Congressional Oversight Panel

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APRIL OVERSIGHT REPORT*

Executive Summary

Assessing Treasury's Strategy: Six Months of TARP

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Executive Summary[*]

With this report, the Congressional Oversight Panel examines Treasury's current strategy and evaluates the progress it has achieved thus far. This report returns the Panel's inquiry to a central question raised in its first report: What is Treasury's strategy? While there is disagreement among Panel members about whether it is appropriate to present alternatives to Treasury's strategy at this time, this report also examines potential policy alternatives available to Treasury, in the event such alternatives become necessary.

This report comes on the six month anniversary of the passage of the Emergency Economic Stabilization Act of 2008 (EESA). In a letter received by the Panel on April 2, 2009, Treasury Secretary Timothy Geithner described four major challenges that Treasury's strategy seeks to address: (1) the collapse of the housing market; (2) frozen secondary markets that "have constrained the ability of even creditworthy small businesses and families" to get credit; (3) uncertainty about the health of financial institutions and the valuation of assets on their balance sheets; and (4) the existence of "troubled legacy assets" on the balance sheets of financial institutions that affect their capitalization and limit their ability to make loans. The Panel appreciates Treasury's explanation of its goals, and it hopes this report inspires a more informed conversation over the fundamental questions raised by Treasury's strategy.

In addition to drawing on the $700 billion allocated to Treasury under the EESA, economic stabilization efforts have depended heavily on the use of the Federal Reserve Board's balance sheet. This approach has permitted Treasury to leverage TARP funds well beyond the funds appropriated by Congress. Thus, while Treasury has spent or committed $590.4 billion of TARP funds, according to Panel estimates, the Federal Reserve Board has expanded its balance sheet by more than $1.5 trillion in loans and purchases of government-sponsored enterprise (GSE) securities. The total value of all direct spending, loans and guarantees provided to date in conjunction with the federal government's financial stability efforts (including those of the Federal Deposit Insurance Corporation (FDIC) as well as Treasury and the Federal Reserve Board) now exceeds $4 trillion. This report reviews in considerable detail specific criteria for evaluating the impact of these programs on financial markets. Six months into the existence of TARP, evidence of success or failure is mixed.

Evaluating the wisdom and success of these efforts requires a broader understanding of the basic choices available to policymakers during this crisis. To deal with a troubled financial system, three fundamentally different policy alternatives are possible: liquidation, receivership, or subsidization. To place these alternatives in context, the report evaluates historical and

[*] The Panel adopted this report with a 3-2 vote. Senator John Sununu and Rep. Jeb Hensarling voted against the report. Additional views are available in the full version of this report at the Panel website: www.COP.Senate.gov.

contemporary efforts to confront financial crises and their relative success. The Panel focused on six historical experiences: (1) the U.S. Depression of the 1930s; (2) the bank run on and subsequent government seizure of Continental Illinois in 1984; (3) the savings and loan crisis of the late 1980s and establishment of the Resolution Trust Corporation; (4) the recapitalization of the FDIC bank insurance fund in 1991; (5) Sweden's financial crisis of the early 1990s; and (6) what has become known as Japan's "Lost Decade" of the 1990s. The report also surveys the approaches currently employed by Iceland, Ireland, the United Kingdom, and other European countries.

Experiences from other times and other countries illustrate the benefits and problems these basic approaches present to dealing with failing banks. In the 1980s savings and loan crisis, for example, the U.S. government liquidated unhealthy financial institutions by transferring depositors to another bank, selling off assets, writing down some debt and wiping out investors. There can be considerable political barriers to this approach, and a surprise or poorly-explained liquidation can reduce market confidence and heighten uncertainty about future government interventions in financial markets. But liquidation also avoids the uncertainty and open-ended commitment that accompany subsidization. It can restore market confidence in the surviving banks, and it can potentially accelerate recovery by offering decisive and clear statements about the government's evaluation of financial conditions and institutions.

Another option is government reorganization of troubled financial institutions using conservatorships, as in the case of Continental Illinois in the U.S. and the financial crisis in Sweden in the 1990s. This approach entails an in-place reorganization in which bad assets are removed, failed managers are replaced, and parts of the business are spun off. Depositors and some bondholders are protected, and institutions can emerge from government control with the same corporate identity but healthier balance sheets. This option also offers clarity to markets about the balance sheets of the reorganized financial institutions and encourages capital investment in the newly-reorganized entity. But reorganization can also tax government capacity and resources. If they are not quickly returned to private hands, government-run financial institutions also pose a risk that political pressure will press the institutions to lend to favored interests and support public policy at the expense of the bank's health, although there is no evidence that this has occurred in recent banking crises.

The third option is government subsidization of troubled institutions. Japan's approach was characterized by a series of direct and indirect subsidizations. Subsidies may be direct, by providing banks with capital infusions, or indirect, by purchasing troubled assets at inflated prices or reducing prudential standards. Cash assistance can provide banks with bridge capital necessary to survive in tough economic times until growth begins again. But subsidies carry a risk of obscuring true valuations. They involve the added danger of distorting both specific markets and the larger economy. Subsidization also carries a risk that it will be open-ended, propping up insolvent banks for an extended period and delaying economic recovery.

A review of these historical precedents reveals that each successful resolution of a financial crisis involved four critical elements:

- **Transparency.** Swift action to ensure the integrity of bank accounting, particularly with respect to the ability of regulators and investors to ascertain the value of bank assets and hence assess bank solvency

- **Assertiveness.** Willingness to take aggressive action to address failing financial institutions by (1) taking early aggressive action to improve capital ratios of banks that can be rescued, and (2) shutting down those banks that are irreparably insolvent.

- **Accountability.** Willingness to hold management accountable by replacing – and, in cases of criminal conduct, prosecuting – failed managers.

- **Clarity.** Transparency in the government response with forthright measurement and reporting of all forms of assistance being provided and clearly explained criteria for the use of public sector funds.

Historical precedents always involve some differences from the current crises. Nonetheless, experience can provide an important comparison against which current approaches can be tested.

One key assumption that underlies Treasury's approach is its belief that the system-wide deleveraging resulting from the decline in asset values, leading to an accompanying drop in net wealth across the country, is in large part the product of temporary liquidity constraints resulting from nonfunctioning markets for troubled assets. The debate turns on whether current prices, particularly for mortgage-related assets, reflect fundamental values or whether prices are artificially depressed by a liquidity discount due to frozen markets – or some combination of the two.

If its assumptions are correct, Treasury's current approach may prove a reasonable response to the current crisis. Current prices may, in fact, prove not to be explainable without the liquidity factor. Even in areas of the country where home prices have declined precipitously, the collateral behind mortgage-related assets still retains substantial value. In a liquid market, even under-collateralized assets should not be trading at pennies on the dollar. Prices are being partially subjected to a downward self-reinforcing cycle. It is this notion of a liquidity discount that supports the potential of future gain for taxpayers and makes transactions under the CAP and the PPIP viable mechanisms for recovery of asset values while recouping a gain for taxpayers.

On the other hand, it is possible that Treasury's approach fails to acknowledge the depth of the current downturn and the degree to which the low valuation of troubled assets accurately reflects their worth. The actions undertaken by Treasury, the Federal Reserve Board and the FDIC are unprecedented. But if the economic crisis is deeper than anticipated, it is possible that Treasury will need to take very different actions in order to restore financial stability.

By offering this assessment of Treasury's current approach and identifying alternative strategies taken in the past, the Panel hopes to assist Congress and Treasury officials in weighing the available options as the nation grapples with the worst financial crisis it has faced since the Great Depression.