Statement before the Congressional Oversight Panel
Of the Troubled Asset Relief Program (TARP)

TARP on a Businesslike Basis

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The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Madam Chairman and Members of the Oversight Panel, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Prior to joining AEI five years ago, I spent 35 years in banking, including twelve years as President and CEO of the Federal Home Loan Bank of Chicago. I have both experienced a number of financial crises and studied the instructive history of recurring bubbles and busts.

TARP in Historical Context

I believe the closest historical analogue to TARP is the Reconstruction Finance Corporation (RFC) of the 1930s. Like TARP, the RFC was created under a Republican administration, and expanded under the succeeding Democratic one (in the RFC case, the Hoover and Roosevelt administrations) as an emergency response to financial crisis. In both cases, the original liquidity idea--loans for the RFC, troubled mortgage assets purchases for TARP-- developed into a solvency idea: providing additional equity to banks in the form of preferred stock.

Consider the approaches available to a government to address a financial crisis. First, there is delay in recognizing losses while issuing assurances (for example: "the subprime problems are contained"). Then there are central bank lending operations, providing liquidity. But however freely the central bank lends, it is by definition providing debt, not equity. No matter how much it lends to entities with negative capital, the capital is still negative. When the capital is gone, new capital, not just liquidity, is needed.

The RFC made preferred stock investments in banks to offset the capital which had been lost. Its goal was to have a modest overall positive return on the taxpayers' money and redemption of the preferred stock at par when growth resumed and the firms were refinanced in the private market. By and large, this strategy appears to have succeeded.

In September, 2008, when considering the original "Paulson Plan" to buy mortgage assets, I expressed the view that something along the lines of the RFC's preferred stock investments would be a better idea. Of course, this is how TARP then turned out, and it is still my opinion that this is the least-bad approach.

TARP has made equity investments in almost 700 financial companies. The RFC made investments in over 6,000 banks, including such major banks of the day as National City Bank of New York, Chase National Bank, Manufacturers Trust Company, National Bank of Detroit and Continental Illinois. The vast majority of these were retired in full, after paying dividends along the way. The RFC also assisted over 1,000 savings and loans. Counting by the number of financial institutions involved, the RFC program was about ten times as big as TARP.

The RFC's bank equity investments totaled about $1.3 billion—scaled to nominal GDP of 1933 vs. 2008, this would be the equivalent of about $325 billion today—comparable to TARP, which has a few gigantic investment positions. The RFC was also involved in numerous other areas, with a total of $10 billion spent fighting the Depression, which would be the GDP-scaled equivalent of about $2.5 trillion.

The RFC, like TARP, got involved in transportation companies. In the RFC's case, this was financing for railroads, said to have been the worst paying of its major investments. This seems likely to be true of TARP's automobile company investments, as well.

Running on a Business Basis

The RFC was run by a conservative Texas Democrat, Jesse Jones, a tough minded and successful entrepreneur, who had dropped out of school after the eighth grade. Jones' memoirs of his experiences, Fifty Billion Dollars—My Years with the RFC, make a highly interesting read. (A lot of the $ 50 billion was war production finance of the 1940s, not relevant to our topic.)

"There was a disposition on the part of President Roosevelt to use the RFC as a sort of grab bag or catchall in his spending programs," Jones wrote, "but I insisted on its being operated on a business basis with proper accounting methods."

"On a business basis," said Jones: in my view, the managers of TARP are fiduciaries for the taxpayers as involuntary investors. The principal goal should be to run the program in a businesslike manner to return as much of the involuntary investment as possible to its owners, along with a reasonable overall profit. The predominant discipline should be that of investment management, not politics.

The language of the Emergency Economic Stabilization Act of 2008 (EESA), which authorized TARP, always speaks of TARP as acquiring assets. In acquiring preferred stock in banks, TARP became an investor in assets different from the original idea, but they are still assets, which can be managed in a businesslike way to recover the taxpayers' investment.

However, with the $50 billion "Home Affordable Modification Program" (HAMP), TARP is not acquiring an asset at all, but simply spending the taxpayers' money to subsidize mortgage loan modifications, including subsidies to mortgage servicing companies. There is no asset acquired. The Wall Street Journal reasonably suggested its fear that TARP is morphing into "an all-purpose bailout fund." And very conveniently, whatever TARP spends is under EESA automatically appropriated by Congress.

