DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

October 28, 2013

The Honorable Christy L. Romero
Special Inspector General
for the Troubled Asset Relief Program
1801 L Street, NW, 4th Floor
Washington, DC 20036

Re: Response to SIGTARP CPP, CDCI Recommendations

Dear Ms. Romero:

I write in response to your September 30, 2013 letter regarding the U.S. Department of the Treasury's contractual right to appoint directors to the boards of certain institutions participating in the Capital Purchase Program (CPP) and the Community Development Capital Initiative (CDCI) under the Troubled Asset Relief Program (TARP). Treasury welcomes oversight of all of its programs, including TARP. We appreciate SIGTARP's insights as we continue to wind down TARP's investment programs.

Treasury undertook the CPP and CDCI to stabilize the financial system in response to the financial crisis of 2008. The programs, together with the many other actions taken by the government, were successful at stopping the financial panic and laying the foundation for economic recovery. Today, our focus is on winding down these programs, which in the case of the CPP has been substantially achieved and should be completed in the near future.

As part of Treasury's management of those investments, Treasury has nominated individuals to the boards of directors of institutions that have missed a certain number of dividend or interest payments. We also have sent Treasury staff to observe other board meetings. We have posted information about this process on our website at www.financialstability.gov, including a fact sheet and frequently asked questions.

SIGTARP's letter offers three recommendations regarding the policies and practices Treasury has followed concerning observers and directors over the last three years. SIGTARP's view appears to be that Treasury should take these actions for every applicable investment, irrespective of circumstance, effectiveness, cost to the taxpayer, or our overall strategy for exiting these investments. As described below, our current focus is on winding down these programs; at the same time, Treasury will continue to nominate members for boards of directors, and will have observers attend meetings, where we believe such actions are most prudent in light of various considerations.

I. Background on CPP and CDCI Investments.

Treasury launched the CPP in October 2008 in order to stabilize the financial system as a whole and support our economy by bolstering the capital position of viable institutions of all sizes. In exchange for the investments, Treasury received preferred stock or debt securities, as well as warrants to purchase common shares or other securities from the institutions. Most CPP institutions pay dividends at five percent per year for the first five years, and then nine percent per year thereafter.[1] Treasury disbursed $205 billion to 707 institutions in 48 states under the CPP. The final investment under the CPP was made in December 2009, and Treasury has since focused on recovering the investments. As of September 30, 2013, the CPP had recovered $224.7 billion – $19.7 billion more than disbursed.

The CDCI was designed to help viable Community Development Financial Institutions (CDFIs) and the low-income communities they serve cope with the effects of the financial crisis. The initial dividend or interest rate was two percent, which increases to nine percent after eight years. CDFI credit unions also could apply to receive secondary capital investments at rates equivalent to those offered to CDFI banks and thrifts. As of September 30, 2013, the CDCI had recovered $121.8 million, compared to $570 million distributed.

Treasury's authority to make new financial commitments under TARP ended on October 3, 2010. Since then, we have been managing and winding down the TARP investments. In May 2012, Treasury announced an exit strategy for winding down its remaining CPP bank investments in a way that protects taxpayer interests, promotes financial stability, and preserves the strength of our nation's community banks. Under that strategy, Treasury has used a combination of repayments, restructurings, and sales to manage and recover those remaining investments.

As of September 30, 2013, 599 CPP investments have been repaid or sold at auction, or the institutions otherwise have exited the program; 108 investments remain, and Treasury will continue to dispose of these investments as efficiently as possible, in the best interest of the taxpayer. As of September 30, 2013, 13 CDCI investments have been repaid or the institutions otherwise have exited the program. Overall, TARP's bank investment programs have resulted in a positive return of more than $28 billion through repayments, dividends, interest, and other income. All told, as of September 30, 2013, Treasury had recovered $273.1 billion on a total investment of $245.1 billion under the banking programs.

II. Treasury Developed Guidelines and Processes for Nominating Directors and Sending Observers, and Treasury has Followed Them.

Treasury's relationship with participating CPP and CDCI institutions is governed by contract. Those contracts give Treasury the right to nominate up to two members to the boards of directors of such CPP and CDCI institutions that fail to make a certain number of dividend or interest payments. Treasury's right applies to CPP institutions that have missed six or more quarterly

[1] In cases where Treasury has received subordinated debentures, such securities pay interest at 7.7 percent per year for five years, after which the rate steps up to 13.8 percent.

payments, and to CDCI institutions that have missed eight or more quarterly payments.[2] Treasury has also sent employees to observe meetings of the boards of directors who are approaching the threshold of missed payments, though the contracts do not require the participating institutions to accept those observers.[3] To date, Treasury has nominated 25 directors to 15 institutions, and we have had observers at 85 institutions.

Treasury developed guidelines and processes for board member appointments and for sending board observers. Treasury has followed these processes and guidelines when exercising its rights.

First, if an institution is close to the threshold for missed dividend or interest payments, in many cases Treasury requests permission to send an observer to board meetings. Treasury observers have been government employees and come from a pool of qualified candidates within Treasury's Office of Financial Stability. Sending a Treasury employee as an observer is a proactive measure that provides an opportunity for early assessments of the institution before Treasury has the contractual right to nominate directors. The information observers collect at board meetings has provided Treasury greater insight into the unique issues facing each individual institution. The observers also have helped Treasury determine the particular qualities in a director that a particular institution would need to help address those issues.

