

February 2010

TROUBLED ASSET RELIEF PROGRAM

Treasury Needs to Strengthen Its Decision-Making Process on the Term Asset-Backed Securities Loan Facility



GAO

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Highlights of [GAO-10-25](#), a report to congressional committees

Why GAO Did This Study

The Term Asset-Backed Securities Loan Facility (TALF) was created by the Board of Governors of the Federal Reserve System (Federal Reserve) to help meet consumer and small business credit needs by supporting issuance of asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS). This report assesses (1) the risks TALF-eligible assets pose to the Troubled Asset Relief Program (TARP), (2) Department of the Treasury's (Treasury) role in decision making for TALF, and (3) the condition of securitization markets before and after TALF. GAO reviewed program documents, analyzed data from prospectuses and other sources, and interviewed relevant agency officials and TALF participants.

What GAO Recommends

Treasury should (1) give increased attention to reviewing risks posed by CMBS, (2) strengthen its TALF decision-making process, and (3) determine which data are needed to track the management and sale of assets TALF borrowers might surrender. To enable more effective review of TARP, Congress also should grant GAO authority to audit Federal Reserve TALF operational and administrative activities. Treasury appreciated GAO's recommendations but said GAO understated TALF's success and overstated the risk of CMBS. The Federal Reserve disagreed that there are limitations on GAO's authority to audit TALF activities. GAO continues to believe that its depiction of TALF is accurate and its recommended actions are necessary to strengthen the oversight and operations of TALF.

View [GAO-10-25](#) or [key components](#). For more information, contact Orice Williams Brown at (202)512-8678 or williamso@gao.gov.

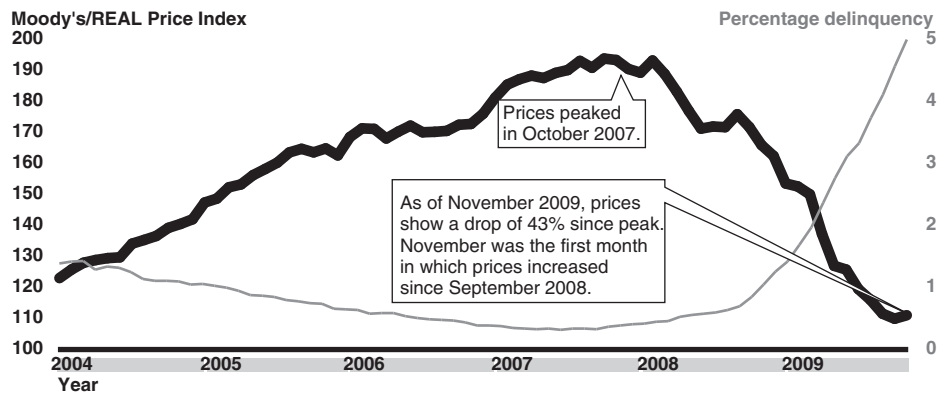
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What GAO Found

TALF contains a number of risk management features that in turn likely reduce the risk of loss to TARP funds, but risks remain. TALF was designed to reopen the securitization markets in an effort to improve access to credit for consumers and businesses. The Federal Reserve Bank of New York (FRBNY), which manages TALF, is authorized to lend up to \$200 billion to certain eligible borrowers in return for collateral in the form of securities that are forfeited if the loans are not repaid. To assist in this effort, Treasury has pledged \$20 billion of TARP funds in the form of credit protection to the program in the event the loans are not repaid. As of December 2009, FRBNY has made about \$61.6 billion in TALF loans, of which \$47.5 billion remained outstanding. For most TALF-eligible collateral, FRBNY will stop providing new TALF loans in March 2010, while new-issue CMBSs will be accepted as collateral on new TALF loans through June 2010. Treasury and FRBNY analyses project minimal, if any, use of TARP funds for TALF-related losses, and Treasury currently anticipates a profit. While GAO found that the overall risks TALF poses to TARP funds are likely minimal, GAO analyses showed that CMBSs potentially pose higher risk of loss than ABSs. As shown in figure 1, ongoing uncertainty in the commercial real estate market and TALF exposure to legacy CMBSs warrant ongoing monitoring. Finally, TALF may present risks beyond the potential risks to TARP, such as the risk that FRBNY might fail to identify material noncompliance with program requirements by TALF participants. Because the Federal Reserve views TALF as a monetary policy tool, however, statutory limitations on GAO's authority prohibited GAO from auditing FRBNY's role in administering TALF.

Figure 1: Commercial Real Estate Prices and CMBS Delinquencies from January 2004 through October 2009



Source: GAO presentation of Moody's/REAL Commercial Property Price Index and Moody's CMBS Delinquency Tracker data.

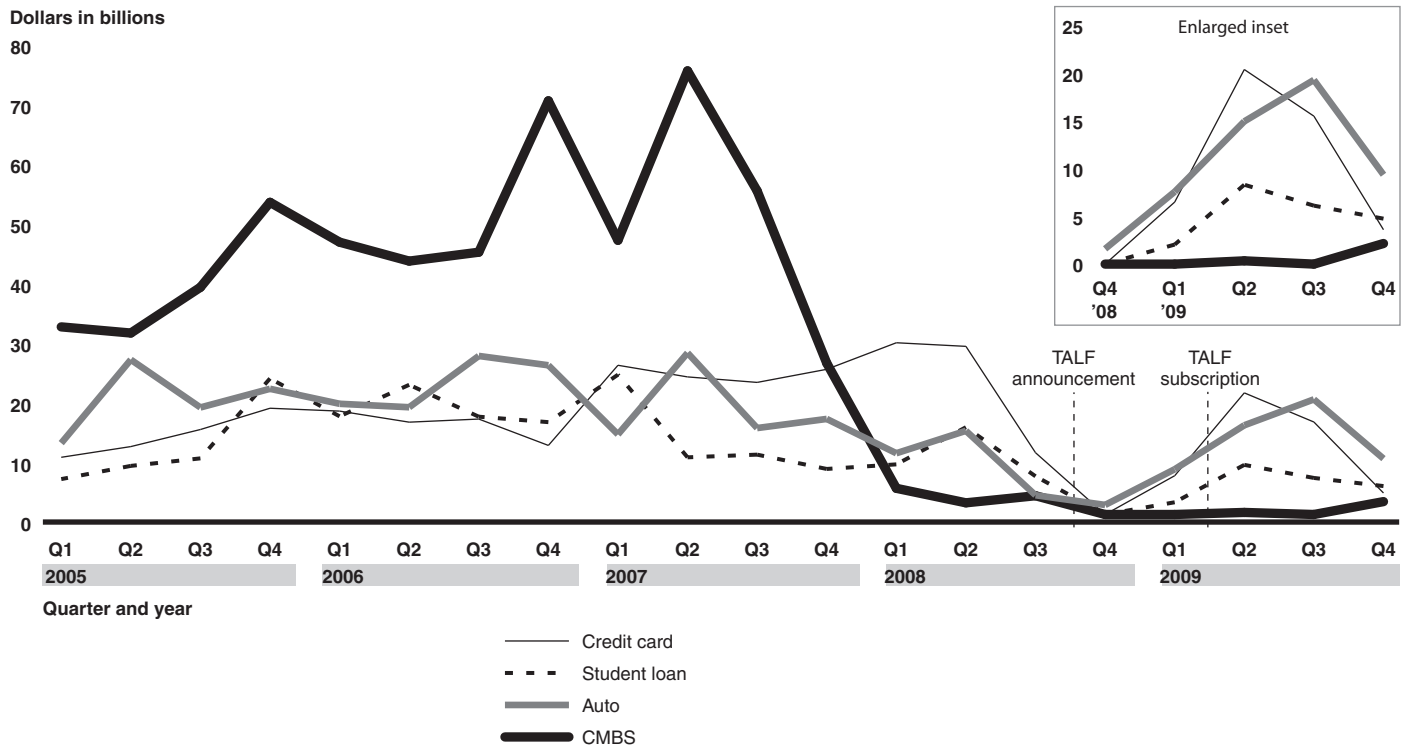
Note: Moody's/REAL Commercial Property Price Index is a report showing the change in commercial real estate asset sales. Moody's CMBS Delinquency Tracker is a monthly report showing delinquency rates for commercial mortgage-backed securities.

Treasury has not fully documented its rationale, as part of its decision-making processes, for reaching final decisions related to the risks of TALF—including decisions involving other agencies. For example, the outcomes of Treasury’s internal analysis of the amount of equity that TALF borrowers should hold in TALF ABS collateral, along with other TALF program terms, sometimes differed from FRBNY’s. However, there was no clear documentation or explanation of how the discrepancies were resolved or how final decisions were made with FRBNY. Documenting the rationale and basis for these decisions would increase transparency and strengthen internal controls for TALF decision-making processes. Moreover, a sound decision-making process would help ensure that TALF objectives are being met and that it is functioning as intended. Unless Treasury documents the basis for major program decisions that it made with the Federal Reserve, it cannot demonstrate accountability for meeting the goals of TALF and could unnecessarily place TARP funds at risk.

FRBNY, in consultation with Treasury, monitors various economic indicators to measure TALF’s impact. Our analysis of such indicators—including securitization volumes, interest rates, and

TALF loan volume trends—suggests that the securitization markets improved for the more frequently traded TALF-eligible sectors after the program’s first activity in March 2009, which is illustrated in figure 2. Figure 2 also shows that ABS issuances in all of the most liquid TALF-eligible sectors dropped sharply in 2008 from their peak levels in 2006 and 2007. Consumer credit rates have not changed significantly since TALF started. FRBNY officials said that it is possible that without TALF, interest rates on loans to consumers and small businesses would be much higher than they are now. While Treasury bears the first-loss risk from any assets that TALF borrowers might surrender in conjunction with unpaid loans, it has not developed measures to analyze and publicly report on the potential purchase, management, and sale of such assets. Without such a plan Treasury cannot measure TALF’s success in meeting its goals under TARP with respect to any collateral that is placed in TALF LLC. Finally, without a plan for communicating the findings that result from tracking and analyzing such metrics, Treasury may not fully inform the public of how the assets are managed and financed, undermining Treasury’s efforts to be fully transparent about TARP activities.

Figure 2: Fluctuations in ABS Issuances, First Quarter of 2005 through the Fourth Quarter of 2009



Source: GAO analysis of Thomson Reuters IFR Markets data.

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Abbreviations

ABS	asset-backed security
AIG	American International Group, Inc.
AUP	agreed upon procedure
CBLI	Consumer and Business Lending Initiative
CMBS	commercial mortgage-backed security
CUSIP	Committee on Uniform Security Identification Procedures
EESA	Emergency Economic Stabilization Act of 2008
Federal Reserve	Board of Governors of the Federal Reserve System
FFELP	Federal Family Education Loan Program
FICO	Fair Isaac Corporation
FRBNY	Federal Reserve Bank of New York
LIBOR	London Interbank Offered Rate
NRSRO	nationally recognized statistical rating organization
OIS	Overnight Indexed Swap
PIMCO	Pacific Investment Management Company, LLC
RMBS	residential mortgage-backed security
SBA	Small Business Administration
SIGTARP	Special Inspector General for TARP
SUBI	special units of beneficial interest
TALF	Term Asset-Backed Securities Loan Facility
TARP	Troubled Asset Relief Program
Treasury	Department of the Treasury

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The recent financial crisis disrupted the securitization markets—which have funded an increasing share of consumer credit and small business loans in recent years—making credit less available to households and small businesses.¹ This “credit crunch” has been a major factor behind the weak economy and slow recovery. The Term Asset-Backed Securities Loan Facility (TALF), which the Board of Governors of the Federal Reserve System (Federal Reserve) first announced in November 2008, was created to help restore the securitization markets. The Department of the Treasury (Treasury) provides credit protection for this program under the Troubled Asset Relief Program (TARP), as authorized under the Emergency Economic Stabilization Act of 2008 (EESA).² The Federal Reserve Bank of New York (FRBNY), which manages TALF, is authorized to lend up to \$200 billion in 3- or 5-year nonrecourse loans to investors to purchase AAA-rated asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS), which are, in turn, pledged as collateral for the loans.³ Nonrecourse loans are provided against collateral, and if the loans are not repaid, FRBNY’s only recourse is to assume control of the pledged assets.⁴ If borrowers do not repay their TALF loans, Treasury will fund the purchase of up to \$20 billion of the collateral backing the loans from FRBNY, creating exposure that places TARP funds, and therefore taxpayers, at risk.

¹Securitization is a process where financial assets are brought together into interest-bearing securities that are sold to investors. Banks receive financing for future loans from securitizations and may rely on the ability to securitize in making certain types of loans.

²Pub. L. No. 110-343, Div. A., 122 Stat. 3765 (2008) (codified at 12 U.S.C. §§ 5201 et seq.).

³The Federal Reserve originally announced that TALF would lend up to \$200 billion, although it subsequently stated that it would be willing to increase the limit to as much as \$1 trillion if needed. As of June 2009, Federal Reserve officials suggested that an increase to \$1 trillion is unlikely.

⁴A nonrecourse loan essentially means that in the event a borrower defaults on the loan, the borrower’s exposure is limited to the assets used to secure nonrecourse loans. Accordingly, the lender, in this case FRBNY, cannot seek repayment of the outstanding debt from any of a borrower’s other assets. However, if a participant in TALF breaches the loan agreement by, for example, misrepresenting its eligibility for a TALF loan, then the loan loses its nonrecourse status and the borrower is personally liable for the outstanding debt.

EESA, which authorized TARP, also provided GAO with broad oversight authorities for actions taken under TARP and requires GAO to report at least every 60 days on TARP activities and performance.⁵ To fulfill our statutorily mandated responsibilities, we have been monitoring and providing updates on TARP programs, including TALF, in prior 60-day reports.⁶ This report expands on previously reported TALF activities.

The Federal Reserve created TALF under Section 13(3) of the Federal Reserve Act, which permits the Federal Reserve to authorize a Federal Reserve Bank to lend to nondepository institutions in “unusual and exigent circumstances.” The Federal Reserve viewed creation of TALF as part of its monetary policy activities because, having already reduced the federal funds target rate to close to zero, it needed additional mechanisms, like TALF, to provide liquidity directly to borrowers and investors in key credit markets. GAO is prohibited by statute from auditing deliberations, decisions, or actions by the Federal Reserve or any Federal Reserve bank

⁵Section 116 of EESA, 122 Stat. at 3783 (codified at 12 U.S.C. § 5226).

⁶See GAO, *Troubled Asset Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency*, [GAO-09-161](#) (Washington, DC: Dec. 2, 2008); GAO, *Troubled Asset Relief Program: Status of Efforts to Address Transparency and Accountability Issues*, [GAO-09-296](#) (Washington, DC: Jan. 30, 2009); GAO, *Troubled Asset Relief Program: March 2009 Status of Efforts to Address Transparency and Accountability Issues*, [GAO-09-504](#) (Washington, DC: Mar. 31, 2009); GAO, *Troubled Asset Relief Program: June 2009 Status of Efforts to Address Transparency and Accountability Issues*, [GAO-09-658](#) (Washington, DC: June 17, 2009); GAO, *Troubled Asset Relief Program: One Year Later, Actions Are Needed to Address Remaining Transparency and Accountability Challenges*, [GAO-10-16](#) (Washington, DC: Oct. 8, 2009); and GAO, *Financial Audit: Office of Financial Stability (Troubled Asset Relief Program) Fiscal Year 2009 Financial Statements*, [GAO-10-301](#) (Washington, DC: Dec. 9, 2009).

that are related to monetary policy matters.⁷ Accordingly, although the Federal Reserve and FRBNY voluntarily gave us access to TALF-related documents and staff, our review of TALF was limited and we did not evaluate the actions of the Federal Reserve with respect to TALF. For example, we did not assess FRBNY's system of internal controls or the role of TALF participants—such as agents, borrowers, or auditors—in certifying and validating compliance with the program's terms.⁸ We also conducted only limited verification of factual information provided by Federal Reserve officials, which we used for background description purposes and to assess Treasury's involvement in TALF.

The objectives of this report are to (1) analyze the risks that TALF presents to TARP funds and therefore to taxpayers, (2) evaluate how Treasury analyzed the risk of TALF assets and used this information in making decisions on TALF with the Federal Reserve and FRBNY, and (3) assess changes in securitization and credit market conditions before and after TALF's implementation, based on indicators tracked by Treasury and FRBNY.

To meet the report objectives, we analyzed data from TALF prospectuses and data providers to understand securitization volumes, prices, and spreads. We also reviewed program operation and design documents, including documentation regarding the selection of eligible asset classes, the amount of equity a TALF borrower is required to hold in a security,

⁷Section 714 of Title 31 of the U.S. Code limits GAO's authority to audit certain Federal Reserve activities. Specifically, GAO audits of the Federal Reserve and Federal Reserve banks may not include, among other things, "deliberations, decisions, or actions on monetary policy matters, including discount window operations, reserves of member banks, securities credit, interest on deposits and open market operations . . . , or transactions made under the direction of the Federal Open Market Committee" 31 U.S.C. § 714 (b)(2)-(3). This prohibition limits GAO's ability to audit the Federal Reserve's actions taken with respect to TALF. The Helping Families Save Their Homes Act of 2009, enacted on May 20, 2009, amended Section 714 to provide GAO authority to audit the Federal Reserve's actions taken under Section 13(3) of the Federal Reserve Act, 12 U.S.C. § 343, with respect to a single and specific partnership or corporation. See Pub. L. No. 111-22, 123 Stat. 1632, 1662-63, codified at 31 U.S.C. § 714(e). Among other things, this amendment provides GAO with authority to audit Federal Reserve actions taken with respect to three entities also assisted under TARP—Citigroup, Inc., American International Group, Inc., and Bank of America Corporation—but does not provide GAO with authority to audit Federal Reserve monetary policy actions taken with respect to TALF. We have raised this concern about audit authority in previous testimonies and reports. See GAO, *Troubled Asset Relief Program: Status of Efforts to Address Transparency and Accountability Issues*, [GAO-09-1048T](#) (Washington, DC: Sept. 2009); [GAO-10-16](#); and [GAO-09-658](#).

⁸See appendix VI for more information on the compliance program for TALF.

and requirements for borrowers and collateral.⁹ In addition, we analyzed agreements between the relevant agencies on TALF. We interviewed officials from the federal agencies responsible for the program, along with policy analysts, economists, and attorneys. We also interviewed current and potential TALF program participants, including investors, underwriters, issuers, and sponsors. For additional information on the scope and methodology for this engagement, see appendix I.

We conducted this performance audit from May 2009 to January 2010 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.

Background

Securitization is a process by which similar debt instruments—such as loans, leases, or receivables—are aggregated into pools, and interest-bearing securities backed by such pools are then sold to investors. These ABSs provide a source of liquidity for consumers and small businesses because financial institutions can take assets that they would otherwise hold on their balance sheets, sell them as securities, and use the proceeds to originate new loans, among other purposes.¹⁰ During the recent financial crisis, the value of many ABSs dropped precipitously, bringing the securitization markets to a virtual halt. As a result, households and small businesses found themselves unable to access the credit that they needed to, among other things, buy homes and expand inventories.

TALF was designed to reopen the securitization markets in an effort to improve access to credit for consumers and businesses. The program provides loans to certain institutions and business entities in return for collateral in the form of securities that are forfeited if the loans are not repaid. To assist in this effort, Treasury provides credit protection for the program as part of TARP's Financial Stability Plan under the Consumer

⁹Eligible asset classes are those types of ABSs accepted for TALF. The amount of equity borrowers are required to hold in the securities pledged as collateral to secure TALF loans is calculated as a percentage of the pledged collateral's value (either its par value, market value, or a value determined from FRBNY internal risk assessments).

¹⁰For additional information on the securitization process, see appendix III.

and Business Lending Initiative (CBLI). Treasury has pledged \$20 billion for TALF LLC—a special purpose vehicle created by FRBNY—to purchase the underlying collateral associated with TALF loans in the event the loans are not repaid. Because of Treasury’s role in protecting these taxpayer funds committed through TARP, Treasury has consulted with the Federal Reserve on TALF’s design. Under TALF, FRBNY is currently authorized to extend up to \$200 billion in nonrecourse loans to eligible borrowers pledging eligible collateral. TALF is authorized to extend new loans against nonmortgage-backed ABSs and legacy CMBS collateral until March 31, 2010, and against newly issued CMBS collateral until June 30, 2010. As of December 2009, FRBNY has made about \$61.6 billion in loans under TALF. Of that amount, \$47.5 billion in TALF loans remained outstanding as of the end of December 2009. The amount of loans outstanding may be less than the amount of loans extended due to loan prepayments by the TALF borrower or paydown of principal.

TALF accounts for a small proportion of TARP funds (see fig. 1). As of December 31, 2009—of the \$20 billion committed—Treasury had loaned TALF LLC \$100 million: \$16 million for administrative expenses and \$84 million for potential asset purchases. This amount is less than 1 percent of the \$25.3 billion apportioned to the CBLI program, which itself represents 5 percent of apportioned TARP funds. TALF will receive TARP funds beyond the \$100 million already loaned if additional funding is required by TALF LLC to purchase surrendered or seized collateral resulting from unpaid TALF loans.

Figure 1: Status of TARP Apportioned Funds as of December 31, 2009

(Dollars in billions)



Source: GAO presentation of Treasury Office of Financial Stability data.

^aThe “other” category consists of the Targeted Investment Program, American International Group Investment, and the Asset Guarantee Program.

Note: Percentages may not total due to rounding.

FRBNY created TALF LLC, a special purpose vehicle, to purchase and manage any assets that TALF borrowers surrender or the FRBNY seizes.¹¹ TALF LLC also holds any excess accumulated interest from TALF loans and the \$100 million funded portion of the Treasury loan for administrative expenses and collateral purchases, plus interest earned from permitted investments.

A portion of the interest earned by FRBNY on all TALF loans—called the “excess interest”—is paid to TALF LLC as a fee for TALF LLC’s commitment to purchase the assets received by FRBNY in conjunction with a TALF loan. As of December 31, 2009, TALF LLC had accumulated approximately \$198 million in excess interest, with roughly \$30 million added each month (according to FRBNY officials), based on the current loan portfolio.

¹¹Special purpose vehicles are legal entities, such as limited liability companies, created to carry out a specific financial purpose or activity.

If accumulated fees and interest earned on TALF LLC's investments are insufficient to cover any asset purchases, Treasury will provide additional TARP funds to TALF LLC to finance up to \$20 billion of asset purchases. Subsequently, TALF LLC will finance any additional purchases by borrowing funds from FRBNY. The TARP loan is subordinate to the FRBNY loan, thus the TARP funds provide credit protection to FRBNY.

Asset Classes Eligible for Use as TALF Collateral

When TALF was first announced, the Federal Reserve made a number of asset classes eligible for use as collateral in consultation with Treasury, adding more as the program evolved (see table 1). Initially, securities backed by automobile, credit card, and student loans, as well as loans guaranteed by the Small Business Administration (SBA), were deemed eligible because of the need to make credit in these sectors more widely available.¹² For most TALF-eligible collateral, FRBNY will stop providing new TALF loans in March 31, 2010, while new-issue CMBSs will be accepted as collateral on new TALF loans through June 30, 2010.

Table 1: Timetable of Asset Classes Accepted As Eligible Collateral

Asset class	Description	Date announced
Auto, credit card receivables, student loans, and small business ^a	<ul style="list-style-type: none"> Auto includes retail loans and leases relating to cars, light trucks, motorcycles, and other recreational vehicles originated on or after October 1, 2007. Credit card receivables include both consumer and corporate credit card receivables maturing in 2009 or the first quarter of 2010. Student loans include federally guaranteed (including consolidation loans) and private student loans with a disbursement date on or after May 1, 2007. Small business includes fully guaranteed SBA 7(a) and 504 loans, debentures or pools originated on or after January 1, 2008. 	November 2008
Mortgage servicing advances, business equipment, vehicle fleet, and floor plan ^b	<ul style="list-style-type: none"> Mortgage servicing advances are receivables created by principal and interest, tax and insurance, and corporate advances made by Fannie Mae- or Freddie Mac-approved residential mortgage servicers for mortgages originated on or after January 1, 2007. Business equipment includes retail loans and leases originated on or after October 1, 2007. Vehicle fleet include commercial and government fleets and commercial loans secured by vehicles and the related fleet leases and subleases of such vehicles to rental car companies, all originated on or after October 1, 2007. TALF-eligible floor plan ABS include revolving lines of credit to finance dealer inventories originated on or after January 1, 2009. 	March 2009

¹²For additional information on these asset classes, see appendix IV.