An obvious difference of the RFC from TARP is that the RFC was a corporation—a government corporation, to be sure, but a separate corporate entity, with dedicated management and a board of directors, its own borrowing authority, and of course, the ability to account for itself as a corporation. "U.S. policymakers of the 1930s," wrote a student of the RFC, Walker Todd, "enacted a separate, politically accountable" organization, with "a clearly defined network of checks and balances."

In general, it seems to me that such interventions as TARP or the RFC, if they are to exist, are better established as separate corporations, rather than as "programs," mixed into other entities, such as the Treasury or the Federal Reserve.

Regular Financial Statements

Jesse Jones, as quoted above: "but I insisted on…proper accounting methods."

In contrast, it appears that in more than a year, no financial statements for TARP have been produced for the Congressional Oversight Panel or the public. EESA does require a public, annual fiscal year financial statement, presumably forthcoming though not yet produced. But good managerial practice and proper accounting methods require much more than that--at a minimum quarterly financial statements.

In my view, TARP should have full, regular, audited financial statements, which depict its financial status and results, exactly as if it were a corporation. There should be a balance sheet, with all assets, liabilities, accumulated profits or losses, and contingencies. There should be a profit and loss statement and a statement of cash flows. The expenses should include the interest cost of the Treasury debt required to fund its disbursements, and like every financial operation, TARP management should be estimating probable losses on investments and reserving accordingly.

Had TARP been organized as a corporation, it would have facilitated this accountability. But even with its status as a "program", we should insist on appropriate and regular accounting. Everybody must agree with this basic requirement for financial responsibility.

Moreover, TARP's financial statements should include line of business reporting. Logical separate profit and loss reporting units would include: the Capital Purchase Program; automotive program; Citigroup; AIG; mortgage modification (of course a total loss from the TARP point of view); and small business and consumer programs.

Enforcing the Temporary Nature of TARP

An essential principle is that government crisis interventions should be kept temporary. They should not be allowed to morph into permanent economic distortions. "Emergencies markedly increase both the demand for and the supply of governmental controls," as Robert Higgs has written in Crisis and Leviathan. The emergency programs need to be turned off when the crisis is over, allowed to wind down over time, and finally disappear, as the RFC (after having its life extended by the crisis of World War II) did.

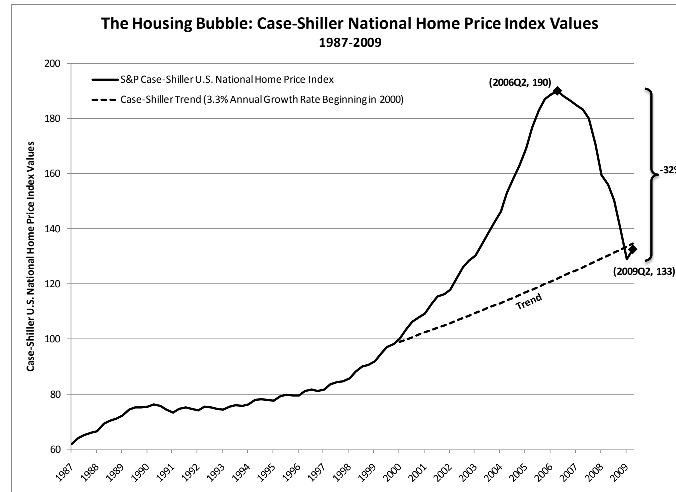
Over the last several months, financial markets have greatly recovered and rediscovered their taste for risky assets. Although obvious problems remain, especially in the smaller banks (as discussed below) the extended panic of summer, 2007 to spring, 2009, has passed.

It is easy to imagine how much the Treasury and the Administration would like to extend as long as possible the power and independent capacity they enjoy through the operation of TARP. But in my view, it is time to observe its target expiration date of December 31, 2009.

The very fact, mentioned above, that TARP disbursements are by law automatically appropriated, is reason enough to enforce a timely expiration.

