Section Two: Additional Views

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We concur with the issuance of the September report and offer the additional observations below. We appreciate the efforts the Panel and staff made incorporating our suggestions offered during the drafting of the report.

In these Additional Views we make the following five points:

- Repayment by TARP recipients of advances received under the program is a misleading measure of the effectiveness of the TARP and therefore should not serve as *the* standard by which the TARP is judged.
- The unlimited bailout of Fannie Mae and Freddie Mac by Treasury and the purchase of $1.25 trillion of GSE-guaranteed MBS in the secondary market by the Federal Reserve benefitted TARP recipients and other financial institutions.
- According to the Congressional Budget Office, the bailout of Fannie Mae and Freddie Mac is projected to cost more than *five times* the projected cost of the TARP, including the Capital Purchase Program employed by Treasury to bail out over 700 financial institutions. TARP recipients and other holders of GSE-guaranteed MBS who benefitted from the bailout of the two GSEs are not required, however, to share any of the costs incurred in the bailout.
- The bailout of Fannie Mae and Freddie Mac permitted TARP recipients to monetize their GSE-guaranteed MBS at prices above what they would have received without the GSE guarantee and use the proceeds to repay their obligations outstanding under the TARP, thereby arguably shifting a greater portion of the cost of the TARP from the TARP recipients themselves to the taxpayers. Costs such as this should be included when evaluating the TARP.
- The TARP created significant moral hazard risks and all but enshrined the concept that some financial institutions and other business enterprises are too big or too interconnected to fail.

1. Treasury Advocates an Inappropriate Metric for Assessing TARP

As is indicated in the report, among the general public the TARP remains one of the most vilified programs enacted by the federal government, viewed largely as an effort by former Wall Street executives to bail out current Wall Street executives at the expense of American taxpayers,

with no measurable benefits accruing to the taxpayers.[397] In contrast, both current and former Treasury officials state over and over that the TARP was a success because it helped avoid a much more severe financial crisis that would have caused taxpayers to suffer even greater harm. In our view, Treasury is struggling to convince the American public of the TARP's success by advocating the acceptance of a metric – whether or not the TARP money has been repaid – that is simply not a credible measure of success. Professor Kenneth Rogoff addressed this issue in his written submission to the Panel where he states:

> A proper cost benefit analysis thus needs to price the risk the taxpayer took on during the financial crisis. Ex post accounting (how much did the government actually earn or lose after the fact) can yield an extremely misguided measure of the true cost of the bailout, especially as a guide to future policy responses.[398]

2. The Bailout of the GSEs and its Consequences to TARP Recipients

One of the important ways this metric can be misleading is if other government programs that are not part of the TARP either directly or indirectly enhanced TARP recipients' ability to repay the government. One program that has potentially played a key role, but has received relatively less attention, is Treasury's bailout of Fannie Mae and Freddie Mac.[399] Had Fannie Mae and Freddie Mac been allowed to fail, TARP recipients and other financial institutions holding MBS guaranteed by the two GSEs most likely would have had little choice but to retain some of the MBS on their books. The eventual write-down in the value of these securities quite possibly would have resulted in many of these institutions suffering significant financial losses.[400] This in turn would have impaired their ability to pay back their TARP funding and may have required them to obtain additional advances from the TARP. As it was, Treasury

[397] In our view, the TARP – acting as the financial equivalent of a hospital ER – was helpful in returning financial stability to the markets during the last quarter of 2008 when properly considered along with the substantial and aggressive interventions of the Federal Reserve, Treasury, and the FDIC as well as the actions of the markets themselves. We nevertheless wonder if the Federal Reserve, Treasury, and the FDIC could not have effectively assisted the markets in achieving financial stability without additional governmental intervention. The TARP, however, has failed as a broader public policy initiative by: (1) permitting Treasury (and not the markets) to pick winners and losers (that is, which companies are bailed out and on what terms); (2) injecting substantial moral hazard risk into the markets; and (3) all but enshrining the doctrine that some financial institutions and other business enterprises are simply too big or too interconnected to fail.

[398] Kenneth Rogoff, Written Answers to Questions Posed by the Congressional Oversight Panel (Aug. 2010). In contrast to a simple "TARP has been repaid" standard, OMB and CBO measure the cost of TARP (as required by Section 123 of EESA) using discounted present value of the cash flows involved ("credit reform" methodology) where the discounted rate is explicitly adjusted "for market risk."

[399] *See* Treasury HERA Update, *supra* note 372.

[400] Even if holders of the GSE-guaranteed MBS were able to avoid the recognition of their built-in losses under the revised mark-to-market accounting rules, the holders would have been required to recognize such losses upon the disposition of the securities.

stepped in and provided unlimited support for all outstanding MBS guaranteed by Fannie Mae and Freddie Mac.