Asset class	Description	Date announced
Insurance premium finance, new-issue CMBSs, and legacy CMBSs ^c	<ul style="list-style-type: none"> Insurance premium finance includes loans originated for the purposes of paying premiums on property and casualty insurance originated on or after January 1, 2009. New-issue CMBSs issued on or after January 1, 2009. Legacy CMBSs issued before January 1, 2009. 	May 2009

Source: GAO presentation of information gathered from the FRBNY Web site.

^aUnder the 7(a) program, SBA provides lenders with guarantees on up to 85 percent of the value of loans to qualifying small businesses in exchange for fees to help offset the costs of the program. Under the 504 program, which generally applies to small business real estate and other fixed assets, SBA also provides certified development companies with a guarantee on up to 40 percent of the financing of the projects' costs in exchange for fees, while the small business borrowers and other lenders provide the remaining 60 percent of the financing with no guarantee. For additional information on these programs, see GAO, *Small Business Administration's Implementation of Administrative Provisions in the American Recovery and Reinvestment Act*, [GAO-10-507R](#) (Washington, DC: Apr. 16, 2009).

^bFloor plan loans are made to auto and nonauto dealers to finance their inventories.

^cCMBSs are securities backed by mortgages for commercial real estate, such as office buildings or shopping centers.

All TALF-eligible ABSs must be denominated in U.S. dollars, must be rated AAA by at least two TALF-eligible nationally recognized statistical rating organizations (NRSRO), must not have a credit rating below the highest investment-grade rating category from a TALF-eligible NRSRO, and must not be on review for a potential rating downgrade.¹³ In general, borrowers must be U.S.-based businesses, investment funds, or U.S.-insured depository institutions, although foreign banks with U.S. branches that maintain reserves with a Federal Reserve bank are also eligible. However, all or substantially all of the eligible collateral's underlying credit exposures must be

- for newly issued ABSs—originated by U.S.-organized entities or institutions, or U.S. branches or agencies of foreign banks—and

¹³Nationally recognized statistical rating organizations, which are registered with the Securities and Exchange Commission (SEC), have designed credit ratings to provide investors with information about a security's credit quality. SEC requires the agencies to undergo an initial application review and subsequent examinations. The rating scales are comparable, ranging from AAA, or its equivalent (excellent), to D, or its equivalent (poor). Anything rated BBB or higher is considered investment grade, and anything below BBB is considered noninvestment grade or speculative. Credit ratings are assigned without regard to whether a security is TALF-eligible or not. The TALF-eligible rating agencies are Fitch Ratings; Moody's Investors Service; Standard & Poor's; DBRS, Inc.; and Realpoint LLC.

-
- for all ABSs—made to U.S.-domiciled obligors or located in the U.S. or one of its territories, in the case of real property.

Interest rates for TALF loans are either fixed or floating and vary according to the collateral securing the loan, as has been determined by FRBNY.

In order to constitute eligible collateral for a TALF loan, both the issuers and sponsors of the proposed collateral must provide certification documents stating that, among other things,

- they have reviewed TALF's terms and conditions;
- the collateral is TALF-eligible;
- an independent accounting firm was provided consent, in certain cases, to contact the TALF compliance fraud hotline if it suspects fraud or illegal acts; and
- purchasers of the securities that are affiliated with the originators, issuers, or sponsors cannot use these securities as TALF collateral.¹⁴

In addition, external auditors review certain representations made by issuers and sponsors about the TALF eligibility of the collateral.¹⁵ If any of these representations change, the issuer and sponsor must provide public notice. If any of the certifications are found to be incorrect, TALF LLC and FRBNY can recover damages and the issuer and sponsor will be subject to review by Treasury, the Special Inspector General for TARP (SIGTARP), and GAO.¹⁶

How TALF Works

A number of entities help administer the TALF program.

¹⁴An issuer is an entity that sells ABSs backed by its assets and can be a special purpose vehicle or similar legal entity. A sponsor is an entity that facilitates such a transaction. For additional information on the securitization process, see appendix III.

¹⁵For more information on the certification process and the role of auditors, see appendix VI.

¹⁶Congress authorized SIGTARP as an oversight entity for TARP. SIGTARP has made numerous recommendations to improve the implementation of TARP and TALF. See EESA § 121, 122 Stat. at 3788 (codified at 12 U.S.C. § 5231).

-
- *TALF agents*, which are primary dealers or designated broker-dealers that operate under FRBNY's Master Loan and Security Agreement. The agents' responsibilities include conducting due diligence on TALF borrowers and making representations to FRBNY regarding eligibility of TALF borrowers and their collateral, submitting TALF loan requests and supporting documentation to FRBNY and the TALF custodian on behalf of borrowers, delivering administrative fees and collateral from TALF borrowers to FRBNY, and distributing the TALF borrower's share of principal and interest payments paid on the collateral backing the TALF loan.¹⁷
 - *The Bank of New York Mellon*, which serves as custodian of the program and is responsible for administering TALF loans, holding and reviewing collateral, collecting payments and administrative fees, disbursing cash flows, maintaining the program's books and records, and assisting other TALF entities with the pricing of collateral.
 - *Collateral monitors*—Trepp LLC and Pacific Investment Management Company LLC (PIMCO)—which check the pricing and ratings of securities; provide valuation, modeling, reporting, and analytical support; and advise on related matters.
 - *CW Capital*, which provides underwriting advisory services related to certain commercial mortgage loans backing newly issued CMBSs.

FRBNY announces monthly subscription periods, during which potential borrowers apply for loans and funds are disbursed. FRBNY has a precertification process to streamline the process for certain eligible borrowers. TALF precertification documents indicate that borrowers must be deemed to be top-tier financial entities—that is, they must be seen as industry leaders and be ranked among the largest entities in the industry or have some of the largest operations.¹⁸ During our audit, FRBNY officials told us that they review loan requests from all borrowers that meet general eligibility criteria, and that not all borrowers need to be precertified; indeed, most are not precertified. Applicants must work through a TALF agent throughout the application process. Because the agents must

¹⁷The primary dealers are 18 banks and securities broker-dealers that trade in U.S. government securities with FRBNY. FRBNY had added 4 more broker-dealers to serve as agents for borrowers accessing TALF, and as of December 31, 2009, there were a total of 22 TALF agents, but currently not all have executed the Master Loan and Security Agreement.

¹⁸These documents also indicated that FRBNY created a proprietary list of such “top-tier” entities for its own internal proposes and has not shared it with the TALF agents.

demonstrate that they know a potential borrower and must vouch for its reputation, they put applicants through a “Know Your Customer” program based on provisions in the Patriot Act.¹⁹ Once this process is completed, TALF agents submit a loan request package to FRBNY that includes:

- borrower identification information, such as name, address, and tax identification number;
- loan information, such as the requested loan amount (\$10 million minimum), the term of the loan, the loan rate, and the type of interest rate (fixed or floating) that corresponds to the type of collateral offered;
- collateral information, such as the CUSIPs of the securities,²⁰ asset class and subclass, price and face value of the collateral, the weighted average life of the collateral,²¹ and the haircut amount—a percentage assigned to the loan based on the asset class, or subsector where appropriate, of the collateral and its weighted average life;
- any appropriate filing documents, including a prospectus and offering documents of the securities expected to be pledged; and
- proof of purchase for the ABSs and CMBSs that are being offered as collateral.

Next, the Bank of New York Mellon and FRBNY verify the data that the TALF agents provide and, among other things, ensure that the ratings submitted for the securities are the most recent. For legacy CMBS collateral, FRBNY evaluates whether the price the TALF borrower paid

¹⁹The 2001 USA Patriot Act established new and enhanced measures to prevent, detect, and prosecute money laundering and terrorism. One of the more important measures for financial institutions was addressed in section 326, Verification of Identification, more commonly referred to as “Know Your Customer.” Pub. L. No. 107-56, 115 Stat. 272 (Oct. 26, 2001).

²⁰CUSIP stands for the Committee on Uniform Security Identification Procedures. CUSIP numbers are alphanumeric identifiers assigned to individual securities.

²¹In general, the weighted average life is the average number of years that unpaid principal is outstanding. The TALF program’s definition varies according to asset class and assumptions that FRBNY developed about the likelihood of prepayment for the different ABS classes. The weighted average life for CMBSs is based on the assumption that each loan amortizes according to schedule and pays in full on its maturity date, without prepayment. FRBNY’s Web site has further details and the formulas used to compute the weighted average life of collateral.

was reasonable based on pricing information FRBNY receives from the collateral monitors and Bank of New York Mellon.²² The collateral monitors, Trepp LLC and PIMCO, also conduct stress tests on pledged legacy CMBS collateral to help ensure that the loan amounts will not exceed the stressed value of the pledged securities. Three weeks prior to each ABS subscription, a newly issued ABS undergoes a risk assessment by FRBNY (with PIMCO's support) to determine if it is likely to be accepted as TALF collateral. The issuer must provide FRBNY any information it provided the NRSROs so FRBNY can conduct its own credit risk assessment. The issuer must also consent to permitting NRSROs to discuss all aspects of the rating with FRBNY, including credit quality of the ABS, modeling, and methodology, among other things.

On each TALF loan's settlement date, the borrower must deliver the loan collateral and administrative fees to FRBNY's custodian, the Bank of New York Mellon, which holds the collateral for the life of the loan. The administrative fees vary by asset class and cover FRBNY's administrative costs for the facility.²³

Determining the Loan Amount

If FRBNY deems the collateral eligible, it will lend an amount calculated by subtracting a designated haircut percentage from the lesser of either par or market value of the pledged collateral (or, in the case of legacy CMBSs, a value based on an internal risk assessment). This percentage, or "haircut," in effect sets the amount of equity the TALF borrower holds in the collateral. Haircuts vary by FRBNY's assessment of market risks for each sector and subsector.²⁴ The haircut represents the difference between the value of the proposed collateral and the value of the loan (table 2).²⁵

²²Trepp LLC and PIMCO assist FRBNY by providing valuation, modeling, analytics and reporting, and advising on these matters. Trepp LLC focuses only on CMBSs. PIMCO analyzes both mortgage-backed and nonmortgage-backed ABSs.

²³Administrative fees due on the settlement date are equal to 10 basis points (bps) or 0.10 percent of the loan amount for nonmortgage-backed ABS collateral, and 20 bps for CMBS collateral.

²⁴A sector is a group of securities that are similar with respect to maturity, type, rating, industry, or coupon.

²⁵Generally, the percentage is applied to the lesser of the market value of the collateral or the par value. In addition, to account for potential risks in legacy CMBSs, the FRBNY conducts a risk assessment of pledged legacy CMBS collateral and applies the haircut to the least of the market-, par-, or assessment-values. For more details, see http://www.newyorkfed.org/markets/talf_faq.html.

Table 2: TALF Haircuts by Asset Class

Sector	Subsector	Weighted average life in years for ABSs						
		0 to less than 1	1 to less than 2	2 to less than 3	3 to less than 4	4 to less than 5	5 to less than 6	6 to less than 7
Auto	Prime retail lease	10%	11%	12%	13%	14%	–	–
	Prime retail loan	6	7	8	9	10	–	–
	Subprime retail loan	9	10	11	12	13	–	–
	Motorcycle or other recreational vehicles	7	8	9	10	11	–	–
	Commercial and government fleets	9	10	11	12	13	–	–
	Rental fleets	12	13	14	15	16	–	–
Credit Card	Prime	5	5	6	7	8	–	–
	Subprime	6	7	8	9	10	–	–
Equipment	Loans and leases	5	6	7	8	9	–	–
Floor plan	Auto	12	13	14	15	16	–	–
	Nonauto	11	12	13	14	15	–	–
Premium finance	Property and casualty	5	6	7	8	9	–	–
Servicing advances	Residential mortgages	12	13	14	15	16	–	–
Small business	SBA loans	5	5	5	5	5	6	6
Student loan	Private	8	9	10	11	12	13	14
	Government guaranteed	5	5	5	5	5	6	6
New-issue CMBSs		15	15	15	15	15	– ^a	– ^a
Legacy CMBSs		15	15	15	15	15	– ^b	– ^b

Source: GAO presentation of information gathered from the FRBNY Web site.

Note: For ABSs benefiting from a government guarantee with average lives of 5 years and beyond, haircuts will increase by 1 percentage point for every 2 additional years (or portion thereof) of average life at or beyond 5 years. For all other ABSs with average lives of 5 years and beyond, haircuts will increase by 1 percentage point for each additional year (or portion thereof) of average life at or beyond 5 years.

^aFor newly issued CMBSs with average lives beyond 5 years, collateral haircuts increase by 1 percentage point of par for each additional year of average life. No newly issued CMBS may have an average life of more than 10 years.

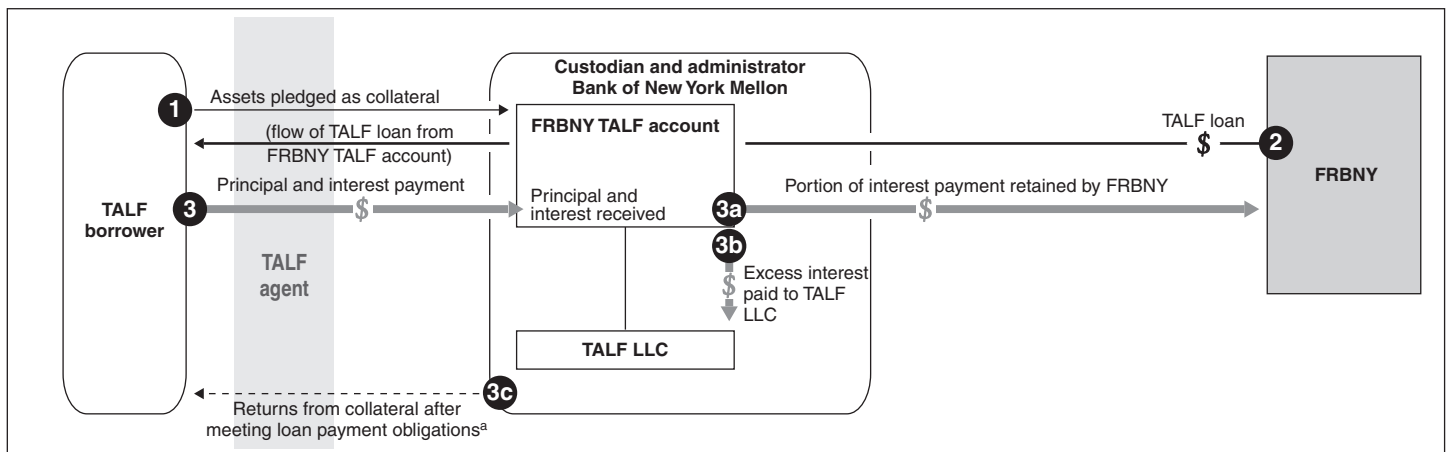
^bFor legacy CMBSs with average lives beyond 5 years, haircuts increase by 1 percentage point of par for each additional year of average life. No legacy CMBS may have an average life of more than 10 years.

Loan Repayment Process

As discussed earlier, the Bank of New York Mellon holds the collateral throughout the life of the loan. As the collateral securities generate cash flows, the Bank of New York Mellon makes all principal and interest

payments to FRBNY on behalf of the TALF borrower. The borrower may earn returns from the collateral after all loan obligations have been satisfied. As shown in figure 2, any returns that the collateral assets earn beyond the required principal and interest payments is delivered to the borrower via the TALF agent after all monthly loan payment obligations are met.²⁶ FRBNY retains a portion of the interest that is calculated using Overnight Indexed Swap (OIS) rates plus 25 basis points (approximately the FRBNY's cost of funds).²⁷ The remaining part of the TALF loan interest payment is transferred to TALF LLC, which would use the funds to purchase surrendered collateral before accessing funds from Treasury. This accumulated interest from TALF loans is held in an account called the cash collateral account, and the Bank of New York Mellon is authorized to invest these funds on behalf of TALF LLC to earn interest income.

Figure 2: TALF Loan Origination and Repayment Process



Source: GAO.

²⁶Under certain circumstances, the excess interest earned on ABS or CMBS above the TALF loan interest payable will be remitted to the TALF borrower only up to a proportion of the original haircut amount, with the remainder of such amount applied to the TALF loan principal. FRBNY refers to this as a net carry diversion, and it accelerates the repayment of the TALF loan and ensures that the TALF borrower maintains a significant equity stake in the ABS or CMBS collateral over the life of the loan.

²⁷A basis point represents .01 percent, or one-hundredth of a percent. In other words, 100 basis points equals 1 percent. For example, the difference between 1.00 percent and 1.50 percent would be expressed as 50 basis points. The OIS rate is a type of interest rate swap that is based on daily federal funds rates.

Process If Borrower Walks Away from the Loan

²⁸If the collateral is not generating enough interest to satisfy the loan obligation, the borrower must eventually make up the difference or surrender collateral.

TALF offers nonrecourse loans, which allow borrowers to walk away—or stop paying a loan—with no personal exposure for the unpaid portion of the debt.²⁸ In this case, borrowers would surrender their collateral through a TALF agent, which would submit a collateral surrender form to FRBNY. Within 10 days of receiving the surrender notice, the Bank of New York Mellon cancels the outstanding balance of the loan and transfers the related collateral to FRBNY. FRBNY has the option to sell the collateral to TALF LLC (see fig. 3) at a price equal to the then outstanding principal amount of the TALF loan plus accrued but unpaid interest. This process has several steps:

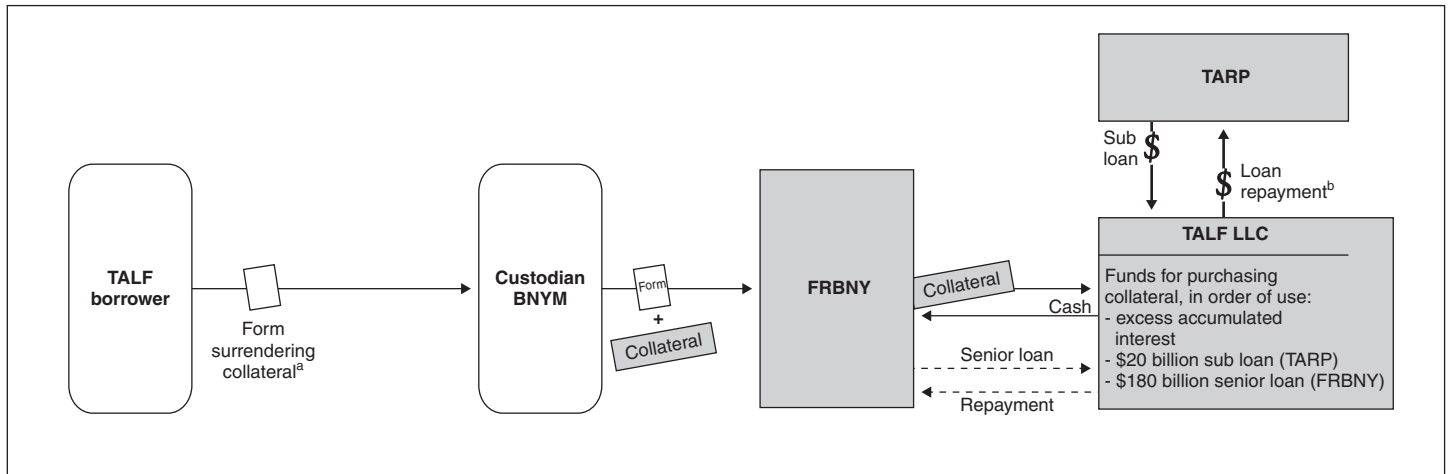
- FRBNY sends a purchase notice to TALF LLC. To purchase surrendered assets, TALF LLC first uses funds that have been accumulating in the cash collateral account (as of December 31, 2009, the account contained approximately \$198 million).²⁹
- When these funds are exhausted, TALF LLC borrows money to purchase any surrendered assets. Its first source of borrowed funds is Treasury, which has committed up to \$20 billion in TARP funds to the TALF program for this purpose. To obtain these funds, TALF LLC must submit a request to Treasury (as the subordinate lender) one business day prior to the desired funding date. Treasury's loan rate is equal to the 1-month London Interbank Offered Rate (LIBOR) rate plus 300 basis points.
- If the \$20 billion TARP loan commitment is fully exhausted, TALF LLC must ask FRBNY for a loan to purchase any additional surrendered assets. FRBNY has committed to provide up to \$180 billion to TALF LLC for this purpose. TALF LLC must submit a borrowing request to FRBNY (as senior lender) one business day prior to the desired funding date. The FRBNY's

²⁸TALF loans are nonrecourse, except in cases involving fraud or other breaches of certain representations.

²⁹This amount excludes the \$84 million (initial \$100 million loan from Treasury less the \$16 million set aside for administrative expenses), which is held in a separate sub-account. Therefore, total funds that could potentially be available to purchase surrendered collateral could be greater, according to Treasury officials, though additional TALF LLC expenses related to surrendered collateral could also be taken from this amount. For that reason, we refer to \$198 million as the amount in TALF LLC that is dedicated to purchasing surrendered assets.

- loan rate is equal to the 1-month LIBOR rate plus 100 basis points. The principal on FRBNY's loan would be repaid before the principal of the \$20 billion TARP loan.

Figure 3: Funding Required if a Borrower Walks Away from a Loan



Source: GAO.

^aThe form goes through the TALF agent and is provided to the custodian and FRBNY simultaneously.

^bTo be supplemented by 90 percent of any remaining TALF LLC assets after meeting all obligations, as noted in the order of payment shown below.

Alternatively, if a TALF borrower stops payment on a loan and does not submit a collateral surrender form, under certain circumstances FRBNY has rights to seize the collateral.

Management of TALF LLC

With the Federal Reserve's and Treasury's agreement, TALF LLC may dispose of assets it has acquired. Agency officials told us that there were no formal guidelines on when to sell any acquired assets and that the decision to sell would be made on a case-by-case basis as is necessary given the differences in types of assets that could be acquired by TALF LLC. However, they added that factors such as market rates and the nature of the underlying collateral would likely play a role in any decision to hold or sell assets purchased by TALF LLC. According to Treasury officials, because the Federal Reserve's monetary policy considerations may not align with Treasury's investment interests in the TALF program, Treasury plans to obtain independent advice on the disposition of investments.

TALF LLC has certain sources of cash inflows, such as the excess interest from TALF loans, interest paid from permitted investments, principal and interest paid on ABS holdings, and proceeds from possible asset sales of ABS holdings. These inflows are distributed according to the order defined in an agreement among Treasury, FRBNY, the Bank of New York Mellon, and TALF LLC. The payment order is as follows:

- Pay TALF LLC expenses.
- Fund expense reimbursement account up to \$15 million.
- Repay outstanding principal on any FRBNY senior loans to TALF LLC.
- Fund the cash collateral account up to the senior loan commitment (currently \$180 billion).
- Repay outstanding principal on any Treasury loans.
- Repay FRBNY loan interest.
- Repay Treasury loan interest.
- Repay any other secured obligations that may arise that have not been specified yet by the agencies.
- Pay Treasury and FRBNY (90 percent and 10 percent, respectively) any residual amounts but only after the above requirements are satisfied.

As of December 2009, cash inflows have been used to pay TALF LLC expenses and fund the expense reimbursement and cash collateral accounts.