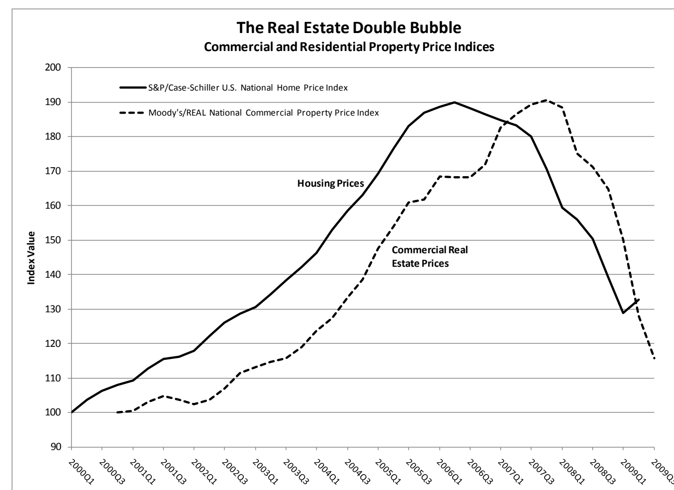
Current Financial Context: Small Banks

The collapse of the vast bubble in housing prices has had national average prices, as measured by the Case-Shiller National Home Price Index, fall about 30% from their mid-2006 peak. They have now returned to their long-term trend line, as shown in the following picture of the bubble.

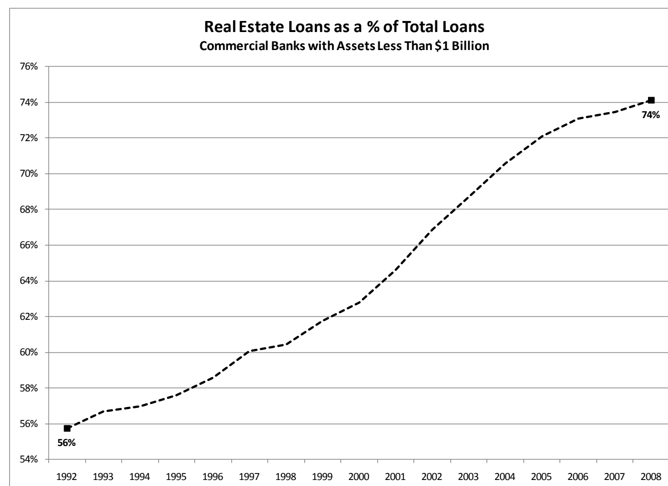


Of course, prices can overshoot the trend on the downside, too, but a great deal of adjustment has already taken place.

However, we have experienced not just a bubble, but a double bubble in real estate prices: one in houses and one in commercial real estate. The two bubbles are remarkably similar in shape, but the second lags the first by about six quarters, as shown below.



Smaller banks are disproportionally concentrated in real estate risk, and in commercial real estate risk in particular. Their concentrations in real estate loans have been growing steadily since the early 1990s, and real estate loans increased to 74% of the aggregate loans of the about 6,500 banks with assets of less than $1 billion, as shown in the next chart.



The implication of difficult credit conditions ahead for these banks is easy to see.

At the same time, the FDIC has announced that its net worth is negative—that is, the government deposit insurer is itself out of capital. Perhaps, before its December 31 expiration, TARP should make a preferred stock investment in the FDIC?

The Use of TARP's Final Net Profit, If Any

According to a cumulative profit and loss statement published at the beginning of 1940, the RFC had a cumulative net profit, after providing for losses and for the cost of debt, of $160 million on its capital of $500 million. "The program of putting capital into banks," wrote Jesse Jones, "was carried out without loss to the government or the taxpayer. On the contrary, it has shown profit through interest and dividends."

If TARP should succeed in making a final overall profit, what should be done with that profit?

EESA provides that all revenues from as well as repayments of TARP investments must go to reduce the federal deficit. But a better idea would be to declare the whole profit of TARP (over and above repayments and expenses), should there be one in the end, as a cash dividend to those American households who actually pay federal income taxes. It was their money all along; they took all the risk; they deserve an explicit return.

A future Congress might consider this idea.

Recoupment of TARP's Final Net Loss, If Any

Section 134 of EESA provides that if there is a final shortfall in TARP, "the President shall submit a legislative proposal that recoups from the financial industry an amount equal to the shortfall in order to ensure that TARP does not add to the deficit or national debt." This is an interesting possible liability of whoever is included in "the financial industry." Of course, Congress may not enact the required Presidential proposal, but this provision is one more good reason to demand full and proper accounting from TARP.

Thank you again for the opportunity to share these views.