Next, if an institution reaches the threshold for missed dividend or interest payments, Treasury has the right to nominate up to two members to its board of directors. Nominating members to the board of directors involves significant time and taxpayer resources. Treasury employees cannot be board members; thus we need to search for external candidates.[4] Those searches take several months, often a year or more, because, among other reasons, (i) Treasury is focused on finding directors who are qualified, experienced, and suitable for the particular institution, (ii) Treasury must conduct due diligence on candidates and candidates must conduct due diligence on the institution, and (iii) the institution's regulator must approve the candidate.

Treasury determines whether and how best to exercise this right after a full evaluation of its investment and incorporating information from the observers. This includes a review of the institution's current board and management, its current capital plan, and its overall financial condition. Treasury also evaluates operational barriers that could preclude Treasury from being able to find a willing, qualified candidate. Such barriers include the lack of directors and officers insurance or lack of director compensation.

Treasury engages an executive search firm to help it identify qualified candidates. Suitable candidates typically have experience and familiarity with financial services, regulations, capital

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[2] The right engages whether or not the missed payment is consecutive – in other words, the right engages after the CPP institution has missed six total dividend payments, not necessarily after six consecutive missed payments.

[3] To date, 12 CPP institutions and one CDCI institution declined our request to send observers. Of the CPP institutions, five remain outstanding, one has repurchased, one has partially repurchased and five have been sold. The CDCI institution has since become current on its dividend payments.

[4] Once appointed, the new board members represent the shareholders of the particular institution. The new board members have the same fiduciary responsibilities to the institution as the other board members. They are not Treasury's agent.

raising, mergers and acquisitions, prior board memberships, and knowledge of the community, among other qualities. Although the consultant may identify several suitable candidates, we have found that many of them may not be interested in serving on the board of the particular institution in question. Just as we look at particular factors in identifying suitable candidates, our experience thus far indicates that candidates also consider a number of factors in deciding whether to pursue the position. Those factors include the location and frequency of board meetings, compensation for directors, reimbursement of travel costs, directors and officers insurance, director indemnification, and the financial condition of the institution. Generally, institutions with investments of $25 million or greater have proven to be the best match, though we have conducted searches at institutions with investments of $15 million or greater.

Additionally, sometimes the nominees are suited to make the greatest impact at the subsidiary bank, though Treasury's contract only is with the bank holding company. In such circumstances, the subsidiary bank itself would have to appoint the member to its own board of directors concurrently with Treasury's nomination to the bank holding company. This circumstance adds further complexity to the process.

When evaluating whether to send an observer and nominate a member to the board of directors, we also consider our strategy for winding down CPP investments. Whereas the CPP originally had 707 institutions in the program, 108 remained as of September 30, 2013 (today the number is 97). We expect some of those institutions to repay in the near future. Many others are not likely to do so. We expect to sell (or restructure) those investments, which include most or all of the institutions that have missed multiple payments.

The CDCI program is in a different stage than the CPP due to the unique circumstances facing CDCI institutions and the communities they serve, and thus does not face issues related to potential near term dispositions. Since many CDFIs do not have the same access to capital markets as larger banks, the CDCI was designed with more generous repayment terms than the CPP. Although the investments are smaller and the threshold for missed payments is higher, we generally follow the same policies and procedures regarding directors and observers for CDCI investments. Only two institutions have missed the threshold number of payments. We have sent an observer to one of them thus far.[5]

III. To the Extent SIGTARP Recommends Treasury Manage the CPP and CDCI Investments in the Manner that Best Protects the Taxpayer Investment, Treasury's Current Practice Addresses SIGTARP's Concerns.

We understand that your recommendations were not made pursuant to any audit of Treasury and therefore appear not to be based on any specific research or fieldwork on this issue, as required under the Generally Accepted Government Auditing Standards. In addition, SIGTARP officials have said on multiple occasions that SIGTARP is not a policymaker. Instead, they have acknowledged that Treasury should make its own policy judgments.

[5] The other involves an investment of $3 million, which is below the $5 million threshold in our guidelines for CDCI observers.

Before sending your letter, you and I discussed the observer and director process. Treasury staff also met with SIGTARP officials to discuss the process as well. We emphasized that our goal is to maximize taxpayer returns by focusing on exit and wind down. That goal does not conflict with nominating directors going forward.

SIGTARP recommends that we exercise the right to appoint directors in all eligible cases simultaneously with selling the investments. The recommendations do not appear to consider that exercising that right may take longer than selling the investment would take. From the standpoint of maximizing the use of taxpayer resources, the timing of a possible sale impacts whether to begin the process of nominating a director.[6]

SIGTARP's letter also implies that the right to appoint a director will disappear – and the benefits that additional directors may bring to the institution would never be realized – if Treasury does not exercise the right prior to selling the investment. This is not the case. The rights under the CPP contracts continue to run with the security, and thus the right to nominate members is generally available to those who purchase the investment from Treasury.[7]

We understand the spirit of your three recommendations to be that Treasury should protect the taxpayers' investment. We agree. I have described above the importance of also considering the time and expense involved; the circumstances of different institutions; and our wind down plans. We will, however, continue to appoint directors and observers where appropriate, given such considerations.

IV. Conclusion.

We continue to consider all available strategies to maximize the taxpayer return as we wind down TARP. We appreciate SIGTARP's interest in those strategies. As always, I am available to answer any questions you have about these issues.

Sincerely,

Tim Massad

Timothy G. Massad
Assistant Secretary for Financial Stability

[6] In addition, another consideration could be whether Treasury intends to sell the investment in the near future, as it would not be appropriate for Treasury to receive non-public information ahead of an expected sale.
[7] This is true except in the situation where purchasers are required by regulators to sign a passivity agreement relinquishing the right to elect directors. In such cases, the purchasers could not re-elect any director previously appointed by Treasury anyway.