TALF Includes Features That Mitigate Potential Losses, but CMBSs Could Pose Greater Risks Than Other Asset Classes

Under some scenarios, TALF borrowers may have economic incentives to stop payment on their loans and surrender collateral. Treasury and FRBNY assessments, along with our analyses, however, suggest that a number of factors reduce the likelihood of this occurring. First, certain TALF features are designed to protect TARP funds and also limit taxpayer exposure. Specifically, FRBNY officials told us that risks in TALF are managed based on four pillars: credit protection, credit ratings, FRBNY due diligence, and market discipline. FRBNY also sought market perspectives on the level of returns from TALF-eligible securities that would be required to encourage market participation while also ensuring proper due diligence by TALF participants, which in turn reduces the risks to taxpayers. Second, most

ABSs issued since the credit crisis began contain features such as increased levels of subordination and overcollateralization that reduce the likelihood that TALF borrowers will stop payment on their loans. Third, Treasury and FRBNY analyses project minimal, if any, likelihood that TARP funds will be used for TALF-related purchases, and Treasury currently projects a profit from TALF. While TALF poses minimal risks to TARP even in adverse market conditions, our analyses showed that CMBSs held as collateral as of September 2009 potentially pose higher risks than ABSs and under adverse conditions losses could exceed \$500 million. TALF presents a range of other taxpayer risks beyond those presented to TARP funds. Such risks include the risk that FRBNY might not identify instances of material noncompliance with program requirements by TALF participants. However, because of statutory audit limitations on GAO, this review has been limited to presenting only descriptive information about FRBNY's role in TALF and we cannot evaluate FRBNY's TALF operations.

Some Scenarios Could Provide TALF Borrowers with Economic Incentives to Stop Payment on Their Loans

As of January 8, 2010, there have been no collateral surrenders by any TALF borrowers, but in some instances, a TALF borrower could have an economic incentive to stop payment on a loan and surrender the underlying collateral.³⁰ A number of scenarios could result in a borrower walking away from a loan. For example, the collateral could lose value so that the loan amount exceeded the value of the collateral. Or, the expected returns from the collateral could be less than the cost of financing the loan. Also, interest rates could rise across the board, decreasing the market value of the collateral or making refinancing more difficult.

A borrower can lose equity in the collateral if the collateral's value falls below the outstanding loan balance. As discussed earlier, TALF's established haircuts determine the amount of equity borrowers have in their collateral. This equity represents the amount of money that a TALF borrower would lose by surrendering the collateral and not repaying the loan.³¹ For example, if the ABSs a borrower seeks to use as collateral on a

³⁰As noted in the background, TARP funds can be used to purchase ABS or CMBS collateral if not enough excess interest has accumulated in TALF LLC.

³¹According to the terms of FRBNY's Master Loan Security Agreement, TALF borrowers can choose to surrender collateral in order to stop making payments on a loan. If they do not voluntarily surrender collateral, FRBNY has the right to take possession of it. In either case, TALF LLC is likely to purchase the associated collateral.

TALF loan were initially valued at \$100,000, a haircut of 10 percent would provide the TALF borrower with a \$90,000 loan and require \$10,000 of its own funds to acquire the securities. This \$10,000 represents the borrower's equity in the securities. If the value of the collateral were to decline—such that the borrower could sell the securities only for some amount less than \$90,000—and especially if it declined dramatically, the borrower could decide to cut further losses by stopping payments on the loan and surrendering the collateral. The borrower is particularly likely to make this choice if such a situation occurs at the point when the loan matures.

As TALF currently works, TALF borrowers earn the difference between the ABS's return and the cost of borrowing from FRBNY on the TALF loan, multiplied by the inverse of the borrower's percent equity stake. However, if the returns on TALF collateral are less than initially anticipated, the TALF loan costs could exceed them, providing another incentive to stop making payments. This situation would be most likely to develop if the underlying loans in the securities defaulted or otherwise failed to meet the terms of the original loan agreement. In this situation, if the returns were less than the total cost of the TALF loan—the interest and principal due—a borrower might stop payment on the loan or surrender the collateral to FRBNY.

Investors might also choose to surrender collateral at the maturity of their TALF loan if overall interest rates on credit increased significantly above levels available at the time the underlying securities were issued. A large increase in interest rates would lower the market value of the securities, especially for those with a fixed interest rate, because future cash flows would be worth less. In this scenario, a borrower could wind up owing more to FRBNY at maturity than the securities were worth. The borrower would need to raise funds at higher interest rates to pay back the TALF loan, but the collateral would be worth less than the new loan, potentially making it difficult to find a lender. This situation would provide an economic incentive for the borrower to surrender the collateral and walk away from the loan. Nevertheless, many of the longer-term securities pledged as collateral for TALF loans have floating interest rates. Generally, floating rate securities do not decline in value when interest rates increase because the interest rates on the securities also increase.

TALF borrowers will not necessarily stop payment on a loan even with one or more of these economic incentives. For example, a market participant and a Treasury official told us that TALF borrowers wanted to avoid “reputation risk” by not walking away from their loans—even if it might be in their financial interest to do so. By continuing to pay on their

loans, even at some loss, borrowers could protect their reputations. Other market participants we spoke with, however, did not mention concerns about reputation, though they thought it was unlikely that TALF borrowers would stop payment on their loans.

Moreover, FRBNY and Treasury officials believe that the most important disincentive for borrowers to stop payment on a TALF loan and surrender collateral is maintaining a positive return based on the difference between the cost of the TALF loan and the return of the underlying ABS collateral. Even if the value of the collateral declines and removes the borrower's equity, these officials stated that borrowers were not likely to walk away from the loan if they were still receiving positive cash flow from the asset. While this assumption may be reasonable, it is conceivable that investors subject to mark-to-market accounting might choose to walk away from an ABS that was still paying the required scheduled interest and principal payments but had lost sufficient market value. Investors would be most likely to walk away if they owed significantly more on the loan than the current value of the asset so that walking away from the asset would have positive implications for the borrower's reported profitability. As of January 8, 2010, no TALF borrowers had surrendered collateral to FRBNY. Nevertheless, because the behavior of individual borrowers is difficult to predict, it remains unclear whether and why borrowers might stop payment on TALF loans based on their own investment strategies and other objectives.

TALF Has Several Features That Likely Protect Taxpayers

Certain TALF features help protect TALF funds and also taxpayer exposures through TARP. We discussed these protections with FRBNY officials but did not evaluate FRBNY compliance with them because of the limitation of our statutory audit authority. FRBNY officials told us that risks in TALF are managed based on four pillars: credit protection, credit ratings, FRBNY due diligence, and market discipline.

- Credit protection is provided primarily by the borrower's equity in the security (set by the haircuts) and a portion of the interest rate on TALF loans that provides accumulated excess interest in TALF LLC. FRBNY officials said that haircuts were designed to approximate multiples of stressed historical impairment rates for ABSs. The size of the haircut is important, because if it is set too low, the borrower will have less equity in the collateral and, in the circumstances that we have discussed, could have an incentive to walk away. The excess interest from TALF loans accumulated in TALF LLC also protects taxpayers, because this money would be used before TARP funds to purchase collateral surrendered from

unpaid loans. FRBNY officials said that such features were designed to ensure that the haircuts and excess interest would result in no credit losses for Treasury or the Federal Reserve.

- The Federal Reserve requires that TALF collateral be rated AAA or its equivalent by two of the nationally recognized statistical rating organizations that it deems eligible to provide credit ratings for TALF, among other requirements for credit ratings.³² Collateral that is offered that has a lower rating is not eligible for TALF. The rating requirement helps ensure that the securities TALF accepts as collateral present minimal credit risks.
- FRBNY due diligence serves as another pillar of taxpayer protection. As discussed earlier, FRBNY, with the support of its collateral monitors, reviews the credit risks related to individual assets FRBNY might consider accepting as TALF collateral. In addition, for legacy CMBSs, FRBNY reserves the right to reject any collateral and has not disclosed its selection criteria to reduce the likelihood that only the poorest-performing collateral is put forward for TALF loans.
- The final pillar, market discipline, includes the TALF borrowers' due diligence conducted on the risks related to the underlying collateral, given their equity in the collateral, as set by the haircut. Such discipline includes reviewing the prospectuses and understanding how the structure of the underlying securities impacts its overall risks. Investors purchasing ABSs would generally review the terms of the security, the anticipated risks, and the likely return. In addition, TALF borrowers help to facilitate price discovery.

These design features are intended to help ensure that TALF borrowers hold equity in the underlying TALF collateral, that such collateral is highly rated, and that TALF borrowers carry out the same due diligence on TALF collateral that they would conduct on any other security.

³²See background for additional detail on the rating requirements for TALF collateral.

Rates of Return for TALF Borrowers on TALF Collateral Have Declined from Their Highs Earlier in 2009

As noted earlier, TALF borrowers earn the difference between the ABS's coupon rate of return and the cost of borrowing from FRBNY on the TALF loan. According to FRBNY officials, they, along with officials from the Federal Reserve and Treasury, were aware of the importance of striking a balance between achieving returns on equity that would encourage program participation in the stressed market conditions when TALF was announced, while also ensuring that investors had incentives for due diligence and that the program would be less attractive during times of less market stress.³³ If borrowers saw an opportunity to earn excessive returns due to a poorly designed program, borrowers might not conduct appropriate due diligence on the underlying securities, which could put taxpayers at risk. Moreover, because the loans are nonrecourse much of the borrowers' risk is shifted to FRBNY and Treasury, while most of the earnings potential remains with borrowers. FRBNY gathered information on the rates of return that would entice potential TALF participants by surveying market participants about expected returns for TALF-eligible asset classes.³⁴

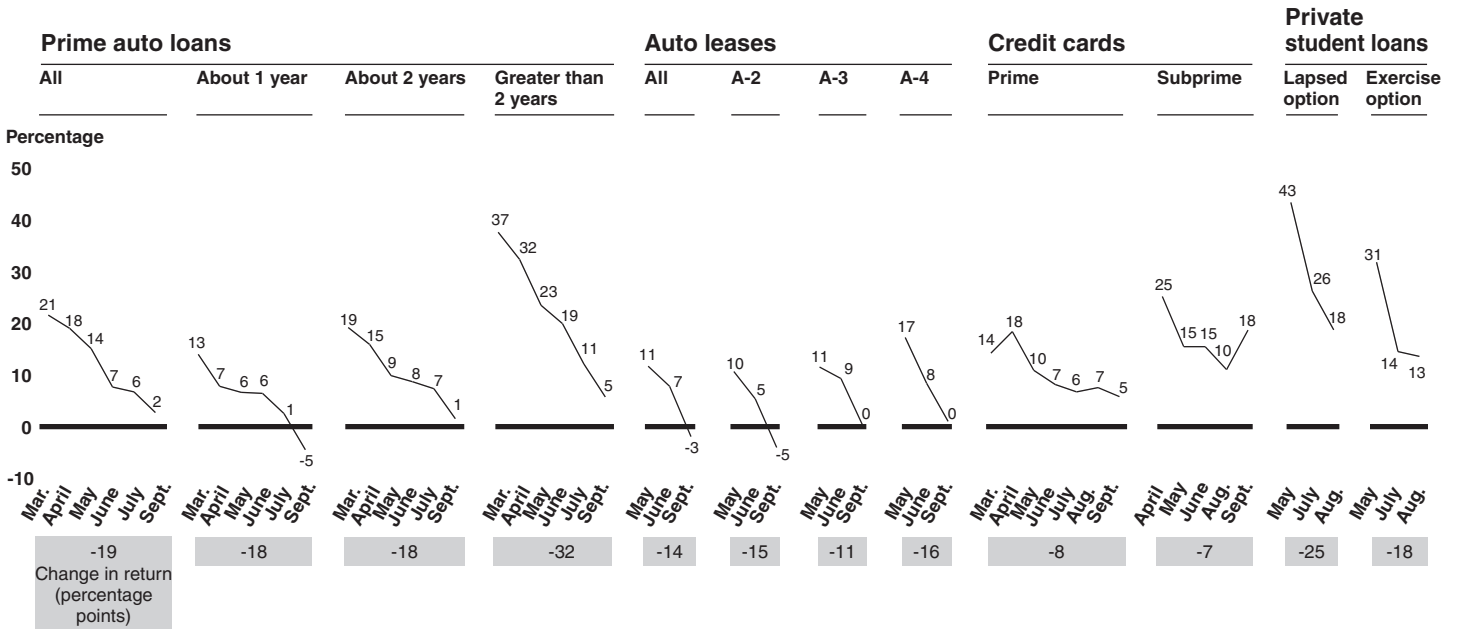
To understand the changes in returns on equity over time and the reasonableness of those returns from the perspective of helping to ensure that taxpayers were not subsidizing high returns, we analyzed fluctuations in returns on TALF eligible collateral from March 2009 through September 2009. As seen in figure 4, returns generally decreased for select classes of TALF-eligible collateral between the first TALF operation in March 2009 and September 2009, with limited exceptions.³⁵

³³For TALF purposes, returns on equity are the earnings on the amount invested in a particular security or the amount that an investor can expect from an investment.

³⁴Because of our audit limitations, we did not review the Federal Reserve's process for surveying the market on what returns on equity would encourage participation for a program like TALF.

³⁵Our analysis focused on auto, credit card, and student loan ABSs, because these securities make up the majority of the market and are the most commonly traded asset classes.

Figure 4: Overall TALF Borrower Returns at Issuance for Select Asset Classes Accepted as TALF Collateral Generally Decreased from March through September 2009



Source: GAO analysis of TALF prospectuses, Standard and Poor's and Moody's Investors Service reports, and Federal Reserve data.

Note: The percentage point change in return for each asset class is calculated from the first month of issuance to the most recent month and may not appear to total correctly due to rounding.

Most asset classes demonstrated a significant decline in returns, from a peak of 43 percent among the first student loan ABS accepted under TALF to lows of -5 percent for 1-year prime auto tranches³⁶ and 2-year auto leases, suggesting that if investors had used TALF to finance the purchase of these auto-related TALF eligible securities they would have locked in

³⁶Some securitizations—such as ABSs backed by auto loans—are divided into different segments, or tranches. A tranche is a piece of a securitization that has specified risks and returns. For additional information on the securitization process and tranches within securitizations, see appendixes III and IV.

losses.³⁷ However, in a sign that health may be returning to the ABS markets, no TALF borrowings were needed to finance the purchase of these negative return securities as the issuances were fully funded by non-TALF investors. The most dramatic decreases in returns have been in the auto loan tranches with longer-term maturities and private student loan ABSs. The average expected return for TALF borrowers that used prime auto loan ABSs as TALF loan collateral declined by nearly a fifth after March 2009. All of the TALF-eligible private student loan ABS transactions that were completed between May 2009 and August 2009 had a unique option feature that significantly lessened investor's expected returns on equity.³⁸ Additionally, the September 2009 increase in return for subprime credit cards was primarily due to the unique structure of an issuance by a large subprime issuer.³⁹

The trend of decreasing returns on equity in the overall market for most asset classes indicates that the returns required to attract investors have decreased since TALF's implementation, as ABS investors perceive the assets to be less risky. In addition, the trend demonstrates that taxpayer

³⁷It should be noted that just because an ABS meets the TALF eligibility requirements, it does not necessarily follow that investors will use TALF to finance their purchase. As part of the price discovery process that the ABS underwriters engage in as part of the marketing of a new issue of ABS, they interact with prospective buyers to achieve the lowest interest rates on the offered bond tranches that will still sell the full offering. As the TALF eligibility verification process must be completed prior to the issue date, it is possible that bonds will have sufficient demand to drive the price up or bonds' coupon rates (since ABSs are issued at or very close to prices of 100 percent of par) down to a level near or below the TALF finance rates paid to the Federal Reserve. This is why investors are increasingly unwilling to use TALF to finance the purchase of TALF eligible securities. In addition, this trend explains why more issuers are choosing to forego the process of seeking TALF eligibility as they feel it is no longer necessary to ensure that their bonds will find buyers.

³⁸This option allowed the issuer to purchase back the bonds after a period of between 30 and 36 months at a significant discount on the face value. For one issuer, the discounts were 7 percent for May 2009 and 6 percent for both July and August 2009. The August 2009 transaction from a new private student loan issuer had a 10 percent discounted exercise price. Exercise by the issuer at this discounted price implicitly reduces the amount of principal that the bondholder receives and negatively impacts the return. The issuer makes up for this expected shortfall in principal payback with a higher interest rate or "coupon" on the bond.

³⁹This subprime credit card issuance was unique in that two tranches had average lives of nearly 5 years, which is longer than most TALF-eligible credit card ABS collateral. Investors in ABSs with longer average lives require higher interest rates to compensate for the greater risk of holding the bond over a longer time period. However, TALF loans for these ABSs are still 3-year loans with the same interest rate as would be paid by a borrower with a shorter-lived ABS. To some extent the increased return is compensation for the risk the borrower is taking given the mismatch on the maturity of the loan and that of the ABS.

subsidies to TALF borrowers have not, over the course of the program, provided what might be considered excessive returns. Although returns were high in the beginning, they diminished once the ABS markets started to revive and overall perceived risk began to decrease. Moreover, the trend toward negative TALF returns on equity have coincided with a drop in TALF participation by TALF borrowers in those asset classes as the rate on the securities' bonds falls below the loan rate charged by the FRBNY. This occurrence is consistent with FRBNY's intention for TALF financing to become less attractive as the ABS market improves and can be viewed as indicating normalization in the market, since investors can purchase such ABSs without TALF funding.

New Securitizations Have Generally Been Structured with More Credit Protections since the Credit Crisis Began

Certain elements of the securities themselves also reduce the risk of loss to TALF and the taxpayer. Among these features are credit enhancements, which have increased since the credit crisis began in the second half of 2008. Credit enhancements are features in the structure of a securitization that protect investors from losses due to defaults on the underlying loans in the securities. Two main forms of credit enhancement include subordination, which helps ensure that more highly rated tranches in a security receive priority of payment, and overcollateralization, which ensures that funds are available if a borrower stops paying or other credit problems develop with the underlying loans. For additional details on the various types of credit enhancement, see appendix V.

Credit enhancements offer several benefits. First, they provide a cushion against losses, making it less likely that TALF borrowers will decide not to repay their loans and surrender the collateral because of credit performance problems in the ABS or CMBS markets. Second, credit enhancements reduce the probability that TALF LLC will suffer principal losses on surrendered ABSs and CMBSs from unpaid loans. For this reason, credit enhancements also provide TALF LLC with an incentive to decide to hold surrendered collateral to maturity. This reduces potential losses to TARP funds, which would finance TALF LLC's purchase of such ABS and CMBS.

We reviewed the credit enhancements on every TALF-eligible ABS issued between the program's initiation in March 2009 and September 2009 and compared them with credit enhancements on ABSs by the same issuer between 2006 and 2008 to identify any changes. As shown in figure 5, the level of enhancement for every TALF-eligible asset class increased.

Figure 5: Increases in Levels of Credit Enhancement on ABSs Since the Credit Crisis Began, March 2009 through September 2009

TALF-eligible ABS	Percentage of credit enhancement in ABS	Percentage increase (rounded)
Prime auto loans	10.5 7.9	33
Subprime auto loans	44.3 43.6	2
Prime credit cards	18.2 13.6	34
Subprime credit cards	27.5 22.6	22
Private student loans	35.3 8.9	295
Auto leases	25.3 9.7	162
Insurance premium finance	11.0 9.0	19
Motorcycle	23.0 10.3	124
Commercial fleet leases	12.5 12.1	3
Equipment	11.6 8.2	42
Mortgage servicing advances	22.7 18.9	20
Nonauto floor plan ^a	24.0 9.0	167

 TALF
 Precrisis

Source: GAO analysis of TALF prospectuses and Moody's Investors Service and Standard and Poor's reports.

^aNonauto floor plan loans are made to finance nonautomotive inventory such as recreational vehicles, boats, and industrial equipment.

In particular, credit enhancements on ABSs backed by private student loans, nonauto floor plans, auto leases, and motorcycle loans at least doubled after the credit crisis.⁴⁰ In other words, from the perspective of protecting TARP funds, taxpayers would receive more than double the amount of credit protection for these particular asset classes compared with these issuers' ABSs before the financial crisis. This increase was a combination of market demands and credit rating agencies' more stringent

⁴⁰Although there was a single auto floor plan ABS deal in September 2009, we could not locate a prior issuance from this issuer to use as a comparison for precrisis levels of credit enhancement; therefore, this asset class is not included in this analysis.

requirements for achieving AAA ratings on many ABSs. TALF agents and a TALF issuer confirmed that credit enhancements had increased since the onset of the financial crisis, even for non-TALF issuances, and noted that requirements from the credit rating agencies had contributed to the increases.

TALF Poses Minimal Risks to TARP Even in Adverse Market Conditions; CMBS Risks are Potentially Higher

While TARP funds designated for TALF are exposed to potential loss if TALF LLC uses them to purchase ABSs or CMBSs used as collateral for unpaid TALF loans, Treasury and FRBNY analyses suggest that the risks of loss are minimal. According to the Federal Reserve's analysis, the accumulated excess interest from TALF loans will likely cover any ABS or CMBS purchases for TALF LLC, and Treasury will not need to provide any TARP funds for such purchases. Accordingly, the total expenditures from TARP funds would include only the \$100 million placed in TALF LLC, which is in the form of a loan that would be repaid. According to the terms of the agreement between FRBNY and Treasury, Treasury will receive 90 percent of the monies accumulated in TALF LLC when the program expires. In particular, if TALF LLC has not purchased any collateral, the excess interest that has accumulated—along with interest income from investing such money—will go mainly to Treasury; therefore, Treasury could potentially gain from its commitment to TALF if losses were minimal.

Treasury Currently Expects to Earn a Profit on TALF

Treasury hired a contractor to provide an estimate of potential losses to TARP funds from TALF.⁴¹ According to one analysis conducted by the contractor, any losses to TARP are likely to be far below the \$20 billion that has been set aside for TALF and in fact are unlikely to exceed about \$190 million. Any assets purchased by TALF LLC would first be paid for with the excess interest and related interest income that had accumulated in TALF LLC, which totaled almost \$200 million at the end of December

⁴¹Treasury asked the Bank of New York Mellon, as the administrator for TARP, to analyze the risks that TALF posed to TARP funds. In turn, the bank hired a firm to conduct this analysis, NSM Structured Credit Solutions, which is now known as RangeMark. The firm's responsibilities include determining how the various TALF asset classes perform and the risks they present to TARP. The contractor made certain assumptions about the composition of the portfolio and the risks of the various types of collateral, and estimated losses in an extreme scenario. The results of this analysis contributed to Treasury's recent financial statement, which anticipates that its commitment of funds for TALF will actually provide a return. See [GAO-10-301](#).

2009.⁴² According to the contractor, the analysis of potential loss of TARP funds did not include this excess interest, so the total estimated losses could be largely offset by accumulated interest. In fact, the contractor and Treasury officials said that a subsequent analysis that included projections for the accumulation of excess interest—and is updated on a quarterly basis—currently projects more than \$1 billion in profit related to Treasury’s TALF exposure.

To assess the reasonableness of Treasury’s position that TALF may actually earn money rather than expose the taxpayer to any losses, we reviewed the Treasury contractor’s model—which is central to estimating losses for the various asset classes accepted in TALF. We found this model appeared to incorporate generally reasonable loss assumptions for the three asset classes that we reviewed and that comprise the largest portion of the TALF portfolio: credit cards, auto loans, and student loans. That is, many of the loss estimates were fairly conservative when compared to recent historical results for these specific assets. For each asset class, the contractor estimated expected loss percentages based on its own research and analysis, which was used to generate total-loss estimates. The model calculates total losses for each TALF borrower on each asset held in the TALF portfolio. The portfolio includes current TALF collateral and projections for future TALF collateral that borrowers will use for TALF loans, based on information the contractor received from Treasury. Potential Treasury losses from these various scenarios were calculated by taking the total loss for the TALF borrower and subtracting the equity that the TALF borrower holds in ABSs. Any difference is considered a loss, first to TALF LLC and potentially to Treasury (through TARP funds) if loans extended to TALF LLC for its purchase of TALF collateral are not repaid. While some of the scenarios generated by the model estimated losses from asset classes that did not have government guarantees, none of the possible scenarios estimated losses to Treasury from CMBSs.