In addition, the Federal Reserve has recently purchased $1.25 trillion of GSE-guaranteed MBS in the secondary market from TARP recipients, other financial institutions and other investors and issuers.[401] Although the Federal Reserve purchased the MBS at fair market value at the time of the transaction, it is significant to note that the pricing reflected the value of the guarantee provided by Treasury through its unlimited bailout of Fannie Mae and Freddie Mac.[402] By returning the GSE-guaranteed MBS to Fannie Mae and Freddie Mac, or by selling them to the Federal Reserve or third-party investors, TARP recipient holders of the MBS were able to remove the securities from their balance sheets at prices above what they would have received without the GSE-guarantee and use the sales proceeds to "pay back" their outstanding obligations under the TARP.[403] The bailout of the two GSEs by Treasury thus had the potential to shift losses suffered under the TARP to losses suffered by another Treasury program that has not been subject to the same oversight or public scrutiny.[404] As this example illustrates, any evaluation of the success of the TARP has to take into account the interaction among all government programs designed to prop up the financial system and how costs may have been shifted among these programs.

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[401] Board of Governors of the Federal Reserve System, *Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet*, at 1 (Aug. 2010) (online at www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport201008.pdf).

[402] Without viable GSE guarantees, the MBS most likely would have traded at fair market value prices of well below par (due to the impairment of the underlying mortgage collateral securing the MBS), but with viable GSE guarantees, the MBS most likely would have traded at or near par. For example, if Fannie Mae and Freddie Mac were insolvent, a $100 face value GSE-guaranteed MBS might have traded for $40, but if Fannie Mae and Freddie Mac were solvent and hence able to perform in full under their guarantees, the same MBS might have traded at or near par, that is, $100. By bailing out Fannie Mae and Freddie Mac, Treasury in effect transferred $60 from the taxpayers to the holders of the GSE-guaranteed MBS. In addition, if TARP recipients and other financial institution sellers had previously written down their MBS, a sale to the Federal Reserve or another investor at or near par might have permitted the institutions to book an accounting gain.

[403] Some of the funds employed to bail out the two GSEs most likely followed a round-trip from Treasury to Fannie Mae/Freddie Mac to TARP recipient sellers of GSE-guaranteed MBS and back to Treasury as the repayment of TARP advances. Since money is fungible, it is possible that the proceeds received from the sale of GSE-guaranteed MBS freed up other funds – including proceeds received from the sale of equity and debt securities – that were actually used to repay amounts outstanding under the TARP.

[404] The bailout of Fannie Mae and Freddie Mac by Treasury arguably permitted TARP recipients to extinguish part of their outstanding TARP obligations with the proceeds received from the disposition of their GSE-guaranteed MBS at prices subsidized by the bailout of the two GSEs. Without the bailout, TARP recipients quite possibly would have been stuck with their illiquid, severely depressed GSE-guaranteed MBS as well as with a greater portion of their outstanding TARP obligations.

3. Analysis of CBO Subsidy Cost of the TARP and Bailout of the GSEs

The Congressional Budget Office (CBO) estimates that Treasury's bailout of Fannie Mae and Freddie Mac will cost the taxpayers approximately $291 billion through fiscal year 2009 and $389 billion through fiscal year 2019.[405] If only 25 percent[406] of the CBO cost of the bailouts ultimately inures to the benefit of TARP recipients and other financial institutions, Treasury will have provided a subsidy to these institutions of approximately $100 billion.[407] This non-TARP government sponsored support – unlike obligations incurred under the TARP itself[408] – remains cost-free to the recipients. That is, holders of GSE-guaranteed MBS are not required to share any of the cost incurred by the taxpayers arising from Treasury's bailout of Fannie Mae and Freddie Mac.[409]

The cost to the taxpayers of the bailout of the two GSEs is all the more remarkable when compared to the most recent CBO cost estimate for the *entire* TARP program of "only" $66 billion.[410] The CBO also estimates that the financial institution bailout component of TARP – the Capital Purchase Program (CPP) – will return a *profit* of approximately $2 billion.[411] While TARP has been vigorously debated throughout the country over the past two years and has served as a lightning rod for those who question government-sanctioned bailout programs, it is indeed ironic that the relatively obscure bailout of Fannie Mae and Freddie Mac is projected to carry a cost to the taxpayers of more than *five times* the projected cost of the much maligned TARP.[412] It is also ironic that the original plan proposed by Secretary Paulson under the TARP to purchase distressed GSE-guaranteed MBS and other "toxic assets" was at least partially

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[405] Congressional Budget Office, *Budgetary Treatment of Fannie Mae and Freddie Mac*, at 8 (Jan. 2010) (online at www.cbo.gov/ftpdocs/108xx/doc10878/01-13-FannieFreddie.pdf).

