evolve.

It is unclear what other approaches Treasury will pursue to meet the purposes of the act, including purchasing and insuring mortgage-related assets. Treasury has established the SSFI program under TARP. According to Treasury, institutions will be considered for participation in SSFI on a case-by-case basis, and there is no deadline for participation in this program. For example, in early November, 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,

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<sup>7</sup>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. In exchange, Treasury receives shares of nonvoting senior preferred stock that pay dividends of 5 percent annually for 5 years and then 9 percent annually, redeemable after 3 years and earlier under certain conditions. Treasury will also receive warrants to purchase a number of shares of common stock at market-based prices. Among other things, the number of shares of common stock underlying a warrant can be reduced by half if a financial institution receives proceeds from one or more "qualified equity offerings" that equal the amount of the preferred shares by December 31, 2009.

<sup>8</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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which Treasury views as systemically significant. 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. For example, Treasury solicited comments on how to structure the program, identify institutions and assets for inclusion, and calculate premiums in the *Federal Register*.<sup>9</sup> Moreover, having decided against large purchases of troubled mortgage-related assets under TARP, Treasury stated that the agency was considering other ways to meet Congress's expectation that Treasury would work with lenders "to achieve aggressive loan modification standards" to mitigate foreclosures but has not yet developed a program to maintain homeownership, an area we continue to closely monitor.<sup>10</sup>

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

Treasury quickly established an overall organizational structure for OFS, filled key leadership roles on an interim basis, and contracted for support services. Currently, it is working to hire the full complement of staff (perhaps as many as 200 full-time-equivalent positions depending on the ultimate design of the program), 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 nature of the program and the upcoming 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 and oversee TARP. Therefore, we made several recommendations aimed at facilitating a smooth transition to the new administration and ensuring effective oversight of the program.

In addition to using permanent staff, OFS plans to rely on contractors and financial agents in several key areas. Treasury used expedited solicitation

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<sup>9</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).

<sup>10</sup>GAO, *Troubled Asset Relief Program: Status of Efforts to Address Defaults and Foreclosures on Home Mortgages*, [GAO-09-231T](#) (Washington, D.C.: Dec. 4, 2008).



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procedures and structured the agreements and contracts to allow for flexibility in obtaining the required services. Most of the contracts awarded thus far have been priced on a time-and-materials basis, which provides for payments based on a set hourly rate plus the cost of any materials. As we have noted in past work, this type of pricing arrangement requires enhanced oversight.<sup>11</sup> Treasury has also taken steps to help promote the use of small businesses in carrying out TARP. In addition, Treasury has 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. As a result, Treasury must continue to take steps to formalize its oversight of conflicts of interest and monitoring time-and-materials contracts.

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 control over TARP activities, including a risk-assessment framework. However, the rapid pace of implementation and the 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 controls, 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.

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<sup>11</sup>GAO, *Defense Contracting: Improved Insight and Controls Needed over DOD's Time-and-Materials Contracts*, [GAO-07-273](#) (Washington, D.C.: June 29, 2007).

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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 institutions 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 Treasury, the Federal Reserve, Federal Deposit Insurance Corporation, and Federal Housing Finance Agency 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. Moreover, 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. Nevertheless, we have preliminarily identified some indicators to facilitate our assessment of TARP's activities. We believe that these preliminary indicators, when viewed collectively, should signal whether TARP and 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.<sup>12</sup>

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Mr. Chairman and Ranking Member Bachus, I appreciate the opportunity to discuss this critically important issue and would be happy to answer any questions that you may have. Thank you.

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## Contact

For further information on this testimony, please contact Thomas J. McCool on (202) 512-2642 or [mccoolt@gao.gov](mailto:mccoolt@gao.gov).

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<sup>12</sup>[GAO-09-161](#), see pp. 49-57.

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