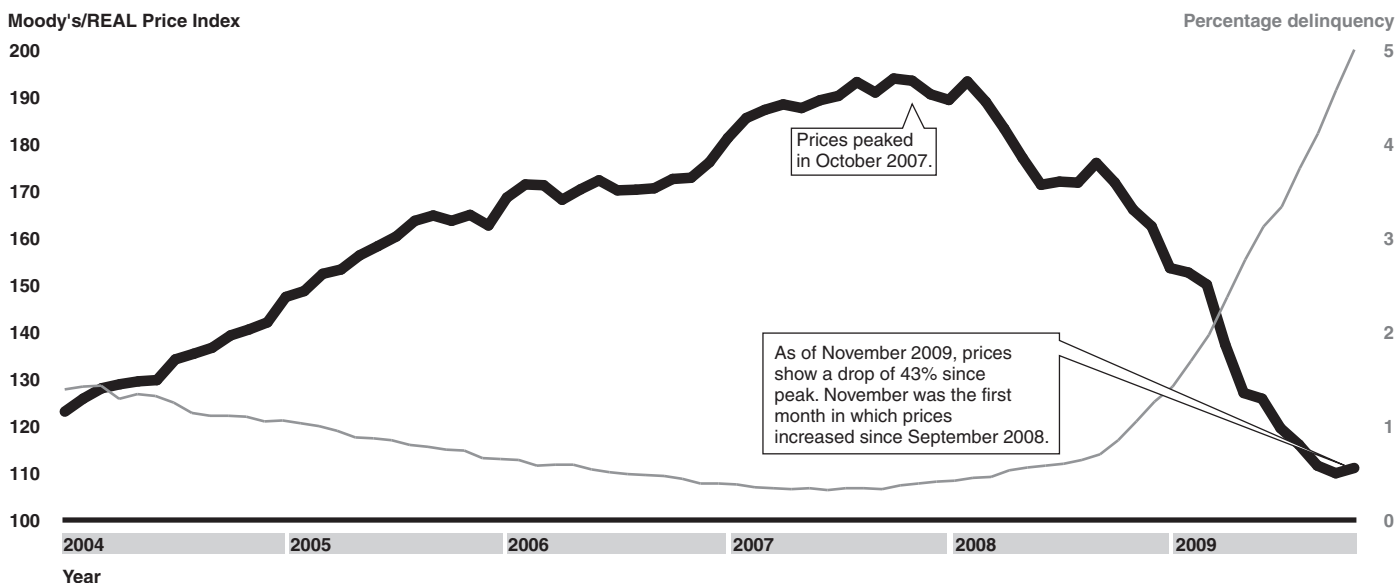
Uncertainty in the Commercial Real Estate Market Could Create the Potential for Losses if Conditions Deteriorate

While Treasury has determined that CMBS-related losses are unlikely for a number of reasons, our analysis shows that if the commercial real estate markets were to be affected similarly to real estate markets in 2008, the potential for loss exists under a worst-case scenario. Treasury and its contractor said that CMBS losses were unlikely for a number of reasons ranging from the relatively large haircuts (at least 15 percent) required on

⁴²As stated earlier, according to FRBNY officials the amount increases at approximately \$30 million per month, based on the current loan portfolio.

CMBS loans to the level of credit enhancement associated with CMBSs accepted for TALF. However, due in part to the recently weak economy, commercial real estate continues to undergo price deterioration that potentially poses risks to the TALF legacy CMBS portfolio and could lead to increased delinquencies and defaults on commercial real estate mortgages. For example, the potential risks that CMBSs pose to TALF, and thus to TARP, are underscored by the fact that 63 percent of TALF's CMBS portfolio was underwritten in 2006 and 2007, when underwriting standards were at their worst. Moreover, as figure 6 shows, commercial real estate prices have been falling since early 2008, following the deterioration in the overall U.S. economy, and shortly thereafter CMBS delinquencies began to rise sharply. The Federal Reserve and Treasury have continued to note their ongoing concerns about this segment of the market.

Figure 6: Commercial Real Estate Prices and CMBS Delinquencies from January 2004 through October 2009



Source: GAO presentation of Moody's/REAL Commercial Property Price Index and Moody's CMBS Delinquency Tracker data.

Note: Moody's/REAL Commercial Property Price Index is a report that shows the change in commercial real estate asset sales. Moody's CMBS Delinquency Tracker is a monthly report showing delinquency rates for commercial mortgage-backed securities.

In addition, prices on CMBSs experienced volatility between May 2008 and November 2009. Even the highest credit quality AAA legacy CMBSs that were used as collateral for TALF loans during the third quarter of 2009 had dropped by one third, on average, between May and November 2008 during the most severe period of the credit crisis. While prices have

recovered since the expansion of TALF to include CMBSs in the second quarter of 2009, market observers project that the sector will continue to perform poorly into 2010.

In light of the ongoing distress in the commercial real estate market, we analyzed the prices and values of 99 percent of the CMBS collateral backing loans made by FRBNY during the third quarter of 2009. We compared the prices at the time the loans were made with the lowest prices in November 2008, a period of extreme stress for CMBSs. Our analysis revealed that if legacy CMBSs accepted as TALF collateral as of September 2009 reached market values equivalent to November 2008 levels, about 88 percent of such collateral would have fallen to levels at which the TALF borrower's equity would be eliminated.⁴³ Moreover, more than \$3.5 billion owed by TALF borrowers—or about 85 percent of the total value of TALF legacy CMBS loans—would have negative equity in this scenario. This extreme market stress scenario would result in a loss in market value on the part of these TALF borrowers of nearly \$1.2 billion. The haircut investment for these borrowers totals \$665 million, providing significant economic incentive to walk away, which would result in a worst-case loss of about \$500 million for TALF.

While this worst-case scenario provides useful information for Treasury to consider as it monitors risk associated with TALF, we agree with the Federal Reserve and Treasury that there are a number of factors that affect whether such losses would be realized even in this adverse scenario. First, as discussed in the ABS analysis, the accumulated excess interest in TALF LLC would help offset potential losses. As of December 31, 2009, the fund had almost \$200 million in excess interest, which will continue to increase every month in the absence of any asset purchases. Second, the risk that all or a large portion of CMBS assets would be surrendered is significantly mitigated by an FRBNY requirement that legacy CMBSs

⁴³We compared the prices on all of the CMBS CUSIPs, with the exception of two, that were accepted by FRBNY as of September 30, 2009. For this analysis, we did not calculate the excess interest that would have accumulated in TALF LLC.

prepay a portion of any returns in excess of certain limits.⁴⁴ In short, the requirement helps ensure that the TALF borrower will retain an equity interest in the underlying CMBSs. The longer the term of the TALF loan (assuming that the underlying collateral provides a return) the more equity the borrower holds, and the less likely the borrower is to surrender the CMBS collateral. Third, as with ABSs, and as indicated by Treasury officials, TALF LLC could hold the securities acquired at a discount from par—instead of selling them—and earn interest income and the equity forfeited by the borrower as long as the underlying mortgages in the security continue to perform well. Fourth, the estimated loss represents less than 1 percent of total TALF loans as of December 2009, and total TALF CMBS loans represent about 14 percent of all TALF loans. Because CMBSs is a small portion of the portfolio, it would present a smaller proportion of total losses. However, if recent TALF borrowing trends hold, CMBS loans are likely to increase as the percentage of total TALF loans. Finally, only senior credit-enhanced tranches within each CMBS can be accepted as collateral. Thus, even if credit losses on the commercial mortgages underlying the TALF CMBS securitizations are significantly higher than currently expected in today's stressed commercial real estate environment, these senior tranches are unlikely to experience principal or interest payment interruptions. While losses associated with CMBSs currently appear unlikely, these securities warrant ongoing scrutiny because of continuing economic uncertainty and the distressed conditions in the commercial real estate market.

⁴⁴Specifically, the amount of money that FRBNY distributes to TALF borrowers that is in excess of the interest due on the TALF loan will be limited for all 5-year loans and for 3-year loans related to legacy CMBSs. In the first 3 years of a 5-year loan, the limit is 25 percent per year of the haircut amount, 10 percent in the fourth loan year, and 5 percent in the fifth loan year. Any amount above this excess is applied to the principal on the TALF loan. For 3-year loans for legacy CMBSs, the limit is 30 percent of the haircut per year. This requirement ensures that borrowers retain some amount of equity interest in the securities and reduces the likelihood of nonpayment. More details can be found on the FRBNY Web site at http://www.newyorkfed.org/markets/talf_faq.html.

Treasury Worked with the Federal Reserve and FRBNY to Analyze Risks Related to TALF but Did Not Fully Document Analysis Supporting Final Decisions

FRBNY, the Federal Reserve, and Treasury worked in a collaborative manner to design certain elements of TALF, according to these agency officials. The Federal Reserve led the initial efforts to determine collateral eligibility and Treasury recommended one asset class and assessed the risks of others. As part of this work, Treasury hired a contractor to conduct independent analyses, and the contractor raised concerns about accepting certain assets as TALF collateral, the size of the haircuts that were required, and other program terms. While Treasury officials said that the contractor's concerns were ultimately resolved, they could not provide documentation showing how Treasury resolved the contractor's concerns, or how the contractor's analysis informed Treasury's final decisions. Treasury also did not document how they reached major decisions that were made with FRBNY and the Federal Reserve. The lack of an effective process to make and document decisions may inhibit transparency and accountability of Treasury's monitoring of the \$20 billion of taxpayer funds at risk through TARP.

The Federal Reserve and Treasury Worked Together to Determine the Eligibility of Proposed TALF Collateral and Their Potential Risks

Treasury, the Federal Reserve, and FRBNY officials with whom we spoke said that the agencies have a positive working relationship when making decisions on TALF. For example, Federal Reserve and FRBNY officials said that they consulted with Treasury to select the types of ABSs to include in TALF as eligible collateral.⁴⁵ Under this process, the Federal Reserve identified all eligible collateral except SBA loan guarantees.

Treasury officials said that one asset class that FRBNY proposed—insurance premium finance loans—required additional analysis to assess the risks.⁴⁶ These loans are not as widely traded or as well understood as other asset classes. Treasury officials worked with Federal Reserve officials to better understand the asset class, including its risks and factors mitigating such risks, and its importance to small businesses. Treasury's contractor also reviewed risk information on this class of ABSs. Treasury

⁴⁵FRBNY also solicited input from market participants on asset classes that might benefit from TALF. According to FRBNY officials, this is part of its regular market monitoring function. Two of these market participants, which are also TALF agents, noted that officials from the Federal Reserve requested their feedback about TALF before the program was announced, seeking information such as how to restart securitization markets, what the latest developments were in those markets, and which asset classes should be considered.

⁴⁶Insurance premium finance loans are used to finance property and casualty insurance premiums.

and Federal Reserve officials determined that this asset class should be eligible for TALF. According to Treasury officials, other asset classes were also reviewed by both agencies and not included in the program because of their risks.

According to Treasury officials, the following criteria were used by Treasury to evaluate the eligibility of asset classes for inclusion in TALF: (1) whether including certain asset classes would have a significant or beneficial effect on the broader economy, small businesses, or consumers; and (2) whether assistance was needed because of a market failure in what were otherwise safe asset classes.⁴⁷ Based on these criteria, Treasury recommended to the Federal Reserve and FRBNY that TALF accept as collateral securities backed by SBA loan guarantees. SBA has two loan guarantee programs—section 7(a) and section 504—that support financing for small businesses.⁴⁸ Treasury requested that these securities be included because they would assist in carrying out TARP’s goals of supporting small businesses and the risks were deemed to be low because of their government guarantees.

As part of the asset class selection process, the Federal Reserve and Treasury each analyzed the potential for loss that the TALF assets presented. Treasury hired a contractor to, among other things, conduct an independent analysis of the credit and other risks of the TALF asset classes and to determine appropriate haircuts for each of the asset classes. In its initial reports to Treasury, the contractor raised some concern about accepting certain asset classes for TALF, provided suggestions for program changes, and, in a few instances, disagreed with haircuts that FRBNY suggested. According to Treasury officials and the contractor, any differences were ultimately reconciled.

⁴⁷For more information on the approved asset classes and the dates they were announced as acceptable collateral for TALF, see appendix IV and the background.

⁴⁸The 7(a) and 504 programs aim to facilitate the accessibility and affordability of financing to small businesses. Under the 7(a) program, SBA generally provides lenders with guarantees on up to 85 percent of the value of loans made to qualifying small businesses in exchange for fees to help offset the costs of the program. Under the 504 program, which generally applies to small business real estate and other fixed assets, SBA also provides certified development companies with a guarantee on up to 40 percent of the financing of the projects’ costs in exchange for fees, while the small business borrowers and other lenders provide the remaining 60 percent of the financing with no guarantee. For additional information, see GAO, *Small Business Administration’s Implementation of Administrative Provisions in the American Recovery and Reinvestment Act*, [GAO-10-507R](#) (Washington, DC: Apr. 16, 2009).

As an example, the contractor's report noted that auto floor plan ABSs faced risks because of the financial problems that the major domestic auto manufacturers faced, and the nationally recognized statistical rating organizations were in many cases unwilling to provide AAA ratings on these securities. The contractor recommended a higher haircut to encourage TALF borrowers to conduct thorough due diligence for this asset class. Treasury questioned the contractor's methodology and asked the contractor to redo its analysis of auto dealer floor plan ABSs. After working with Treasury and FRBNY to understand the differences in methodologies between its analysis and FRBNY's for this asset class, the contractor agreed with FRBNY's estimates on haircuts and even suggested a haircut lower than FRBNY's.

Treasury Did Not Fully Document Its Analysis or Basis to Support All Major Agreements with the Federal Reserve and FRBNY

Although Treasury told us what its reasons were for not accepting all of the contractor's recommendations, Treasury officials were unable to provide documentation showing when the contractor conducted the analyses or when or how Treasury made decisions based on these analyses. Further, no documentation was available showing how major differences were resolved, including those involving program terms, the eligibility of asset classes, and differences in haircut estimates among Treasury, Treasury's contractor, the Federal Reserve, and FRBNY.

Additionally, Treasury officials could not provide documentation on the rationale for major program decisions that Treasury, the Federal Reserve, and FRBNY officials reached. Treasury officials told us that FRBNY, the Federal Reserve, and Treasury had a positive working relationship when making decisions on TALF and described the process as "fluid;" therefore, there was not always documentation of discussions and final outcomes. Moreover, Treasury officials said that they spoke almost daily to Federal Reserve and FRBNY officials. In some cases, according to Treasury officials, FRBNY and the Federal Reserve consulted Treasury, although technically no consultation was required. Treasury and the Federal Reserve did not formally document their conversations, but the end result of those conversations was documented and reflected publicly on the TALF Web site administered by FRBNY.

Finally, some of the early decisions on TALF were made by Treasury officials who are no longer at the agency. Without documentation, there are no records to show, for instance, how certain suggestions made by these officials about asset classes or program terms were incorporated into policy choices for TALF.

Our *Standards for Internal Control in the Federal Government* states that internal control activities help ensure that government management directives are carried out.⁴⁹ Such activities are critical to helping ensure accountability and stewardship for government resources, and include proper documentation of major decisions. In the context of the Emergency Economic Stabilization Act of 2008—and the unprecedented size and scope of government assistance to support the financial sector—transparency and accountability are of the utmost importance. As an example, for the largest program in TARP—the Capital Purchase Program—all major decisions are recorded in meeting minutes that report who was present, what decisions were made, and when they were made.⁵⁰ In past TARP reports, we recommended that Treasury increase the transparency and accountability of TARP, in part by documenting and reporting certain processes and decisions.⁵¹

As we noted in past TARP reports, given the economic environment surrounding the creation of TARP, and subsequently TALF, during the fall of 2008, the change in administrations and the lack of staff that Treasury’s administrative office for TARP—the Office of Financial Stability—faced, Treasury may have initially had difficulty establishing its decision-making processes for TALF and recording decisions and important meetings on TALF program terms. At the time that TALF was created, the Office of Financial Stability had been in existence for barely a month, and its strategy and overall staffing needs were not yet in place. The broader context at the onset of the program—with unprecedented economic challenges and low, impermanent staffing—may help explain why such processes were not established and documented when the program was first established.

However, for TALF decision-making processes and the activities of TALF LLC to be viewed as credible, Treasury needs to ensure that it has developed an effective process to document the basis for its decisions. A year has passed since Treasury began rolling out TARP-related programs, and other larger programs—such as the Capital Purchase Program—have

⁴⁹GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00.21.3.1](#) (Washington, D.C.: November 1999).

⁵⁰See [GAO-09-161](#).

⁵¹See GAO, *Troubled Asset Relief Program: Treasury Actions Needed to Make the Home Affordable Modification Program More Transparent and Accountable*, [GAO-09-837](#) (Washington, D.C.: July 23, 2009) and [GAO-10-16](#).

established systems for documenting decisions and the rationale for decisions. But Treasury's decisions for TALF still lack a clear process for tracking how important program decisions are made and why. Without such documentation, ascertaining what information has been considered to protect TARP funds committed to TALF is difficult. Further, the lack of documentation inhibits transparency and accountability.

Treasury's and FRBNY's Indicators Suggest That Credit Market Conditions Have Shown Some Improvement, but Treasury Lacks Performance Indicators in the Event that It Must Purchase TALF Assets

FRBNY, in conjunction with Treasury, monitors TALF by tracking indicators—such as securitization volumes, changes in pricing, and TALF loan volumes—by amount and borrower type to identify any possible impact from TALF. Our analysis of these and other indicators suggests that market conditions have begun to improve for some TALF-eligible asset classes, but that others, such as CMBSSs, continue to show weakness. However, any assessment of the effectiveness of an individual program presents challenges. As we have reported, no indicator can provide a definitive measure of TALF's impact because a myriad of programs have been initiated to stabilize the markets, including actions taken under the Capital Purchase Program and the Automotive Industry Financing Program.⁵² Challenges remain for some of the TALF-eligible asset classes, and FRBNY and Treasury monitor the performance of TALF loans and collateral to be aware of all potential risks to TARP funds. However, according to Treasury officials, Treasury has not yet developed a plan for tracking assets that might be surrendered to TALF LLC or for publicly disclosing how up to \$20 billion in TARP funds would be monitored.

Treasury, FRBNY, and the Federal Reserve Collaborate on Monitoring Market Indicators

Federal Reserve and Treasury officials said that they collaborated on monitoring indicators that could help measure TALF's effectiveness in improving conditions in the securitization markets and, in turn, its impact on the availability of credit to households and small businesses. Although the officials have said they do not have specific benchmarks or targets they hope to achieve for ABS issuance volumes or volumes of TALF loans, they are monitoring those indicators. Officials also track interest spreads for TALF-eligible asset classes, the number of borrowers accessing the facility, and information about TALF borrowers, such as investor type. FRBNY collects data on these indicators to monitor TALF's impact. According to Treasury officials, they review FRBNY's metrics related to

⁵²See [GAO-10-16](#) and GAO, *Auto Industry: Summary of Government Efforts and Automakers' Restructuring to Date*, [GAO-09-553](#) (Washington, DC: Apr. 23, 2009).

TALF, including cash flows from TALF loans that it receives monthly from FRBNY, and speak daily with FRBNY officials.

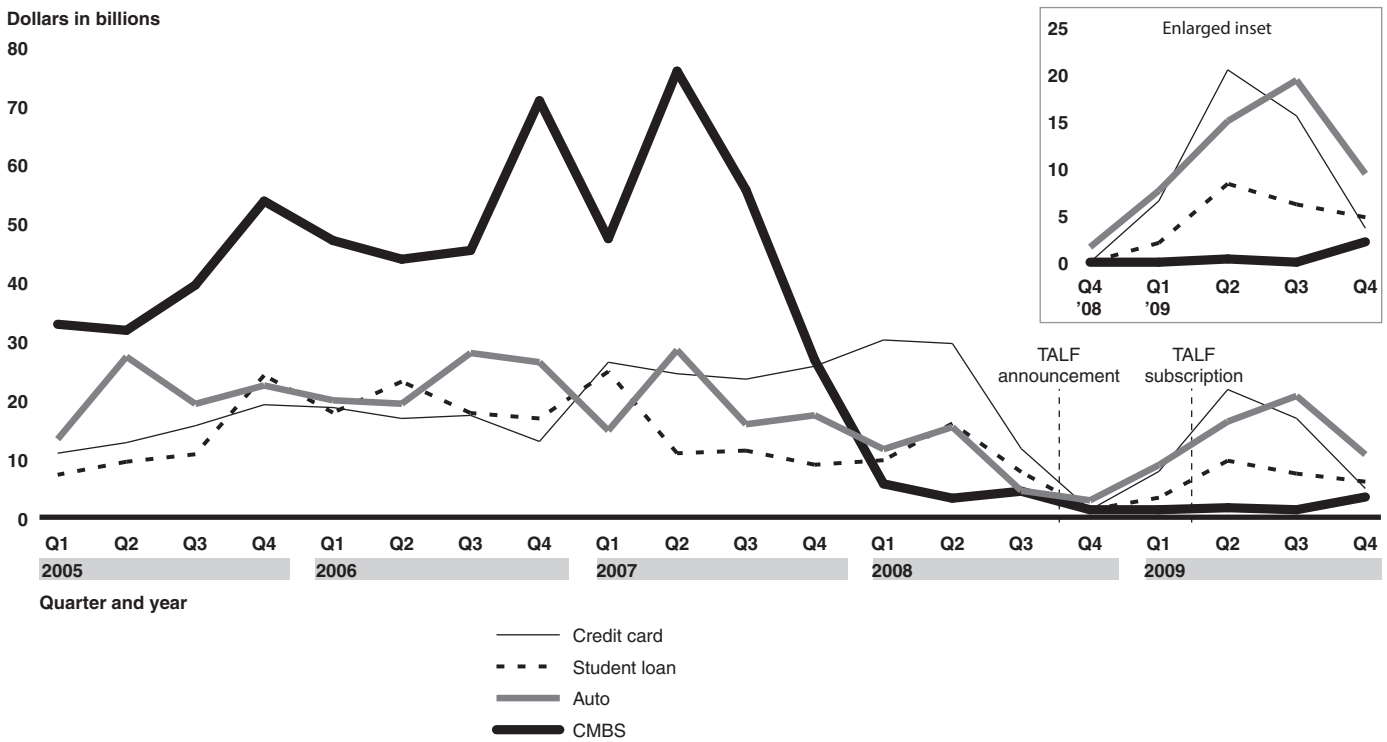
New Issuances in Various Asset Classes Increased after TALF's First Subscription in March 2009

To determine the condition of the securitization markets, we also have been monitoring similar indicators, such as new ABS issuances and changes in interest rates, types of investors, and spreads—using data from before and after TALF's implementation.⁵³ In general, data from the indicators that we have collected show increases in securitization volumes, little change in the cost of credit, and declines in perceptions of risk in certain asset classes since TALF began. ABS issuances in all of the most liquid TALF-eligible sectors dropped sharply in 2008 from their peak levels in 2006 and 2007. As figure 7 indicates, new issuance of ABSs had come to a virtual halt in 2008, significantly reducing a major source of credit for consumers and businesses.⁵⁴ While securitization volumes increased since the end of 2008, these increases have not been sustained throughout 2009.

⁵³In this instance, spread refers to the difference between a security's yield and a benchmark yield. For ABSs, the customary benchmark yield is interest rate swap yields. Interest rate swaps are contracts in which one party agrees to pay a fixed interest rate to another party in exchange for a floating rate.