[406] Since the CBO estimates that the bailout of Fannie Mae and Freddie Mac will cost the taxpayers approximately $400 billion, Treasury should disclose the amount of the subsidy cost that will inure to the benefit of TARP recipients and other financial institutions.

[407] $389 billion CBO subsidy cost estimate for the bailout of Fannie Mae and Freddie Mac multiplied by 25 percent, equals $97.25 billion.

[408] Participants in the Capital Purchase Program (the financial institution bailout program included in the TARP) are required to repay all funds advanced thereunder, together with interest or dividends (as applicable) thereon, and to grant Treasury warrants to purchase equity interests in the recipients.

[409] Presumably, Treasury could have underwritten, for example, only 50 percent of the unfunded guarantee obligations of Fannie Mae and Freddie Mac and required the holders of the GSE-guaranteed MBS to absorb the remaining loss.

[410] CBO Report on the TARP – March 2010, *supra* note 67, at 3 (noting a subsidy cost for the TARP of $109 billion as of March 2010). *See also* CBO's Latest Projections for the TARP, *supra* note 68 (noting a subsidy cost for the TARP of $66 billion as of August 20, 2010).

[411] *See* CBO Report on the TARP – March 2010, *supra* note 67, at 3. *See also* CBO Budget and Economic Outlook, *supra* note 68, at 70.

[412] $389 billion CBO projected subsidy cost for the bailout of Fannie Mae and Freddie Mac through 2019, divided by $66 billion CBO projected subsidy cost for the TARP, equals 5.89.

implemented outside of the TARP by the Federal Reserve through its quantitative easing program and by Treasury through its unlimited bailout of Fannie Mae and Freddie Mac, both at no cost to TARP recipients and other holders of GSE-guaranteed MBS but at significant long-term expense to the taxpayers.

4. Moral Hazard and Too-Big-To-Fail Risks Enhanced by the TARP

Other potential costs of the TARP that we feel deserve more attention are the future costs resulting from the use of TARP funds to bail out systemically important financial and other firms. By targeting much of the TARP funding towards large firms such as Citigroup, Bank of America, A.I.G., Chrysler, GM, and Ally Financial (formerly GMAC),[413] which solidified the market's belief in an implicit guarantee from the government for these firms, the TARP has exacerbated the "too big to fail" phenomenon.[414] This in turn provides these large firms with a substantial cost advantage over their smaller, less systemically important competitors, which will lead to a more concentrated financial sector and higher prices paid by customers of banks and other financial companies. In addition, creating larger, more systemically important financial firms increases the likelihood of future financial crises because these firms have an incentive to

[413] It is worth noting that while markets seemed to recognize the existence of the "too big to fail" guarantee for large financial firms, by using the TARP to bail out Chrysler and GM, Treasury appears to have extended Too-Big-To-Fail to large non-financial firms.

[414] The Additional Views issued by J. Mark McWatters and former Panel member Paul S. Atkins with respect to the Panel's January 2010 report on "Exiting TARP and Unwinding Its Impact on the Financial Markets" describes some of the challenges presented by the TARP:

> The January report analyzes the difficulties that may arise when the United States government directly or indirectly undertakes to prevent certain systemically significant institutions from failing. Although the government does not generally guarantee the assets and obligations of private entities, its actions and policies may nevertheless send a clear message to the market that some institutions are simply too big or too interconnected to fail. Once the government adopts such a policy it is difficult to know how and where to draw the line. With little public debate, automobile manufacturers were recently transformed into financial institutions so they could be bailed out with TARP funds and an array of arguably non-systemically significant institutions – such as GMAC – received many billions of dollars of taxpayer funded subsidies. In its haste to restructure favored institutions, the government may assume the role of king maker – as was surely the case in the Chrysler and GM bankruptcies – and dictate a reorganization structure that arguably contravenes years of well-established commercial and corporate law precedent. The unintended consequences of these actions linger in the financial markets and legal community long after the offending transactions have closed and adversely – yet subtly – affect subsequent transactions that carry any inherent risk of future governmental intervention. The uninitiated may question why two seemingly identical business transactions merit disparate risk-adjusted rates of return or why some transactions appear over-collateralized or inexplicably complicated. The costs of mitigating political risk in private sector business transactions are seldom quantified or even discussed outside the cadre of businesspersons and their advisors who structure, negotiate and close such transactions, yet such costs certainly exist and must be satisfied.

Congressional Oversight Panel, *Additional Views of J. Mark McWatters and Paul S. Atkins -- January Oversight Report: Exiting TARP and Unwinding Its Impact on the Financial Markets*, at 157-158 (Jan. 14, 2010) (online at cop.senate.gov/documents/cop-011410-report-atkinsmcwatters.pdf).

invest in riskier projects as a result of the guarantee provided by the government. The additional costs borne by consumers in the form of higher prices for financial services and the additional costs that result from additional financial crises need to be included in any accounting of the costs of the TARP.