⁵⁴We focused on auto, credit card, and student loan ABSs and CMBSs because these asset classes represent the largest sectors of the securitization markets and, in the case of CMBSs, experienced the greatest levels of disruption that could be measured.

Figure 7: Fluctuations in ABS Issuances, First Quarter 2005 through Fourth Quarter 2009



After having shown little activity since the last quarter of 2008, issuance of credit card, auto, and student loan ABSs increased after the initial TALF subscription in March 2009 (shown as first quarter 2009 in figure 7). The majority of ABS issuances in the credit card and auto sectors have been supported by TALF loans. Specifically, of the \$46 billion in ABSs issued on credit card debt in 2009, \$29.7 billion, or about 65 percent, have been eligible for TALF financing. Similarly, about 88 percent—or \$44.9 billion—of the \$51.2 billion in ABSs issued on auto loans in 2009 were TALF-eligible deals. For more detailed information on securitization volumes, see appendix VII.

By the third quarter of 2009, credit card and student loan issuances had declined again in dollar terms, while auto issuances continued to increase. A number of factors—such as the combined effects of the numerous stimulus programs, changes in consumer demand for credit, and investor willingness to invest—also may have contributed to the trend in securitization volumes in these sectors. Federal Reserve officials

suggested that some companies may have been hesitant to issue credit card ABSs because of uncertainty regarding the continued availability of the FDIC's "Safe Harbor" rule in light of new accounting rules effective for annual financial periods beginning after November 15, 2009.⁵⁵

Figure 7 also shows that CMBS securitization volumes peaked in mid-2007 and dropped significantly in late 2007 and early 2008 before coming to a complete halt by the end of 2008. CMBS volumes did not pick up again until the second quarter of 2009, but those were the result of repackaging existing securitizations rather than new CMBS issuances. FRBNY officials noted that the first new CMBS deal to come to the market since summer 2008 was a TALF-eligible, single-issuer deal in the fourth quarter. CMBS issuances have remained relatively flat nonetheless, and it is unclear if they will increase in the future. According to FRBNY and Treasury officials, one possible reason for the small CMBS issuance volumes could be that the time it takes to complete a CMBS deal is often longer than for other asset classes.

⁵⁵The Federal Deposit Insurance Corporation (FDIC) Rule 360.6 provides that the FDIC will not use its statutory authority as conservator or receiver to disaffirm or repudiate certain contracts pertaining to any financial assets transferred by an insured depository institution to a special purpose entity in connection with a securitization or participation, provided that such transfer satisfies all conditions for sales accounting treatment under generally accepted accounting principles (GAAP). For most insured depository institutions, the 2009 GAAP modifications will be effective for reporting periods after January 1, 2010. However, in November 2009, FDIC amended Rule 360.6 to extend the safe harbor to assets transferred in connection with securitizations completed prior to March 31, 2010, so long as those securitizations complied with the accounting rules as they existed prior to the 2009 GAAP modifications. See, "Defining Safe Harbor Protection for Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation," 74 Fed. Reg. 59066 (Nov. 17, 2009) (interim rule and request for comments).

Interest Rates in Most Asset Classes Have Generally Not Decreased Since TALF Was Announced

One of TALF's goals is to increase the availability of credit to consumers and businesses. TALF assistance to the securitization markets is intended to result in lower loan rates and increased credit availability to businesses and individual consumers, including the auto loan, credit card, and student loan sectors that account for the majority of securitizations.⁵⁶ Recent increased activity in the securitization markets has been accompanied by a substantial decrease in interest rates for loans originated by auto finance companies. However, there have been few changes in credit card rates or interest rates for consumers in auto loans originated by commercial banks. Consumer interest rates remain flat.

Because auto finance companies rely more heavily on securitizations for funding than commercial banks, the effects of positive changes in the securitization markets are more likely to be reflected in their loan rates than in those of commercial banks. As figure 8 shows, auto loan rates offered by commercial banks remained fairly steady before and after the implementation of TALF. The average finance company auto rate has been consistently below commercial bank auto rates, with the exception of the fourth quarter of 2008, perhaps reflecting the financial challenges facing the auto industry at that time.⁵⁷ Since then, rates at auto finance companies have declined from an average of 7 percent to approximately 3 percent. This reduction coincides with the launching of TALF but may also reflect assistance from the numerous government stimulus programs, especially those focused on the auto industry. While fixed credit card rates have remained fairly flat in recent years, variable credit card rates have increased by approximately one percent since TALF's inception. FRBNY officials attributed the elevated credit card rates to increased charge-offs, which have raised companies' costs of funds. These rate changes could also be the result of credit card companies' efforts to anticipate the implementation of the remaining part of the Credit Card Accountability

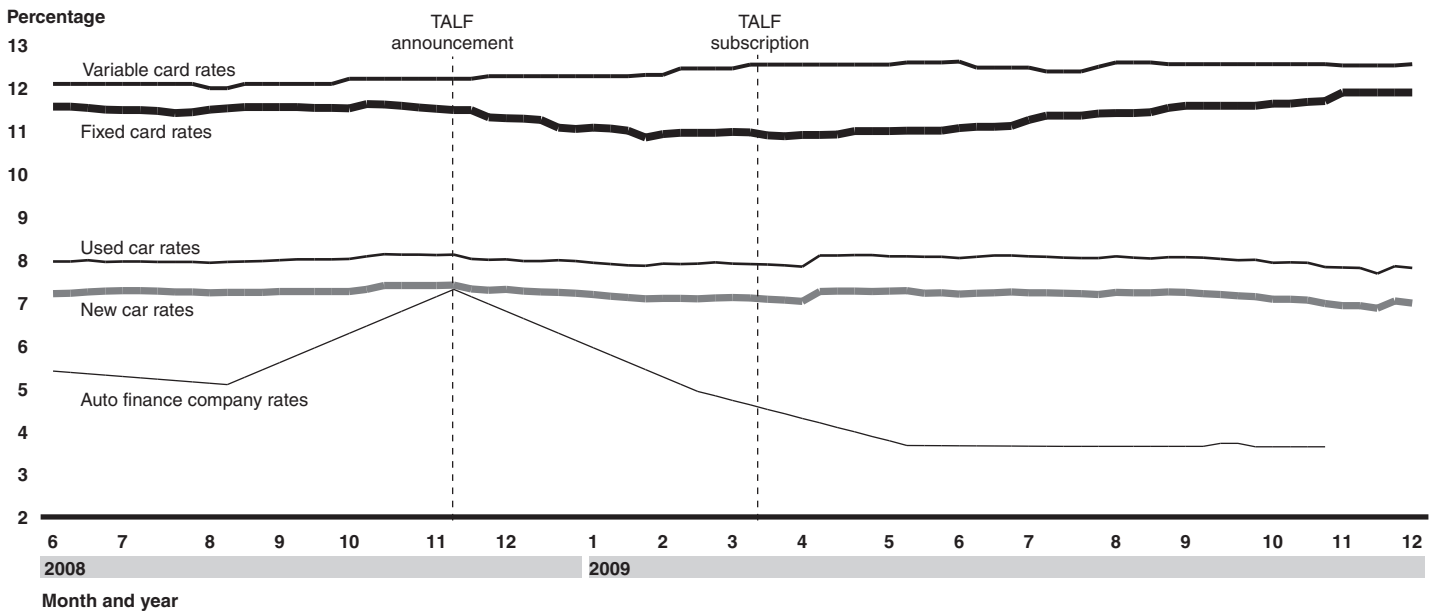
⁵⁶Auto finance companies such as Ford Motor Credit Company, GMAC, and Chrysler Financial provide financing for consumer automotive and dealer purchases. We focused on interest rates for credit cards and automotive loans and did not evaluate changes in interest rates for student loans because reliable and consistent data were unavailable for private student loans. We also did not evaluate changes in interest rates for commercial mortgages, because these rates depend on factors such as geographic location and property type, making it difficult to draw broad conclusions about interest rate trends.

⁵⁷See [GAO-09-553](#).

Responsibility and Disclosure Act of 2009, which will take effect in February 2010.⁵⁸

FRBNY officials said that it is possible that without TALF interest rates on loans to consumers and small businesses would be much higher than they are now. Issuers of TALF-eligible ABSs have told FRBNY that without TALF they would have made fewer loans and those loans would have been at higher rates. Data on private student loan rates are difficult to obtain, but FRBNY officials said that Sallie Mae has reduced its rates on private student loans over the past few months.

Figure 8: Trends in Average Finance Rates for Credit Cards, Auto Loans at Banks, and Auto Finance Companies, June 2008 through December 2009



Source: Bankrate.com and the Federal Reserve.

Note: Auto finance company rates from the Federal Reserve are only available through October 31, 2009.

⁵⁸Provisions in the law will limit credit card companies' ability to increase interest rates, among other things, so some companies have raised interest rates in anticipation of the law taking effect. See GAO, *Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, But Options for Reducing Fees Pose Challenges*, GAO-10-45 (Washington, DC: Nov. 19, 2009).

TALF Loan Volumes and the Composition of TALF Participants Have Changed since the Program Began

As illustrated in table 3, the volume of TALF loans made since the inception of the program has fluctuated by month, with loan volumes peaking in May 2009 and June 2009. As of December 31, 2009, a total of \$61.6 billion in TALF loans had been granted; however, the balance of loans outstanding at that date was \$47.5 billion due to loan prepayments and principal paydowns. As we reported previously, agency officials indicated that improvements in securitization and loan markets had made issuers less dependent on TALF support.⁵⁹ However, according to FRBNY officials, other issuers remain more heavily dependent on investor access to TALF financing. FRBNY officials noted that there have been a number of prepayments, and market participants also told us that financing under TALF was now less favorable because better financing terms could be found in the private sector for certain asset classes. Notably, the first and only subscription for new-issue CMBSs occurred in November 2009. FRBNY and Treasury officials stated that the slow new-issue CMBS activity may be due to the length of time it takes to complete a deal.

Table 3: TALF Loans Disbursed by Asset Class, March 2009 through December 2009

Dollars in millions

Asset class	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total by loan type
Auto	\$1,909	\$797	\$2,311	\$2,946	\$2,831	\$555	\$1,160	\$191	\$0	\$0	\$12,699
Credit card	2,804	891	5,515	6,023	1,459	2,554	4,399	224	63	1,529	25,461
Equipment	0	0	446	590	0	0	111	39	57	199	1,441
Floor plan	0	0	0	0	0	1,005	0	887	445	172	2,510
Insurance premium finance	–	–	–	464	0	0	530	0	0	0	994
Servicing advances	0	0	0	439	34	108	0	475	0	138	1,193
Student loan	0	0	2,281	227	987	2,445	177	288	85	665	7,155
Small business	0	0	87	29	62	147	162	262	409	275	1,433
Legacy CMBSs	–	–	–	0	636	2148	1,351	1,931	1,330	1,282	8,677
New-issue CMBSs	–	–	–	0	0	0	0	0	72	0	72
Total	\$4,713	\$1,688	\$10,639	\$10,717	\$6,009	\$8,962	\$7,890	\$4,297	\$2,461	\$4,259	\$61,636

Source: GAO analysis of FRBNY data.

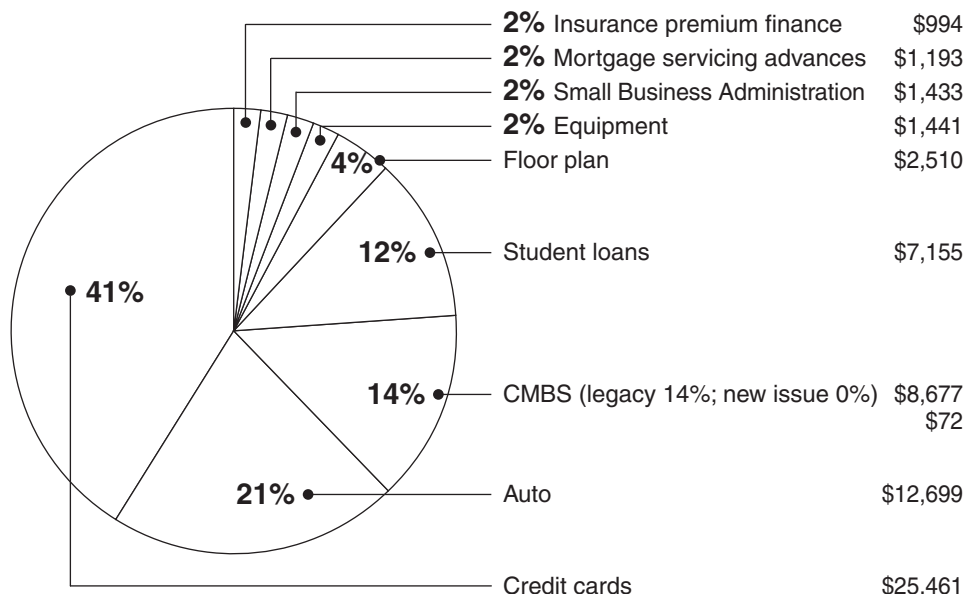
⁵⁹See [GAO-10-16](#).

Note: Not all numbers will total due to rounding. Until September 2009 the FRBNY's Web site showed only TALF loans requested, not loans disbursed. FRBNY provided us with data prior to September 2009. In addition, in discussions with FRBNY we learned that the program changed in April 2009 to allow for new interest rates on loans secured by ABSs with weighted average lives to maturity of less than 2 years had resulted in the refinancing of some existing TALF loans. As a result, May 2009 figures may include double counting due to this refinancing.

As shown in figure 9, approximately 75 percent of TALF loans involved the purchase of ABSs backed by auto loans and leases, credit card receivables, and student loans. This activity reflects the historical trends in auto, credit card, and student loan securitizations, which represent the majority of the ABS markets.

Figure 9: Composition of TALF Loans Disbursed by Asset Class as of December 2009

(Dollars in millions)



Source: GAO analysis of FRBNY data.

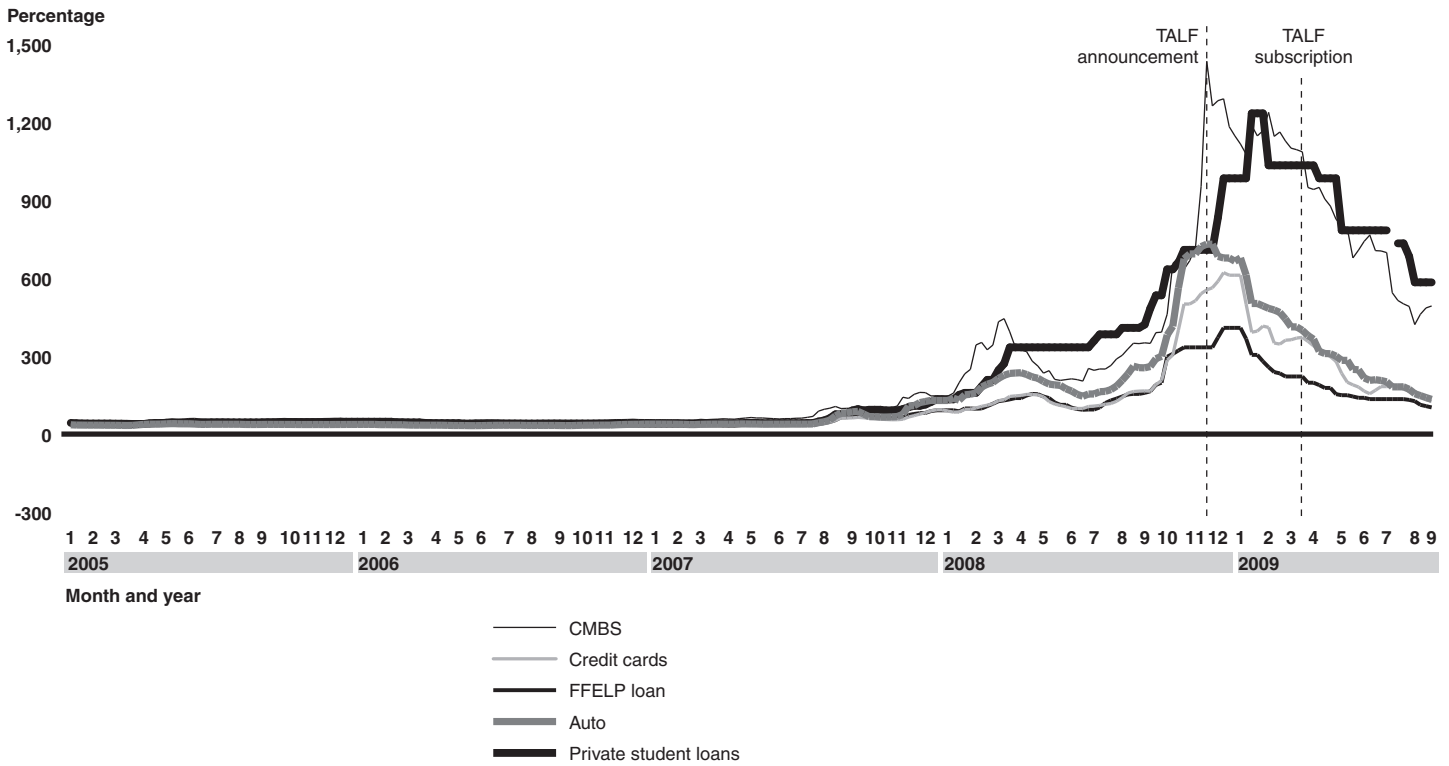
According to Treasury and Federal Reserve officials, TALF was designed to encourage broader investor participation in the securitization markets, with the goal of reviving consumer lending. These officials noted that the securitization markets stopped functioning in 2008 when many investors stopped purchasing these securities. The lack of securitization market activity disrupted a significant source of funding for businesses and consumers. Gradually, some of these investors have returned to the markets, but at a slower rate than during past market downturns. Specifically, Treasury officials noted increasing participation in TALF

securitization by asset managers, hedge funds, and traditional institutional investors such as pension funds and insurance companies. They consider the return of investors to the securitization markets to be a measure of the program's success. Hedge funds traditionally have not invested in ABSs because of the low returns relative to other opportunities. However, FRBNY officials believe the access to low-cost financing through TALF made ABS returns attractive to hedge funds. FRBNY also noted participation by private investors and banks.

Differences in Prices and Benchmarks Have Decreased for Most TALF-Eligible ABS Collateral

As we have discussed, one method of measuring market participants' perceived risk of a security is to compare the difference between the security's yield and a benchmark yield. The difference is called a spread, and wide spreads, or large differences, generally indicate that participants perceive high risk in the market that requires a high rate of return. As perceived risk declines, differences in such prices decrease, or narrow. During the fourth quarter of 2008 and first quarter of 2009, spreads likely reflected high expected costs of selling securities prior to their maturity, which contributed to low desirability for those securities. Figure 10 shows the change in spreads in the following TALF-eligible asset classes: auto loan, credit card, student loan, and CMBS. A trend of widening spreads in these asset classes began in mid-2007, indicating negative perceptions about risk. Although there were fluctuations throughout 2008, spreads began to narrow in early 2009, indicating a perceived decline in risk by market participants and potentially improved credit market conditions.

Figure 10: Trends for AAA ABS and CMBS Spreads from January 2005 through September 2009



Source: GAO analysis of spread data from multiple banks.

Treasury Reviews TALF-Related Data from FRBNY's Indicators but Has Not Developed Indicators to Collect and Disclose Data on Future TALF LLC Assets

Treasury reviews the data that FRBNY collects on TALF loan volumes and borrowers by type, securitization volumes, and changes in pricing. Treasury officials noted that personnel at both agencies were responsible for a variety of tasks in tracking TALF-related metrics. We found that Federal Reserve officials, particularly at FRBNY, typically took the lead in collecting data and calculating metrics. We also found that Treasury officials did not have a plan to collect and analyze information related to assets that might be placed in TALF LLC—assets to which Treasury would have an exposure. Such information might include the purchase and sale price of the assets, their current market value, total outstanding loans by Treasury to TALF LLC for the ABS purchases, and the rationale behind TALF LLC's possible future sale of assets. Treasury has not yet developed such a plan because no TALF collateral has been surrendered thus far, and Treasury believes it is unlikely that it will have to use TARP funds to finance TALF LLC's purchase of surrendered collateral. Moreover, Treasury does not have a plan to publicly communicate such information

in the event that collateral is surrendered and placed there. In previous TARP reports and in this report, we have discussed the importance of improving the transparency and accountability of TARP programs. We have also recommended that Treasury build on existing oversight procedures to better monitor and report on the use of TARP funds and to better quantify program results.

Although Treasury is not responsible for implementing or administering TALF, it has pledged support to TALF LLC with the first \$20 billion of potential loans to allow it to purchase surrendered TALF collateral. As discussed earlier, commercial real estate continues to show weakness and could potentially pose greater risks to TARP funds. Without a system for tracking and reporting on any potential assets such as CMBSs that are surrendered to TALF LLC, Treasury cannot assure transparent management of these assets or determine if it is achieving its goals under CBLI with respect to the use of TARP funds for TALF-related activities. Further, without properly planning for its role in managing the collateral should they have to be purchased by TALF LLC, Treasury may not be able to effectively assess any risks associated with such assets or exercise appropriately its decision-making responsibilities regarding the potential sale of any assets.

Conclusions

TALF is one of several programs created by the Federal Reserve to help address the recent crisis in the financial sector. Specifically, this program was designed to restart securitization markets, a critical part of financial markets. Given the myriad of programs initiated to stabilize the financial system and increase credit availability, it is difficult to attribute improvement in markets to any one program. Nevertheless, according to a variety of indicators, TALF appears to be contributing to measured improvements in the securitization markets. As of December 31, 2009, \$61.6 billion in loans were made through TALF and TALF LLC had received \$100 million of the \$20 billion in TARP funds committed to the program. In addition to the \$20 billion, funds provided by FRBNY to operate TALF could expose additional risks. However, because we are statutorily prohibited from auditing the Federal Reserve's monetary policy activities, we believe our ability to completely assess and report on taxpayers' exposure to the entire program or the Federal Reserve's management of the program is limited.

Although the government has taken a number of steps to mitigate the risk of loss from TALF, in the long term risks remain. For example, while analyses by the Federal Reserve and a Treasury contractor that were

based on predictions of market performance and other factors estimated that a loss of a substantial portion of the \$20 billion TARP commitment would be unlikely based on current conditions in the securitization markets, we found that until the TALF borrowers repay their loans, TALF still presents risks. While we acknowledge that overall market conditions have generally improved since 2008, some asset classes—specifically CMBS—are still performing poorly and may continue to perform badly for the foreseeable future. Moreover, markets remain fragile and predicting how the overall ABS markets will perform in the future and how borrowers might respond to new declines in the markets is difficult. A return to 2008 conditions could have adverse impacts on the program, such as significantly reducing the value of TALF collateral, providing an economic incentive for borrowers to walk away from their loans, and requiring TARP funds be used to buy TALF collateral. However, several TALF program features make this less likely.

Treasury, which worked with FRBNY and the Federal Reserve on certain decisions related to TALF, was not able to provide documentation on how these decisions were made. As we noted in past TARP reports, Treasury has yet to develop systems to ensure the transparency and accountability for TARP activities by implementing a strong, transparent strategic framework with appropriate oversight mechanisms. Among other things, these mechanisms would ensure accountability by tracking why decisions are made, and whether goals are being achieved. Documenting the basis for decisions is an important part of the decision-making process. Moreover, documenting the rationale for major program decisions would help ensure that the program objectives are being met and that it is functioning as intended. Unless Treasury documents the rationale for major program decisions that it made with the Federal Reserve, it cannot demonstrate accountability for meeting the goals of TALF and could unnecessarily place TARP funds at risk.

Believing it is highly unlikely that it will have to use TARP funds to finance ABS purchases by TALF LLC, Treasury has not taken steps to develop a set of metrics or a plan for tracking and reporting on the performance of the collateral that could be placed in TALF LLC. While TARP funds may never be used to finance purchases of ABS or CMBS used as TALF collateral, Treasury should at least be prepared for the possibility. Without a plan for collecting and analyzing such data, Treasury would have to develop one as it is financing or after it has financed collateral purchases by TALF LLC and risks being ill prepared to make informed decisions on whether TALF LLC should keep collateral until the securities mature or sell them. Unlike many other programs that were developed and

implemented in the midst of the crisis, Treasury has an opportunity to be strategic by developing a plan in the event that its role in TALF is triggered. In addition, without a plan Treasury cannot measure TALF's success in meeting its goals under CBLI with respect to any assets that are placed in TALF LLC. Finally, without a plan for communicating the findings that result from tracking and analyzing such metrics, the public will not be aware of how the assets are managed and financed, undermining Treasury's efforts to be fully transparent about TARP activities.

Matter for Congressional Consideration

To enable GAO to audit TARP support for TALF most effectively, we recommend that Congress provide GAO with audit authority over all Federal Reserve operational and administrative actions taken with respect to TALF, together with appropriate access authority.

Recommendations for Executive Action

To improve transparency of decision making on the use of TARP funds for TALF and to ensure adequate monitoring of risks related to TALF collateral, we recommend that the Secretary of the Treasury direct the Office of Financial Stability to take the following actions:

1. Given the distressed conditions in the commercial real estate market, as part of its ongoing monitoring of TALF collateral, continue to give greater attention to reviewing risks posed by CMBSs.
2. Strengthen the process for making major program decisions for TALF and document how it arrives at final decisions with the Federal Reserve and FRBNY. Such decisions should include how Treasury considers expert and contractor recommendations and resolves those recommendations that differ from those of the Federal Reserve and FRBNY.
3. Conduct a review of what data to track and metrics to disclose to the public in the event that TALF LLC purchases surrendered assets from FRBNY. Such data and metrics should relate to the purchase, management, and sale of assets in TALF LLC that potentially impact TARP funds. Metrics related to TALF LLC could include periodic reports on the date and purchase price of assets; fluctuations in the market value of assets held; the date, price, and rationale when assets are sold; and the total amount of loans outstanding to Treasury.

Agency Comments and Our Evaluation

We provided a draft of this report to Treasury for its review and comment. We also provided the draft report to the Federal Reserve to verify the factual information they provided to us about TALF. Treasury and the Federal Reserve provided written comments that we have reprinted in appendixes VIII and IX, respectively. Treasury and the Federal Reserve also provided technical comments that we have incorporated as appropriate.

In their response Treasury welcomed our recognition that TALF contributed to improvements in the securitization markets but believed that the draft report understated the success of the program. In so doing Treasury reiterated several points that were already underscored in the draft report. For example, as discussed in the draft report and Treasury's response, we acknowledged that securitization volumes in markets had come to a complete halt in 2008, but increased after TALF's first subscription in March 2009. Moreover, we also noted that recent TALF subscription levels for the majority of eligible asset classes have tapered off, which is an indication that investors' perception of risk has decreased. As we have noted in our previous TARP reports, any assessment of the effectiveness of TALF is complicated by the fact that a variety of programs have been established by the Federal Reserve, Treasury, and others to stabilize the markets—making it virtually impossible to definitively single out and measure TALF's impact.

Treasury also stated that it disagreed with our methodology related to potential losses for CMBSs. As we discussed in the report, the adverse scenario analysis of the TALF CMBS portfolio was not intended to project an expected loss amount for this portfolio but to help assess the possible range of losses in TALF. We used a stress scenario and selected loss assumptions that were similar to those the Federal Reserve imposed on the 19 bank holding companies that participated in the 2009 stress test. Treasury states that it would take a 65 percent loss on underlying commercial real estate prices to experience losses. While we agree that this is an unlikely event, commercial real estate prices have already fallen by an average of 43 percent since prices peaked. Combined with the fact that CMBSs have much longer time horizons than other TALF ABS asset classes and hence greater uncertainty of outcomes, we continue to believe that CMBS warrants ongoing attention.

Treasury also noted that it appreciates the recommendations GAO makes in the report to strengthen the documentation of decisions Treasury made concerning changes to the program. Treasury stated it is committed to ensuring that not only TALF, but TARP as a whole, is administered in a way that protects the taxpayer. We believe that development of a sound

decision-making process that includes steps for formal approval and documentation of the basis of the final decisions at an appropriate management level will improve transparency and accountability of the TALF program. As we noted in past TARP reports and most recently in the October 2009 report, Treasury has yet to develop systems to ensure the transparency and accountability for TARP activities by implementing a strong, transparent strategic framework with the appropriate oversight mechanisms. Among other things, these mechanisms would ensure accountability by tracking why decisions are made and whether goals are being achieved.

Finally, regarding our recommendation that Treasury review what data to track and metrics to disclose to the public in the event that TALF LLC purchases surrendered assets from FRBNY, Treasury noted that it will continue to enhance its existing reporting on its investments in TALF that strikes an appropriate balance between its goal of transparency and the need to avoid compromising either the competitive positions of investors or Treasury's ability to recover funds for taxpayers. We believe that having a plan in place for tracking and reporting on the performance of any collateral that could be placed in TALF LLC will help Treasury strike that balance.

In its comments, the Federal Reserve did not agree with our recommendation that Congress consider providing GAO with authority to audit the Federal Reserve's TALF operational and administrative actions because it disagreed that there are limitations on GAO's authority to audit these Federal Reserve activities. The Federal Reserve also noted that it fully cooperated in GAO's conduct of this audit and provided us access to records and personnel.

The Federal Reserve did cooperate and voluntarily provided all access we requested in this audit of Treasury. We appreciate this cooperation, which enabled us to factually describe the TALF program and to evaluate Treasury's involvement in it. However, we believe the express statutory prohibition in 31 U.S.C. § 714(b) on GAO auditing the Federal Reserve's monetary policy and discount window activities, which the Federal Reserve believes include TALF's operation and administration, prohibits us from auditing the Federal Reserve's TALF activities, even from the perspective of TARP. We limited the scope and conduct of this audit accordingly, and thus did not request access to information to audit the

Federal Reserve's performance of these activities.⁶⁰ Further, the Federal Reserve's decision to voluntarily provide requested access in this instance, while helpful, does not create GAO authority for access to information the agency may not volunteer, nor GAO authority to audit the Federal Reserve's TALF operational activities or other performance. In our view, our lack of authority to audit the Federal Reserve's actions limited our ability to fully assess the risk to taxpayer funds presented by TALF. Accordingly, we continue to believe that Congress should provide GAO with authority to audit the Federal Reserve's operation and administration of the TALF program. Our detailed response to the Federal Reserve's comments on these issues is contained in appendix X.

We are sending copies of this report to the Congressional Oversight Panel, Financial Stability Oversight Board, Special Inspector General for TARP, 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>.

⁶⁰A performance audit of the Federal Reserve's TALF operational and administrative activities would, for example, have involved evaluating the sufficiency of how certain TALF program terms were arrived at, such as whether the haircuts or the amount of equity the TALF borrower holds in the collateral protected TALF from losses. We also would have evaluated FRBNY's system of internal controls and the role of TALF participants in certifying and validating compliance with certain program requirements. In addition, we would have interviewed some of the entities that helped administer TALF to validate agency information and to better understand their roles and interactions with the Federal Reserve and FRBNY. These would have included entities such as the TALF agents, Bank of New York Mellon, Trepp, or CW Capital.

If you or your staffs have any questions about this report, please contact Orice Williams Brown at williamso@gao.gov or (202) 512-8678. 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 XI.

A handwritten signature in black ink that reads "Gene L. Dodaro". The signature is written in a cursive style with a long horizontal flourish extending to the right.

Gene L. Dodaro
Acting Comptroller General
of the United States

List of Committees

The Honorable Daniel K. Inouye
Chairman
The Honorable Thad Cochran
Vice Chairman
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

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 Dave Camp
Ranking Member
Committee on Ways and Means
House of Representatives

Appendix I: Objectives, Scope, and Methodology

The objectives of this report are to (1) analyze the risks that the Term Asset-Backed Securities Loan Facility (TALF) presents to Troubled Asset Relief Program (TARP) funds and therefore to taxpayers, (2) evaluate how the Department of the Treasury (Treasury) analyzed the risk of TALF assets and used this information in making decisions on TALF with the Board of Governors of the Federal Reserve System (Federal Reserve) and the Federal Reserve Bank of New York (FRBNY), and (3) assess the condition of securitization and credit markets before and after TALF's implementation based on indicators tracked by Treasury and FRBNY.

GAO has statutory limitations on auditing certain functions of the Federal Reserve.¹ Because of these limitations, the evaluative content of this report is limited to Treasury's role of safeguarding TARP funds related to TALF and we did not review or evaluate any monetary policy actions taken by the Federal Reserve or FRBNY with respect to TALF. We collected information on Federal Reserve practices related to TALF, but did not audit those practices. Specifically, we did not evaluate the sufficiency of how certain TALF program terms, such as haircuts and interest rates, were arrived at.² In addition, we did not assess FRBNY's system of internal control or the role of TALF participants such as agents, borrowers, and auditors in certifying and validating compliance with certain TALF terms. Finally, we did not validate the comments or background information provided to us by Federal Reserve and FRBNY officials about TALF.

¹Section 714 of Title 31 of the U.S. Code limits GAO's authority to audit certain Federal Reserve activities. Specifically, GAO audits of the Federal Reserve and Federal Reserve banks "may not include deliberations, decisions, or actions on monetary policy matters, including discount window operations, reserves of member banks, securities credit, interest on deposits and open market operations. . . , or transactions made under the direction of the Federal Open Market Committee" 31 U.S.C. § 714 (b)(2)-(3). This prohibition limits GAO's ability to audit the Federal Reserve's actions taken with respect to TALF. The Helping Families Save Their Homes Act of 2009, enacted on May 20, 2009, amended Section 714 to provide GAO authority to audit Federal Reserve Board actions taken under Section 13(3) of the Federal Reserve Act with respect to a single and specific partnership or corporation. See Pub. L. No. 111-22, 123 Stat. 1632, 1662-63. Among other things, this amendment provides GAO with authority to audit Federal Reserve actions taken with respect to three entities also assisted under TARP—Citigroup, Inc., American International Group, Inc., and Bank of America Corporation—but does not provide GAO with authority to audit Federal Reserve monetary policy actions taken with respect to TALF generally.

²Haircuts set the amount of equity the TALF borrower holds in the collateral and is a percentage assigned by the FRBNY. Haircuts vary by FRBNY's assessment of market risks for each sector and subsector.

To address the first objective, we first reviewed publicly available documentation on the Web sites of the Federal Reserve and FRBNY. We also interviewed Treasury, FRBNY, and Federal Reserve officials to understand how TALF fits in to Treasury’s Financial Stability Plan and how risks to the taxpayer were reduced in TALF’s design. Next, we assessed how Treasury reviewed the risks of the various asset classes considered for TALF eligibility by collecting and analyzing reports that Treasury requested through a contractor, Bank of New York Mellon, which in turn subcontracted the work to NSM Structured Credit Solutions, which has since been acquired and is now known as RangeMark. We also reviewed the subcontractor’s methodology for assessing the likelihood of loss to TARP funds and interviewed the subcontractor, contractor, and Treasury officials about the assumptions in the loss model. We also reviewed other factors that have an impact on the risk to TARP funds and taxpayers, including the return on equity for TALF borrowers, credit enhancement of TALF securities, and the risks of asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS).

- To assess the changes in return on equity (ROE), we analyzed the returns based on information collected from prospectuses for TALF-eligible ABSs on credit cards, auto loans, auto leases, and private student loans issued between March and September 2009. Some of these prospectuses were provided by the Federal Reserve. We also used information collected from reports from Moody’s Investors Service and Standard & Poor’s. We calculated returns for fixed-rate bonds by using the tranche-level³ interest rate paid to the FRBNY. For floating-rate bonds, we used a spread between the interest rate paid to the FRBNY and an index, such as the London Interbank Offered Rate. This is the “coupon” variable in the equation below:

$$\text{ROE} = \frac{\text{Coupon} - (1 - \text{Haircut\%}) * \text{Rate_on_loan_paid_to_FRBNY}}{\text{Haircut\%}}$$

- To assess the levels of credit enhancement for TALF securities, we analyzed information collected from prospectuses related to public and private offerings of TALF-eligible securities issued between March and September 2009, along with related reports from Standard & Poor’s and

³Some securitizations—such as ABSs backed by auto loans—are divided into different segments, or tranches. A tranche is a piece of a securitization that has specified risks and returns.

Moody's Investors Service. For each security, we compared the level of credit enhancement for the TALF issuance with that issuer's most recent securitization prior to TALF, which ranged from 2004 through 2008.

- To understand the recent activity in CMBS markets, we collected information from Moody's Investors Service on commercial real estate prices (Moody's/REAL Commercial Property Price Index) and on CMBS delinquency (Moody's CMBS Delinquency Tracker). We determined that the data was reliable for our purposes of demonstrating recent trends in the commercial mortgage sector. In addition, we collected CMBS price performance data from Thomson Reuters DataScope and determined that the information on the price, yield, and performance of securities was reliable for our purposes of understanding trends in CMBS prices and vintages for the TALF portfolio.
- We interviewed a range of market participants and market observers about the taxpayer protections and other features of TALF, to include three dealers that also serve as TALF agents; three issuers (one for credit cards, one for auto loans, and one for student loans) and an SBA securities dealer; three industry associations representing the CMBS market, the hedge fund industry, and small and regional banks; a buy-side investment firm with interest in TALF; two large auditing firms that provide auditor attestations for TALF; an attorney with securitization market expertise; two TALF-qualified credit rating agencies, or nationally recognized statistical rating organizations; an academic in banking and securitization at the Massachusetts Institute of Technology; an analyst from Brookings Institution; an analyst from a student loan firm; and a representative of a consumer advocacy organization.
- For details on our methodology for assessing adverse scenario losses from TALF ABSs and CMBSs, see appendix II.

To address the second objective on Treasury's analysis of the risk associated with TALF assets and how that analysis was used to make decisions with the Federal Reserve and FRBNY related to TALF, we analyzed reports from a subcontractor with Treasury—NSM Structured Credit Solutions—that provided assessments of various risks of TALF to TARP funds. In analyzing these reports, we reviewed the asset class risk assessments, the recommendations made to change TALF program terms, and the suggested haircuts for each asset class. We also interviewed Treasury's contractor and the subcontractor for clarification on the reports and to understand Treasury's interaction with both. In addition, we interviewed Treasury officials about their role in reviewing and shaping the terms of TALF, how they considered the analysis and

recommendations of the subcontractor, how they decided to include certain asset classes, and how they came to agree on haircuts and other program terms with the FRBNY and Federal Reserve. We also interviewed officials from FRBNY and the Federal Reserve about the reasons for differences in haircuts and other TALF program terms and how they were resolved with Treasury and the subcontractor.

To address the third objective on changes in the securitization and credit markets before and after TALF was created, and to understand how Treasury tracks the impact of TALF and its potential risks to TARP funds, we collected and analyzed information from a variety of data sources relevant to the ABS, CMBS, and credit markets. Specifically:

- To review changes in securitization markets for ABSs backed by auto loans, credit cards, student loans, and commercial mortgages, we collected data from Thomson Reuters IFR Markets, a database that collects information on activity in the securitization markets. To analyze changes in interest rates for auto loans and credit cards, we reviewed quarterly data from the Federal Reserve's G.19 Consumer Credit Release, a widely used data source, as well as weekly data provided by BankRate.com. We selected the auto, credit card, student loan, and CMBS asset classes because they were the most widely traded in securitization markets and the latter had recently experienced significant trading and price volatility. Because reliable interest rate data for private student loans and commercial mortgages were more difficult to obtain, we collected and analyzed data only on auto loans and credit cards. We validated the securitization and interest rate information against reports and data provided by credit rating agencies, issuers, and dealers. We determined that the data sources were sufficient for our purposes of demonstrating trends in the markets before and after TALF was created.
- To report on the amount of TALF loans settled, we accessed data publicly available on the FRBNY Web site and also information provided to us from FRBNY for periods when FRBNY did not publicly report the settled loan amounts, but only the requested amounts. Because of the limitations on our audit authority, we did not review the internal systems that generated this information.
- To analyze spreads for ABSs backed by auto loans, credit cards, student loans, and CMBSs, we analyzed dealer-provided data from three dealer banks. Because this spread information is not available from one data provider, we determined that collecting data from three dealers—and

ensuring that the numbers were within an acceptable range of each other—would ensure the reliability of such data for our purposes.

- To determine what information Treasury collects to assess TALF's impact on securitization and credit markets and the risks TALF poses to TARP funds, we interviewed officials from the Treasury about what data they collect and received reports that Treasury's subcontractor provided on the various risks of TALF activities. We also interviewed Federal Reserve and FRBNY officials about what type of data they collect related to TALF's impact on the securitization and credit markets.

Appendix II: Methodology for Market Value Analysis of ABSs and CMBSs

To understand the possible range of losses to Troubled Asset Relief Program (TARP) funds from the Term Asset-Backed Securities Loan Facility (TALF), we conducted an analysis based on extreme market value losses, similar to those experienced in the asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) markets in November 2008. This provides an alternative approach to the Department of the Treasury (Treasury) subcontractor’s analysis, and provides an estimate of how large losses potentially could be in the event that the markets returned to their November 2008 lows. Selecting November 2008 as the market low point is generally consistent with the approach used by the Board of Governors of the Federal Reserve System (Federal Reserve) in its “stress tests” for determining the capital that large bank holding companies must maintain. Our scenario provides a more-adverse than expected loss estimate for our sample of ABSs and all of the CMBS loans remaining as of September 30, 2009.

Our first analysis focused on ABSs. We conducted a market value analysis on a sample of the three largest asset classes—ABSs backed by credit cards, auto loans, and student loans—because they make up the majority of TALF’s portfolio. Of the \$42.5 billion in TALF loans backed by credit card, auto loan, and student loan ABSs that had been disbursed as of September 30, 2009, we took a sample of \$16.5 billion, or 39 percent. The sample was selected to broadly match the makeup of these asset classes in this subset of the TALF portfolio (see table 4).

Table 4: GAO Sample Selection for ABS Extreme Market Value Loss Analysis

Dollar in billions			
Asset class	Collateral	Percent of sample	Percent of TALF Portfolio (as of Sept. 30, 2009)
Credit cards	\$9.35	57%	56%
Auto loans	4.54	27	30
Student loans	2.64	16	14
Total	\$16.53	100%	100%

Source: GAO.

Within each asset class the sample was selected to include ABSs that gave the largest sample size on a TALF loan dollar basis; hence larger deals predominate. In addition, TALF loans were spread across 6 of the 7 TALF ABS subscription months between March and September. Nevertheless, it is a nonprobability sample and is not necessarily generalizable to all TALF deals.

We modeled TALF collateral cash flows using assumptions consistent with the FRBNY's assumptions on the rate at which ABS principal is paid back to investors. Then we calculated the discount rate that brought the price back to par as of the issuance date. To this discount rate, we added the incremental yield (or spreads) that would be required to deplete the borrowers' entire equity investment and any excess interest that had built up in TALF LLC as of September 30, 2009, for that specific tranche.¹ These incremental spreads were compared with the widest levels seen in November 2008 for the appropriate asset class and expected average life. November 2008 spreads were obtained from Wall Street ABS-dealer weekly price data that are published for the more widely traded ABS classes. If the spread seen in November 2008 was greater than that required to deplete the borrower's equity and TALF's excess interest, a stress loss was calculated. No loss was assumed if the required spread widening was less than the extremes of November 2008.

Our analysis makes the following assumptions: (1) excess interest has accumulated as of September 30, 2009 at the tranche level of each TALF security; (2) borrowers will surrender their TALF ABS collateral to the FRBNY and stop paying the TALF loan when the ABS market value falls below the TALF loan balance; (3) TALF will mark-to-market the surrendered collateral, ignoring any recovery that Treasury might make if the ABS collateral fully pays all cash flows over the life of the securities; and (4) the change in market value is strictly based on mark-to-market, with no assumption about the underlying credit performance of the ABS.

For the separate analysis on the risks that legacy CMBS collateral may pose to TARP funds, we compared the prices on the 139 legacy CMBS CUSIPs that were accepted by FRBNY as of September 30, 2009, with the exception of 2 for which no price information was available.² These prices were then compared with the lowest prices that, on average, most CMBS across the TALF portfolio reached in November 2008. This CMBS analysis did not include consideration of the excess interest accumulated in TALF LLC but otherwise made the same assumptions noted above for the ABS analysis. As discussed earlier, the \$198 million of excess interest that had accumulated in the cash collateral account as of December 31, 2009, would be available to absorb the first losses bourn on surrendered

¹A tranche is a piece of a securitization that has specified risks and returns.

²CUSIP stands for the Committee on Uniform Security Identification Procedures. CUSIP numbers are alphanumeric identifiers assigned to individual securities.

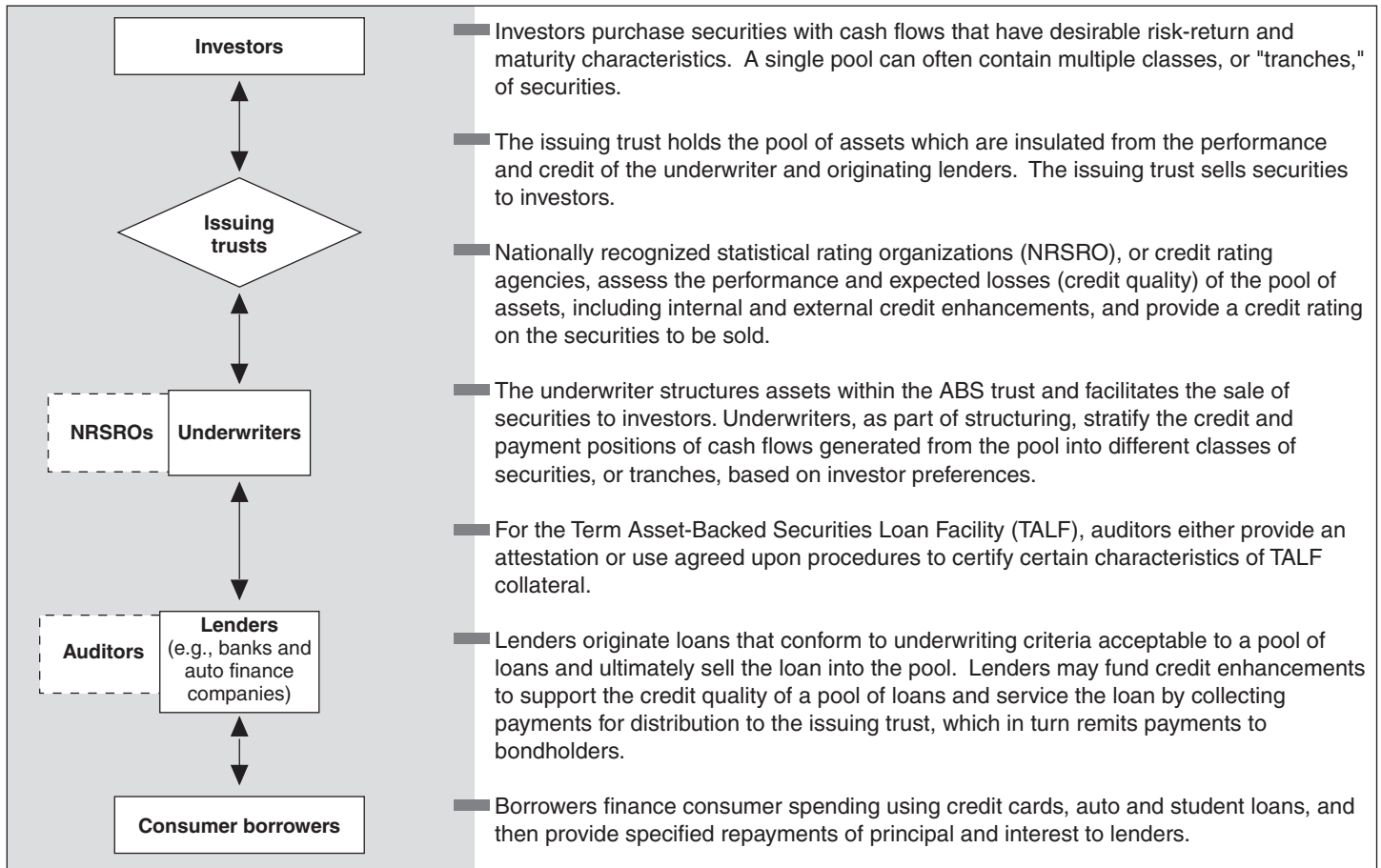
collateral prior to any outlay by Treasury, and this amount is expected to increase over time. In conducting this analysis we utilized certain data from Thompson Reuters Datascope and the Federal Reserve.

Appendix III: The Securitization Process Explained

Securitization is a process that packages relatively illiquid individual financial assets—such as loans, leases, or receivables—and converts them into interest-bearing, asset-backed securities (ABS) that are marketable to capital market investors. As outlined below, the market participants in securitization—borrowers, consumer and small business lenders, investment banks or pool assemblers, credit rating agencies, and investors—each derive specific benefits from the transaction. For example, borrowers might gain access to loanable funds with more favorable terms, such as longer repayment periods and lower interest rates, than may otherwise be available. Similarly, securitization offers consumer and small business lenders a funding source for making new loans, improving balance sheet and capital management, and diversifying fee or income streams. Securitization also allows the cash flows from asset pools to be structured to satisfy the maturity, risk, and return preferences of investors.

The degree to which participants receive these benefits depends, in large part, on how efficiently the markets for securitized assets are functioning. With accurate and more comprehensive performance data regarding financial assets, capital markets can more easily profile the risk of a pool of similar assets. This risk can be divided and sold to investors who are willing to purchase it at an acceptable risk-adjusted return, sometimes called the “investor-required yield.” As the markets for securitized asset classes grow in volume and liquidity, and as the performance and risk characteristics of those assets become better understood, investor-required yields on particular ABSs and transaction costs of securitizing those assets may decline. Declining investor-required yields and transaction costs can lower the cost of financing for consumer and small business lenders and ultimately borrowers. Conversely, with inadequate performance data, and low volumes of similar financial assets, these benefits may not sufficiently materialize for securitization to be a viable financing arrangement for consumer and small business lenders or borrowers.

Figure 11: The Securitization Process



Source: GAO.

Appendix IV: Descriptions of Asset-Backed Securities

Auto Loan and Lease

Asset-backed securities (ABS) for the auto market compose the largest share of ABS issuances. Auto securitizations are collateralized with a fixed pool of loans. In most cases, these transactions are divided into at least four senior segments, or tranches, which have the same payment priority in the event of default but different priorities for principal repayment (with the exception of the shortest pay securities or A1 tranche designed to be marketable to money market funds, which take priority). Tranches are structured so that all scheduled principal amortization and prepayments of principal are paid back first to the tranche with the lowest interest rate. This tranche is generally designated the A1 tranche. Once the principal on the first tranche is paid off, subsequent principal is paid to the A2, A3, and A4 bondholders. The sizes of the tranches are designed so that the expected average life on these securities is generally consistent within each tranche—for instance, the A1 average life is usually 3 months, the A2 average life 1 year, the A3 average life 2 years, and the A4 average life approximately 3 years or more. In some deals, there are also “subordinate tranches,” or tranches that receive ratings below AAA. In many cases, the issuer retains subordinate tranches rather than selling them to the public. Auto ABSs include the following subasset classes: prime auto loans, subprime auto loans, auto leases, and motorcycle loans.

Credit Card

Credit card ABSs tend to use a master trust structure through which a credit card issuer collateralizes a series of ABS issuances with receivables from a large pool of credit card accounts. This pool is not a static set of account balances but absorbs new receivables as they are created. New issuance can be used to support an increase in the size of the receivables collateralizing the securitizations. Investments in credit card ABSs are usually divided into senior and subordinated, or junior, tranches where the investors in the senior tranches are paid first.

Student Loan

Student loan ABSs can be collateralized with either federally guaranteed Federal Family Education Loan Program (FFELP) loans or consumer loans that are not part of a government guarantee program. Student loan ABSs tend to have longer terms to maturity than other ABS classes due to the longer repayment terms and the fact that students do not tend to pay any principal or interest until at least 6 months after they graduate, thus lenders might not receive cash flows on a student loan for years after the initial cash disbursement.

Insurance Premium Finance

Insurance premium finance ABSs are collateralized with loans made to businesses to finance their property and casualty insurance coverage. The typical commercial insurance policy requires a down payment, with equal monthly payments, typically over a time frame shorter than the term of the insurance policy, which in effect creates overcollateralization. When a policy is cancelled, refunds of unearned premiums will be used for making payments to the securitization trust for the remaining term of the loan to protect the ABS holders.

Commercial Mortgage-Backed Securities

Cash flows on commercial mortgage-backed securities (CMBS) are generally backed by principal and interest payments on a pool of commercial mortgage loans. Most commercial mortgage loans are structured with a 30-year amortization term, but CMBS terms are generally shorter than the corresponding amortization terms. However, recent years have seen an increase in the number of loans with interest-only periods during which the mortgagee pays no principal on the mortgage. Commercial mortgages are made on a wide variety of different property types, including rental apartment buildings, industrial properties, office buildings, hotels, healthcare related properties, and retail properties such as shopping malls, strip malls, and freestanding outlets. CMBSs are highly structured and frequently have more than 20 tranches in their capital structure. The coupon payment generally is positively correlated with both the expected average life of the tranche and the risk that the bondholder will not receive the entire principal amount. Also differentiating CMBSs from other asset classes is their sensitivity to the underlying commercial real estate prices and the cash flow generated from the commercial properties backing the mortgages.

Commercial Fleet Leases

Unlike other ABS classes for which investors own direct stakes in the trust assets, commercial fleet lease ABSs are collateralized with special units of beneficial interest (SUBI) in open-ended leases and fleet management receivables on a pool of vehicle leases mainly for commercial trucks, trailers, and equipment. The leases are made on a per-vehicle basis to large corporate customers with fleets that may have more than 5,000 vehicle leases with the issuer. Open-ended leases require the lessee to reimburse any loss in a vehicle's residual value to the lessor. Commercial fleet ABSs usually are structured out of a master trust with the ability to issue numerous term securities. Collateral in the master trust can be replenished with new or renewed leases as older contracts prepay and expire. The lease SUBI entitles the ABS holders to receive the monthly lease payments. This SUBI also includes beneficial interest in all the vehicles

that are being leased or are in the process of being leased but have not completed the process. The fleet management receivables SUBI includes beneficial interest in the receipt of management and other fees that the lessees pay to the lessor.

Mortgage Servicing Advances

Mortgage servicing advance ABSs are collateralized with receivables owed to the servicer for servicing advances made by the servicer to and on behalf of the residential mortgage-backed securitization (RMBS) trusts. There are three types of advances: principal and interest, which cover these types of payments on delinquent loans; escrow advances, which cover expenses related to maintaining ownership of a mortgaged property, including property taxes and insurance premiums; and corporate advances, which are costs for the process of foreclosure, including attorney and other professional fees and expenses related to maintaining a repossessed home. As there is no interest paid to the RMBS trusts when advances are paid back out of either the proceeds of the liquidation of a repossessed property (loan-level servicing advances) or broader pool level cash flows (pool-level servicing advances), a discount factor is applied. The discount factor reflects the estimated time frame for repaying the loan. As a result of this discount factor, the issuer receives less than the face value of the servicing advance at the time of securitization.

Dealer Floor Plans

Floor plan ABSs are collateralized by loans made to finance either automobiles or nonautomotive durable goods. Nonautomotive floor plan inventory includes, among other things, recreational vehicles, boats, motorcycles, industrial equipment and farm equipment, appliances, and electronics. Automotive dealer floor plan arrangements tend to be between a single financial entity and a dealer network. Nonauto dealers can have multiple floor plan arrangements with several capital providers. Financing could be in the form of revolving or nonrevolving lines of credit. Once a floor plan agreement is in place, dealers place orders for inventory from the manufacturer and specify that a lender will provide the financing. The loan is repaid by proceeds from inventory sales, or the dealer can arrange to repay the loan in monthly installments.

Equipment

Equipment ABSs are collateralized with retail installment sale contracts, loans and leases secured by new and used agricultural equipment, construction equipment, industrial equipment, office equipment, copiers, computer equipment, telecommunications equipment, and medical equipment, among other things.

SBA-Loan Backed ABS

The Small Business Administration (SBA) provides guarantees on loans made to small businesses. The most common SBA loan programs are 7(a) and 504. In the 7(a) program, SBA guarantees up to 85 percent of the loan amount made by participating lenders. 7(a) loans are usually made for general business purposes, including working capital, equipment, furniture and fixtures, and land and buildings. 504 program loans are typically long-term, fixed-rate loans for the purpose of expanding or modernizing a small business. When pooled together for securitization purposes, underlying loans must have similar terms and features—for example, similar maturity dates.

Appendix V: Credit Enhancement

Credit enhancements are features in the structuring of a securitization that protect investors in the securitization from losses due to defaults on the underlying loans. The following are some methods of credit enhancement that have been used on asset-backed securities (ABS) eligible for the Term Asset-Backed Securities Loan Facility (TALF).

Subordination: This feature is a method of prioritizing cash flows from the underlying loan collateral. The senior tranches within a securitization get priority over subordinate, or junior, tranches in the event of a default on the underlying collateral.¹ All TALF-eligible securitizations must have a AAA rating from at least two TALF-eligible nationally recognized statistical rating organizations, and all of the AAA-rated ABSs have first priority for cash flows. While most AAA tranches or bonds within an ABS have the same priority in the event of a default, the sequential nature of the principal paydown for certain classes of ABSs (for example, auto loans) leads to higher risk of default for the tranches with weighted average lives that extend further into the future. This higher risk requires the issuer to pay a higher interest rate or coupon on longer tranches. Any losses are applied to the most subordinate tranche first.

Overcollateralization: When the total face value on the loan collateral underlying an ABS is greater than the face value of the bonds, the securitization is said to be overcollateralized. These assets are maintained on the balance sheet of the issuer and are the first to absorb credit losses on the collateral.

Reserve account: This is a cash account set up at the origination of an ABS. This account is accessed when the cash flows from the collateralized loan assets are insufficient to cover the contractual payments on the bonds, including servicing and other fees.

Excess spread: Excess spread refers to the funds leftover after payments to bondholders and other contractual obligations have been met. This can be used to make up for insufficient cash flows if the underlying borrowers are delinquent or default on the loan.

¹Some securitizations—such as ABSs backed by auto loans—are divided into different segments, or tranches. A tranche is a piece of a securitization that has specified risks and returns.

Yield-supplement overcollateralization: This feature applies to securitizations with assets in the underlying pool that are paying interest that is below the coupon rate on the bonds. For example, borrowers frequently pay very low interest rates on loans within certain auto loan securitizations. These loans are often extended with advantageous borrower terms as part of a sales promotion. Generally, the issuer will set up a yield-spread overcollateralization account to make up the difference over some portion of the life of the securitization. The initial balance in this account is set as the present value of the shortfall on those loans for the life of the loans.

Mortgage servicing advance discounts: A form of enhancement that is implicit in the discounted price at which the securitization trust purchases the servicing advance receivables from the mortgage servicing company issuing the security. The servicing advances are segregated into several classifications based on whether the servicing advances are treated at the pool- or loan-level in order of repayment, whether the underlying mortgage is located in a state that has a judicial or nonjudicial foreclosure regime, and the type of cash flow for which the servicer is advancing payment. The servicing advance is classified into one of three classes: principal and interest advance, escrow advances, and corporate advances. Principal and interest advances are made by mortgage servicers to holders of residential mortgage-backed securities for mortgages whose underlying borrowers are delinquent on their monthly payments. Escrow advances are used to pay the property taxes, insurance premiums, or other property-related expenses that the borrowers should have paid. Corporate advance costs, usually in the form of attorneys' and other professional fees, are also accounted for in the event that the servicer incurs them while foreclosing on and liquidating repossessed real estate.

The advance discount percentage is calculated based on assumptions about the length of time it will take to repay that particular type of advance and the risk that it might not be paid back. Pool-level servicing advances have the lowest discount percentage, because the advances can be repaid to the servicer out of the entire pool's available funds, including principal and interest payments received for nondelinquent mortgages. Loan-level servicing advances are not repaid until the borrower repays all the money advanced or from the proceeds of the sale of the repossessed property (the likely scenario in a default). Servicing advances on mortgages secured with properties in judicial foreclosure states have higher discount rates than those in nonjudicial states, because judicial foreclosures take longer. Principal and interest servicing advances are

viewed as the safest instruments and have lower discount rates than escrow, which in turn has slightly lower discount factors than corporate advances.

Appendix VI: Additional Information on TALF Compliance

According to Federal Reserve Bank of New York (FRBNY) officials, FRBNY has in place a number of compliance measures to (1) ensure that borrowers and collateral are eligible for the Term Asset-Backed Securities Loan Facility (TALF); (2) protect FRBNY from fraudulent activity; (3) reduce the risk of fraud and address conflicts of interest; (4) ensure that agents have adequate compliance regimes; and (5) build multiple layers of compliance where possible.

TALF has a certification regime in place for a number of TALF participants. TALF agents and sponsors must certify that they are complying with certain TALF requirements, and TALF agents review the eligibility of TALF borrowers. According to FRBNY officials, TALF agents are the first line of defense against fraudulent participants in TALF, as they conduct “Know Your Customer” reviews of potential TALF borrowers. FRBNY noted that it had antifraud measures in place and receives referrals for those investors that TALF agents raised concerns about. Moreover, FRBNY officials stated that they have developed an inspection program to conduct on-site reviews of TALF Agent’s “Know Your Customer” programs and files. The entire process is under the management of FRBNY, without the Department of the Treasury’s (Treasury) participation.

Sponsors and issuers must include in any offering document a certification required by FRBNY. Borrowers must also provide representations to the TALF agent, who conducts the review of the borrower. According to FRBNY officials, because the issuers and sponsors include certification to TALF eligibility and acknowledge certain responsibilities related to the TALF collateral in the offering documents, any material misrepresentations would be covered under relevant securities laws. In addition, the TALF agents and borrowers also make certain representations on their eligibility and the eligibility of the collateral. Though this is a certification and self-disclosure regime, FRBNY officials told us they have established additional measures to detect and address noncompliance. First, FRBNY has a 24-hour fraud hotline. Second, it has hired a law firm to assist in assessing fraud risks associated with the program. Third, it is cooperating with other government and law enforcement agencies to gather additional information on potential TALF participants.

In addition to certifications, FRBNY requires auditor attestations for non-CMBS collateral, which state that the Report on Management Compliance fairly states compliance with certain TALF program criteria specified by FRBNY. For CMBS collateral, agreed upon procedures (AUP) are required to provide more detailed specifications on what to review.¹ FRBNY has published broad guidelines to the auditors for carrying out these responsibilities, which are paid for by the issuers of TALF-eligible securities. In addition, FRBNY requires that the attestation and AUP processes follow standards issued by the Public Company Accounting Oversight Board and the American Institute of Certified Public Accountants. Most of the information that the auditors review is provided by the issuers and is not verified independently, according to auditors we spoke with. FRBNY officials added that loan-level testing is required and this includes a review of original loan files or electronic versions thereof.

According to Treasury officials, Treasury provided some input into the design of the auditor attestations and AUPs but primarily leaves oversight of this function to the Board of Governors of the Federal Reserve System and FRBNY, which are responsible for designing and implementing TALF. Treasury does not review these documents; however, should the assets be placed to TALF LLC, Treasury may review them.

¹According to the guidance provided by the American Institute of Certified Public Accountants, Public Company Accounting Oversight Board, and discussions with two auditors involved in the process, attestations are generally considered a higher form of assurance than AUPs. This is because in an attestation the auditor must attest to all of its statements and design a methodology that provides reasonable assurance of the accuracy of its attestation. In the case of an AUP, the process is stipulated ahead of time and the auditor simply follows it, providing a statement as to the outcome of the process.

Appendix VII: New Securitization Volumes Have Increased since the Inception of the TALF Program

Since the Term Asset-Backed Securities Loan Facility's (TALF) March 2009 inception, securitization volumes have increased in some TALF-eligible sectors. For auto loan securitization, new issuance dropped off significantly in the third quarter of 2008, bottoming in the fourth quarter (see table 5). By 2009 issuance began to pick up, especially in the second and third quarters, when most were TALF-eligible. There were 45 issuances through December 2, 2009, a marked contrast to the peak of 85 in 2005.

Table 5: Auto Loan Securitization Volume, 2005 through Fourth Quarter 2009

Dollars in millions

Year of issuance	Deals	Total issuance volume	Number of TALF securitizations	Number of non-TALF securitizations	TALF Issuance Volume (dollars)	Non-TALF issuance volume (dollars)
2005	85	\$76,912	–	–	–	–
2006	78	88,114	–	–	–	–
2007	69	71,015	–	–	–	–
2008	32	29,113	–	–	–	–
2009	45	51,192	35	10	\$44,941	\$6,251
Q1 2008	10	10,265	–	–	–	–
Q2 2008	14	14,022	–	–	–	–
Q3 2008	5	3,226	–	–	–	–
Q4 2008	3	1,600	–	–	–	–
Q1 2009	5	7,583	3	2	5,213	2,370
Q2 2009	11	14,952	10	1	13,445	1,507
Q3 2009	14	19,294	12	2	18,394	900
Q4 2009	15	9,363	10	5	7,889	1,474

Source: GAO analysis of Thomson Reuters IFR Markets data.

Credit card securitization volumes show a similar pattern (see table 6). The peak in credit card securitizations occurred in 2007, with 112 issuances, a sharp contrast to 2009 when only 35 securitizations were issued through December 2, 2009. The majority of credit card ABSs issuances in 2009—about 65 percent—have been TALF supported.

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Table 6: Credit Card Receivables Securitization Volume, 2005 through Fourth Quarter 2009

Dollars in millions

Year of issuance	Deals	Dollar volume	Number of TALF securitizations	Number of non-TALF securitizations	TALF issuance volume	Non-TALF issuance volume
2005	80	\$53,019	–	–	–	–
2006	93	60,374	–	–	–	–
2007	112	94,539	–	–	–	–
2008	67	67,319	–	–	–	–
2009	35	45,988	23	12	\$29,713	\$16,275
Q1 2008	25	28,785	–	–	–	–
Q2 2008	24	28,180	–	–	–	–
Q3 2008	18	10,354	–	–	–	–
Q4 2008	0	0	–	–	–	–
Q1 2009	2	6,500	1	1	3,000	3,500
Q2 2009	15	20,385	8	7	13,835	6,550
Q3 2009	15	15,500	12	3	10,775	4,725
Q4 2009	3	3,603	2	1	2,103	1,500

Source: GAO analysis of Thomson Reuters IFR Markets data.

Student loan securitization volumes show similar patterns to the auto and credit card asset classes, with a marked low of no new deals in the last quarter of 2008 (see table 7). Lenders may be tightening their lending standards, potentially resulting in fewer loans and reducing the need to access the securitization markets as frequently as in the past. Although both Federal Family Education Loan Program (FFELP) and private loan securitizations are TALF eligible, to date no FFELP deals have been underwritten to TALF eligibility standards. There have been five TALF private student loan securitizations since the program’s inception.

**Appendix VII: New Securitization Volumes
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Table 7: Student Loan Securitization Volume, 2005 through Fourth Quarter 2009

Dollars in millions

Year of issuance	Total student loan deals	Total dollar volume	FFELP deals	Private deals	FFELP volume	Private dollar volume	Private TALF dollar volume	Private Non-TALF dollar volume
2005	42	\$46,277	–	–	–	–	–	–
2006	43	70,058	–	–	–	–	–	–
2007	28	50,672	23	5	\$42,663	\$8,009	–	–
2008	22	29,427	21	1	29,302	125	–	–
2009	20	21,247	13	7	12,350	8,897	\$7,367	\$1,530
Q1 2008	6	8,400	6	0	8,400	0	–	–
Q2 2008	10	14,624	10	0	14,624	0	–	–
Q3 2008	6	6,403	5	1	6,278	125	–	–
Q4 2008	0	0	0	0	0	0	–	–
Q1 2009	2	2,047	1	1	547	1,500	0	1,500
Q2 2009	5	8,315	4	1	5,722	2,593	2,593	0
Q3 2009	5	6,124	1	4	1,910	4,214	4,184	30
Q4 2009	8	4,761	7	1	4,171	590	590	0

Source: GAO analysis of Thomson Reuters IFR Markets data.

Note: Thomson Reuters IFR Markets data does not break out FFELP and private securitizations until 2007.

This report discussed the severe disruption in the commercial real estate sector following the economic downturn. Table 8 shows that commercial mortgage-backed securities (CMBS) volumes peaked in 2006 with 97 issuances before dropping dramatically to just 7 by 2008. These sharp declines in part motivated the inclusion of CMBSs as a TALF-eligible asset class. Three new-issue deals have been offered since TALF was expanded to CMBSs, and only one used TALF for financing. Other CMBS deals in 2009 were repackaging of existing securitizations. Part of the sluggish activity in the CMBS sector could be attributed to the length of time it takes to put together a deal, which officials have noted is considerably longer than for the other asset classes. There could be other reasons as well. As we discussed in this report, the CMBS sector continues to show signs of volatility resulting from sharp declines in commercial real estate prices and increases in CMBS delinquency rates.

**Appendix VII: New Securitization Volumes
Have Increased since the Inception of the
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Table 8: CMBS Securitization Volume, 2005 Through Fourth Quarter 2009

Dollars in millions				
Year of issuance	Number of deals	Par value	TALF	Non-TALF
2005	80	\$152,271	–	–
2006	97	201,419	–	–
2007	73	199,925	–	–
2008	7	9,482	–	–
2009	6	2,500	\$400	\$2,100
Q1 2007	17	45,959	–	–
Q2 2007	25	74,360	–	–
Q3 2007	19	54,236	–	–
Q4 2007	12	25,370	–	–
Q1 2008	3	4,387	–	–
Q2 2008	2	1,955	–	–
Q3 2008	2	3,140	–	–
Q4 2008	0	0	–	–
Q1 2009	0	0	–	–
Q2 2009	2	343	–	343
Q3 2009	0	0	–	–
Q4 2009	4	2,157	400	1,757

Source: GAO analysis of Thomson Reuters IFR Markets data.

Appendix VIII: Comments from the Department of the Treasury



ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 1, 2010

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:

The Department of the Treasury (Treasury) appreciates the opportunity to review a draft of the GAO's latest report on Treasury's Troubled Asset Relief Program (TARP) which focuses on the Term Asset-Backed Securities Loan Facility (TALF). Treasury welcomes the recognition by the GAO that (1) TALF is contributing to improvements in the securitization markets and (2) TALF is unlikely to result in a loss to taxpayers.

Indeed, on the first issue, the draft report understates the success of the program. The securitization markets have dramatically improved since the fourth quarter of 2008 as a result of TALF. Before the launch of TALF, the asset-backed securitization (ABS) market came to a complete halt. There were no new ABS issuances that supported credit to consumers and small businesses. There was very little investor confidence and, as a result, spreads for asset backed securities widened to historic levels. For instance, spreads on securities backed by auto loans and credit card receivables widened to 600 basis points from their historic average of less than 100 basis points. Since the launch of TALF, investor confidence has improved dramatically: ABS spreads have been reduced to at or near their historic averages, which represents a reduction of 70% to 90% depending on the collateral type. Similarly, issuers of ABS have been able to extend credit to consumers and small businesses, which is the overall goal of TALF.

On the second issue, as the report notes, Treasury currently projects a net profit from TALF. The GAO report expresses concern that there could be losses with respect to commercial mortgage backed securities (CMBS). We disagree with GAO's methodology in projecting those losses and note that, for a senior CMBS to experience losses, the underlying property pool would have to experience losses in excess of 65%, assuming a 30% AAA subordination requirement and a 20% TALF haircut.

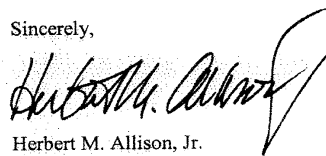
As the report notes, TALF is administered by the Federal Reserve Bank of New York. Treasury does not run the program or make loans directly to private parties. Treasury continues to work collaboratively with the Federal Reserve to structure TALF to minimize taxpayer risk and achieve the program's purpose of encouraging lending to consumers and businesses. With respect to the operation of the program, we appreciate the suggestions the GAO makes in the

**Appendix VIII: Comments from the
Department of the Treasury**

report to strengthen the documentation of decisions Treasury made concerning changes to the program. Treasury is committed to ensuring that not only TALF, but TARP as a whole, is administered in a way that protects the taxpayer. In this regard, we note that the GAO recently completed its audit of the annual financial statements of the Office of Financial Stability, which cover the first year of operations of TARP, and rendered an unqualified opinion. GAO also performed a review of internal controls and found no material weaknesses (and nor were any issues cited with respect to TALF). Treasury will also continue to enhance its existing reporting on its investments in TALF that strikes an appropriate balance between our goal of transparency and the need to avoid compromising either the competitive positions of investors or Treasury's ability to recover funds for taxpayers.

We appreciate the time your staff took to discuss the report with us and to review areas where we disagreed with your characterization of the program. We look forward to reviewing the final report and continuing to work with the GAO regarding any remaining areas of disagreement and Treasury's implementation of programs to stabilize the financial system.

Sincerely,



Herbert M. Allison, Jr.
Assistant Secretary for Financial Stability

Appendix IX: Comments from the Board of Governors of the Federal Reserve System



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SCOTT G. ALVAREZ
GENERAL COUNSEL

January 29, 2010

Mr. Richard Hillman
Managing Director
Financial Markets and Community Investment
Government Accountability Office
Washington, D.C. 20548

Dear Mr. Hillman:

I am writing regarding the draft audit report of the Government Accountability Office (GAO) on the Treasury Department's decisionmaking and reporting on the Term Asset-Backed Securities Loan Facility (TALF) program,¹ a joint program of the Federal Reserve and the Treasury Department (Treasury). Treasury participates in the TALF under the Troubled Asset Relief Program and the GAO conducted the audit pursuant to its statutory responsibility to audit and oversee the Troubled Asset Relief Program.

The draft report indicates that GAO believed it could not conduct an effective review of the Troubled Asset Relief Program because the Federal Reserve participates in and administers portions of the TALF. The Federal Reserve does not agree with this assessment and believes that the draft report does not reflect the full scope of the GAO's audit authority with respect to the TALF. For the reasons explained in the attached memorandum, we believe that the GAO has ample authority to audit all aspects of the TALF's operations and the Treasury's participation in that program, including the manner in which the Federal Reserve administers the program on behalf of the Federal Reserve and Treasury, within the scope of existing law. Indeed, the Federal Reserve provided the GAO full access to information about its administration of the TALF program, including access to all related personnel and records, in reliance on this view.

The Federal Reserve fully cooperated with the GAO in connection with its audit of the TALF. We provided all documents and information requested by the GAO about the TALF program. Federal Reserve staff maintained an ongoing dialogue with GAO staff in order to provide an overview of the TALF program and answer detailed questions. As is clear from the draft report, the Federal Reserve provided the GAO

¹ GAO-10-25, as provided to Federal Reserve staff on January 15, 2010.

extensive information concerning the terms, conditions, and operations of the TALF, as well as the manner in which the Federal Reserve administers the TALF program on behalf of the Federal Reserve and the Treasury. For example, the Federal Reserve provided the GAO with detailed, loan-level data concerning all collateral pledged by borrowers for each loan extended by the Federal Reserve under TALF through October 2009, as well as a memorandum explaining the methodology used by Federal Reserve staff in developing the recommended "haircuts" that the Federal Reserve and the Treasury should establish for each type of collateral eligible for the TALF. In addition, as the report recognizes, the Federal Reserve provided the GAO with information concerning the certifications that issuers and sponsors must provide to the Federal Reserve regarding collateral pledged to secure a TALF loan and the due diligence conducted by the Federal Reserve and its collateral monitors to assess the credit risks of collateral offered by potential borrowers to secure a TALF loan. Each of these requirements is an integral component of the protections built into the TALF to protect taxpayers.

Nevertheless, the GAO has asserted that restrictions in current law prohibit the GAO from auditing the Federal Reserve's role in administering the TALF in connection with the GAO's audit of the Troubled Asset Relief Program. We believe this assertion is belied by the draft audit report itself, the analysis and recommendations of which rely heavily on information provided by the Federal Reserve concerning the Federal Reserve's administration of the TALF. For example, the GAO's analysis in the report of potential losses on TALF loans backed by commercial mortgage-backed securities (CMBS) is based on the loan-level data provided by the Federal Reserve, as well as other information provided by the Federal Reserve regarding its operation of the TALF.²

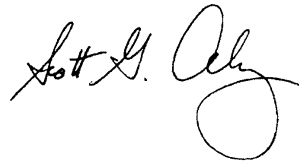
Moreover, for the reasons discussed in the attached memorandum, we believe that current law provides the GAO full authority to audit the operations of the TALF--including the internal systems used by the Federal Reserve to operate the TALF program and the internal controls established and used by the Federal Reserve to limit the potential risks to taxpayers from TALF lending--as part of the GAO's audit of the Troubled Asset Relief Program. We have strongly encouraged the GAO to adopt this view, which we believe is consistent with Congress' intent. To the extent the GAO disagrees with our view of the GAO's statutory authority to audit the TALF, we believe the cooperation and access to information provided to the GAO by the Federal Reserve as part of this review strongly illustrates our voluntary agreement to allow GAO to conduct a complete and thorough audit of the Treasury's role, decisionmaking, reporting, and exposure under the Troubled Asset Relief Program with respect to all aspects of the TALF.

² For example, the draft report notes that the risk that the TALF would experience a loss due to the surrender of a substantial amount of CMBS assets is significantly mitigated by the Federal Reserve's requirement that borrowers obtaining TALF loans backed by legacy CMBS collateral prepay a portion of any returns in excess of certain established limits.

**Appendix IX: Comments from the Board of
Governors of the Federal Reserve System**

The Federal Reserve stands ready to continue to work with the GAO concerning the TALF to allow the GAO to fully assess the performance of, and risks to, the Troubled Asset Relief Program. Federal Reserve staff separately has provided GAO staff with technical and correcting comments on the draft report. We hope that these comments were helpful.

Sincerely,



Attachment

Memorandum Attachment

Background on the TALF

The TALF is a joint program of the Federal Reserve and the Treasury Department (“Treasury”), each of which participates in the TALF under separate legal authorities. The Board of Governors authorized the Federal Reserve Bank of New York to participate in the TALF under section 13(3) of the Federal Reserve Act (12 U.S.C. § 343) in order to assist financial markets in meeting the credit needs of consumers and businesses of all sizes by facilitating the issuance of asset-backed securities (ABS) collateralized by a variety of consumer and business loans. The TALF also is intended to improve market conditions for ABS more generally by, among other things, restarting the securitization markets for consumer- and business-related ABS. These markets came to a halt in mid-2008, cutting off an important source of funds to support consumer and business lending. In this way, the TALF furthers the monetary policy objectives of the Federal Reserve as established by Congress: price stability and maximum sustainable employment.

The Treasury participates in the TALF through the Troubled Asset Relief Program (TARP) in order to achieve the objectives and purposes of the TARP as established by the Congress in the Emergency Economic Stabilization Act of 2008 (EESA).¹ These purposes include restoring liquidity and stability to the financial system of the United States, promoting jobs and economic growth, and maximizing overall returns to the taxpayers of the United States.

Under the TALF, the Federal Reserve makes non-recourse loans that are fully secured by specified types of high-quality consumer- and business-related ABS, including, for example, ABS backed by student loans, floorplan loans for automobile dealers, and commercial real estate loans. Borrowers commit their own risk capital in the form of haircuts against the collateral, which serve as the borrower’s equity in the transaction and act as a buffer to absorb any decline in the value of the collateral in the event the borrower does not repay the loan.

The Federal Reserve Bank of New York operates and administers the TALF on behalf of the Federal Reserve and the Treasury. However, because of the joint nature of the program, all material terms governing the operation of the program—including the types of ABS that are eligible to be pledged as collateral for a TALF loan and the appropriate haircut to be applied to each class of eligible collateral—are agreed to by both the Federal Reserve and the Treasury. Once agreed, these terms are posted on the public website of the Federal Reserve Bank of New York.²

¹ See section 2 of the EESA (12 U.S.C. § 5201).

² See http://www.newyorkfed.org/markets/talf_terms.html.

An important aspect of the TALF is the credit protection provided by Treasury under the TARP. Specifically, the Treasury has agreed to provide up to \$20 billion under the TARP to cover any losses that may ultimately be incurred by the TALF.³ However, the Federal Reserve transfers to the TALF LLC any excess interest earned by the Federal Reserve on TALF loans above the Overnight Index Swap (OIS) rate plus 25 basis points. These amounts, plus any returns earned on their investment prior to use, are available to absorb first any loss that may be incurred on TALF loans. As the GAO report acknowledges, both the Federal Reserve and the Treasury currently project that any potential losses on TALF loans would be fully covered by this retained excess interest and the returns achieved through its investment and, accordingly, the TARP will not incur a net loss on its commitment to the TALF.

Statutory Framework Governing GAO Audits

The EESA expressly authorizes the GAO to audit the programs and activities of the Treasury under the TARP--including the TALF--for purposes of conducting ongoing oversight of the activities and performance of the TARP, which is a fiscal program operated by the Treasury. See 12 U.S.C. § 116(a) and (b)(2).

The GAO also has broad authority to audit the activities and programs of the Federal Reserve. For example, all of the Federal Reserve's supervisory and regulatory functions are subject to audit by the GAO to the same extent as the supervisory and regulatory functions of the other federal banking agencies. However, for sound public policy reasons, the Congress has excluded monetary policy deliberations and operations (including discount window operations) from the scope of GAO audits. 31 U.S.C. § 714(b). Considerable experience shows that monetary policy independence--within a framework of legislatively established objectives and public accountability--tends to yield a monetary policy that best promotes price stability and economic growth.

The unique, hybrid nature of the TALF initially created questions concerning the GAO's ability to audit the TALF in conjunction with its audits and oversight of the TARP.⁴ In response, the Congress in May 2009 enacted new statutory provisions specifically to clarify and ensure the GAO's ability to audit the TALF for purposes of assessing the performance of the TARP. These provisions, which were included in an amendment to the EESA offered by Senator Grassley and adopted as part of the Helping Families Save Their Homes Act, specifically provide:

Notwithstanding any other provision of law, *and for purposes of reviewing the performance of the TARP*, the Comptroller General shall have access, upon request, to any information, data, schedules, books, accounts, financial records, reports, files, electronic communications, or other papers, things, or property belonging to or in use

³ As of December 31, 2009, only \$100 million of this commitment had been disbursed under the TARP in support of the TALF.

⁴ See Statement of Acting Comptroller Gene L. Dodaro before the Senate Finance Committee, March 31, 2009.

by the TARP, any entity established by the Secretary under the Act, any entity that is established by a Federal reserve bank and receives funding from the TARP [such as the TALF LLC], or any entity (other than a governmental unit) participating in a program established under authority of the Act”.⁵

When these provisions were adopted by the Senate, Senator Grassley, the sponsor of the amendment, submitted for the record written material indicating the “actions currently covered by the new language.”⁶ This material specifically provides that the amendment “would expand the GAO’s authority to oversee the TARP, including the *joint Federal Reserve-Treasury Term Asset-Backed Securities Loan Facility (TALF)*.”⁷ Importantly, Senator Grassley also indicated that the amendment was not intended to “threaten monetary policy independence.”⁸

Application to the TALF

The Federal Reserve firmly believes that these statutory provisions provide the GAO the authority to audit the terms, conditions, and operations of the TALF—including those aspects of the TALF that are administered by the Federal Reserve—as necessary to understand and assess the performance of, and risks to, the TARP. Among the matters that GAO may audit under this authority are—

- the minimum credit rating standards established for TALF collateral by the Federal Reserve and Treasury;
- the due diligence requirements imposed by the Federal Reserve’s Master Loan and Security Agreement on broker-dealers that act as agents in the TALF borrowing process;
- the certifications required of issuers and sponsors of the ABS pledged as collateral for a TALF loan;
- the minimum haircuts established by the Federal Reserve and the Treasury for each class of eligible TALF collateral;
- evaluations conducted by the Federal Reserve or the Treasury of the potential for TALF loans to result in losses to the program; and
- the internal controls established and used by the Federal Reserve for purposes of ensuring that participants in the TALF program and all collateral pledged in support of TALF loans meet the requirements established for the program by the Federal Reserve and the Treasury.

⁵ See Helping Families Save Their Homes Act of 2009, § 601, Pub. L. 111-22, 123 Stat.1632, 1659 (codified at 12 U.S.C. § 5226(a)(2)(B))(emphasis added). The amendment also provides certain protections for proprietary and trade secrets information obtained by the GAO.

⁶ 155 Cong. Rec. S5181 (Daily ed. May 6, 2009)(emphasis added).

⁷ *Id.*

⁸ *Id.*

Each of these matters affect the risk that ultimately may be borne by TARP and, thus, are within the scope of the GAO's authority to audit the TALF in order to assess and evaluate the performance of, and the risk to, the TARP. In addition, information concerning these matters is "in use" by the TARP because these standards, requirements, procedures, and controls are integral parts of the measures taken under the joint TALF program to limit the risks to which the TARP may be exposed.

The Federal Reserve already has provided extensive information to the GAO on these matters, as well as all other matters identified by the GAO, to assist the GAO in fulfilling its audit responsibilities under the EESA.

We believe this approach not only is fully consistent with the language of the relevant statutory provisions, but also represents the best way to balance and achieve the Congressional intent underlying the directive for GAO to audit the performance of the TARP and the prohibition on GAO audits of monetary policy deliberations and operations (including discount window operations). It gives substantive effect to each of the relevant statutory provisions,⁹ ensures that the GAO may fully understand and assess the TARP, and protects the independence of monetary policy. In particular, the Federal Reserve believes that this approach does not abridge the limitations in 31 U.S.C. § 714(b) on the ability of the GAO to audit monetary policy or discount window deliberations, decisions, and operations of the Federal Reserve.

⁹ The Supreme Court has indicated that separate statutes should be interpreted, whenever possible, in a manner that gives effect to each. See Lockheed Corp. v. Spink, 517 U.S. 882, 895 n.6 (1996) (Court "would be reluctant to infer that [one federal statute] bars conduct affirmatively sanctioned by other federal statutes" absent clear evidence that Congress intended such a conflict); County of Yakima v. Confederated Tribes and Bands of the Yakima Indian Nation, 502 U.S. 251, 265 (1992) ("Judges are not at liberty to pick and choose among congressional enactments, and when two [or more] statutes are capable of co-existence, it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective.") (internal quotations and citations omitted).

Appendix X: Analysis of Legal Comments Submitted by the Federal Reserve

As noted, in its comments, the Board of Governors of the Federal Reserve System (Federal Reserve) did not agree with our recommendation that Congress consider providing GAO with authority to audit the Federal Reserve's operational and administrative actions because it disagreed that there are limitations on GAO's authority to audit these Federal Reserve activities.

However, we believe the express statutory prohibition in 31 U.S.C. § 714(b) on GAO auditing the Federal Reserve's monetary policy and discount window lending activities, which the Federal Reserve believes includes the Term Asset-Backed Securities Loan Facility's (TALF) operation and administration, prohibits us from auditing the Federal Reserve's TALF activities, even from the perspective of the Troubled Asset Relief Program (TARP). We limited the scope and conduct of this audit accordingly, and thus did not request access to information to audit the Federal Reserve's performance of these activities.¹ Further, the Federal Reserve's decision to voluntarily provide requested access in this instance, while helpful, does not create GAO authority to audit the Federal Reserve's TALF operational activities or other performance. In our view, our lack of authority to audit the Federal Reserve's actions limited our ability to fully assess the risk to taxpayer funds presented by TALF.

The basis of the Federal Reserve's view that GAO has authority to audit its TALF operational and administrative actions is a May 2009 amendment to the Emergency Economic Stabilization Act of 2008 (EESA), the statute authorizing TARP. While GAO vigorously pursues its audit and access authority in all appropriate circumstances, the amendment referenced by the Federal Reserve, section 601 of the May 2009 amendments, provides no authority for GAO to audit the Federal Reserve.² Rather, responding to congressional concern that GAO lacked authority to obtain access to

¹A performance audit of the Federal Reserve's TALF operational and administrative activities would, for example, have involved evaluating the process by which certain TALF program terms were arrived at, such as whether the haircuts or the amount of equity the TALF borrower holds in the collateral protected TALF from losses. We also would have evaluated FRBNY's system of internal controls and the role of TALF participants in certifying and validating compliance with certain program requirements. In addition, we would have interviewed some of the entities that helped administer TALF to validate agency information and to better understand their roles and interactions with the Federal Reserve and FRBNY. These would have included entities such as the TALF agents, Bank of New York Mellon, Trepp, or CW Capital.

²See section 601 of the Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, 123 Stat. 1632, 1659 (May 20, 2009), codified at 12 U.S.C. § 5226.

information directly from banks and other firms receiving TARP funds, the amendment provided GAO with such access to enable us to more effectively review Treasury's actions under our existing TARP audit authority. As the Federal Reserve correctly noted in its comments, section 601 included access to records of any entity "that is established by a Federal reserve bank and receives funding from the TARP," thus covering records of TALF LLC, the special purpose vehicle created by the Federal Reserve Bank of New York to which Treasury has committed up to \$20 billion of TARP funds. But GAO's authority to obtain access to records of TALF LLC does not provide GAO access to other TALF program information, nor GAO authority to *audit* the Federal Reserve's operation or administration of TALF.

As support for its view that the May 2009 amendment in section 601 authorized GAO to audit the Federal Reserve's TALF performance, the agency quoted a portion of remarks made by Senator Grassley, a lead sponsor of the amendment. As Senator Grassley noted, however, he was describing the Federal Reserve's position. The Senator provided material for the record stating in part, "According to Federal Reserve staff, . . . [Senate] amendment No. 1020 [section 601] would expand GAO's authority to oversee TARP, including the joint Federal Reserve-Treasury Term Asset-Backed Securities Loan Facility (TALF) . . ."³ As noted, however, the Federal Reserve was only partially correct: section 601 provided GAO authority to access records of the Treasury-funded TALF LLC in order to audit Treasury, but not authority to audit and evaluate the Federal Reserve's TALF actions.

That section 601 did not authorize GAO to audit the Federal Reserve is confirmed by the legislative history of a second amendment authored by Senator Grassley, section 801 of the May 2009 amendments. An earlier version of section 801 would have modified GAO's Federal Reserve authority under 31 U.S.C. § 714 to authorize audit of all Federal Reserve emergency actions under section 13(3) of the Federal Reserve Act, as well as Federal Reserve TARP-related actions, thus giving GAO TALF audit authority. Changes to section 801 shortly before the committee vote eliminated GAO's TALF audit authority, however, leaving GAO authorized only to audit Federal Reserve actions taken under section 13(3) "with respect to a single and specific partnership or corporation"—that is, AIG,

³155 Cong. Rec. S5181 (daily ed. May 6, 2009).

Citigroup, Bank of America, and Bear Stearns. This language was enacted as a new subsection (e) to 31 U.S.C. § 714.⁴

Finally, the Federal Reserve commented that because of TALF’s unique “hybrid” nature—it serves objectives of both monetary policy and TARP—GAO has “ample authority” to audit TALF operations, Treasury’s participation in them, and the Federal Reserve’s administration of TALF “on behalf of” Treasury, all from the perspective of TARP. In this regard, the Federal Reserve noted that in practice, it obtains Treasury’s input and agreement on many aspects of TALF. However, the view that GAO can separately audit the Federal Reserve’s TALF performance as long as the audit is limited to TARP objectives, without violating the statutory prohibition against GAO auditing Federal Reserve monetary policy actions, is not supported by either the language of 31 U.S.C. § 714, its original legislative history, or the amendments Congress enacted to it in May 2009.

Section 714(b)(2) prohibits GAO from auditing the Federal Reserve with respect to “deliberations, decisions, or actions on monetary policy matters, including discount window operations . . .” In the Federal Reserve’s view, all of its TALF activities are an exercise of its monetary policy and discount window lending authority, thus prohibiting GAO from auditing these actions at least from the perspective of monetary policy. While the Federal Reserve stated it believes the prohibition does not apply to non-monetary policy aspects of “hybrid” Federal Reserve actions, permitting GAO to audit the agency from the perspective of TARP, for example, the debate leading to enactment of § 714(b) in the Banking Agency Audit Act of 1978 indicates Congress did not intend to create such an exception. Representative Ashley, the author of the final version of the § 714(b) prohibitions, made clear that the monetary policy prohibition extends to all discount window lending actions, even those serving multiple objectives such as regulation/supervision and monetary policy. Rep. Ashley explained that all discount window lending is necessarily

⁴Section 801 (Senate Amendment 1021) as introduced would have removed all restrictions on GAO’s authority to audit the Federal Reserve in 31 U.S.C. § 714(b), including the prohibition against auditing monetary policy actions. 155 Cong. Rec. S4991 (daily ed. April 30, 2009). As detailed by Senator Grassley, a substitute amendment then narrowed GAO’s audit authority to all Federal Reserve section 13(3) actions and TARP-related actions, 155 Cong. Rec. S5118-19 (daily ed. May 5, 2009), and the final version narrowed GAO’s authority even further, to Federal Reserve section 13(3) actions “with respect to a single and specific partnership or corporation.” 155 Cong. Rec. S5173-74, S5181-82 (daily ed. May 6, 2009); sec. 801, Pub. L. No. 111-22, 123 Stat. 1662-63 (May 20, 2009).

“inextricably bound up in monetary policy” and is intended to be covered by the prohibition.⁵ Under this reading, GAO is prohibited from auditing the Federal Reserve’s TALF discount window lending activities even from the perspective of TARP.

The Federal Reserve’s position also conflicts with Congress’ enactment of § 714(e) in May 2009, noted above, authorizing GAO to audit Federal Reserve section 13(3) actions with respect to a single and specific partnership or corporation. If GAO already could audit TARP aspects of “hybrid” Treasury and Federal Reserve activity, such additional authority would have been unnecessary regarding AIG, for example, because both Treasury and the Federal Reserve already were providing assistance to AIG. Yet GAO was required, as the Federal Reserve then agreed, to await enactment of additional authority in order to audit this joint assistance.⁶

In light of these statutory restrictions on GAO’s authority to audit the Federal Reserve’s TALF activities, we continue to believe that Congress should provide GAO with authority to audit the Federal Reserve’s operation and administration of the TALF program.

⁵123 Cong. Rec. H11015-20 (daily ed. Oct. 14, 1977).

⁶See GAO, *Troubled Asset Relief Program: Status of Government Assistance Provided to AIG*, [GAO-09-975](#) (Washington, D.C.: Sept. 21, 2009), p. 2.

Appendix XI: GAO Contact and Staff Acknowledgments

GAO Contact

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Staff Acknowledgments

In addition to the contacts named above, Karen Tremba (Assistant Director), Angela Burriesci, Emily Chalmers, Rudy Chatlos, Joe Cisewski, Rachel DeMarcus, Mike Hoffman, Robert Lee, Sarah McGrath, Marc Molino, Tim Mooney, Omyra Ramsingh, Susan Sawtelle, and Cynthia Taylor made important contributions to this report.

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