Whatever Happened to the *Troubled Assets* Relief Program?

Testimony of

Alan S. Blinder
Gordon S. Rentschler Memorial Professor of Economics and Public Affairs
Princeton University

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Mr. Chairman, members of the Committee, I'd like to thank you for the opportunity to testify here today. I come neither to praise the TARP ("Troubled Assets Relief Program"), nor to bury it, but rather to urge Congress to exercise its oversight authority to ensure that the Secretary of the Treasury pursues the stated goals of the legislation. Failing that, Congress should invoke Section 115 of the legislation to take the Secretary's checkbook away. We'll have a new Secretary of the Treasury in about two months.

Mr. Chairman, I think you remember that I was among the earliest voices calling upon Congress to establish something akin to the TARP. Specifically, I recommended two new institutions: one to purchase and refinance imperiled mortgages, the other to buy up some of what are now called "troubled assets," that is, mortgage-backed securities ("MBS") and related assets. The Emergency Economic Stabilization Act, signed by the President on October 3rd, established the TARP to serve both purposes. So it is with great dismay that I survey what has been done and conclude that the TARP is not performing its legislatively-mandated duties.

I object to the decisions Secretary Paulson has made on at least three levels: the choices he has made regarding how to deploy the money; the execution of those choices;

and what seems to me a sharp deviation from congressional intent. I'll take them up in turn, after a few words of background.

1. Overview: The Purposes of the TARP

Months ago, before the legislation was passed, people like me, who were recommending such an institution, thought of it as one component—albeit an important and expensive one—of a plan to get the nation's financial markets out of the EMS stage and into the surgical ward, where it will subsequently need major repairs. The hope was that, if we acted quickly, the wounded financial system might not drag the real economy into a deep recession.

But we did not act quickly, and all such hopes vanished the day Lehman Brothers was allowed to fail. So we remain in the EMS stage, with the financial markets in many respects sicker than they were before Lehman. And the hope that we might avoid a serious recession is now gone. I now view the TARP, the many initiatives of the Federal Reserve, what I hope will be a large new stimulus bill, and much else as pieces of a broad package designed to hold the recession line at, say, 8% unemployment. We have a chance of achieving that modest goal, but the odds are shifting against us daily.

Since the financial crisis has grown to be so complex and multi-faceted, it is worth recalling that it all began with falling house prices and defaults on mortgages—or, rather, fears that defaults would become rampant. (Those fears depressed the values of securities based on mortgages, and made them "troubled.") Foreclosures are personally painful and economically costly; they undermine property values; and they lead to fire sales of homes, which depress house prices further, thereby continuing the vicious cycle. It is difficult to see a way out of this mess without reducing the coming tsunami of defaults and foreclosures.

Understanding that, Congress wrote legislation that, at numerous points, exhorts, encourages, and even directs the Secretary of the Treasury to use TARP funds to acquire mortgages and get them refinanced. But he has not done so. Nor has he purchased any mortgage-related assets. So let me start with congressional intent.

2. What the Law Says

The law authorizes establishment of the TARP to purchase "troubled assets," which it defines in Section 3.9 as:

> *(A) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages,…the purchase of which the Secretary determines promotes financial market stability; and*
> *(B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.*

I think of this language as defining three classes of assets as eligible for purchase: mortgages, mortgage-related securities, and the catch-all "any other financial instrument." And please notice that Congress required specific justification, in writing, for utilizing the catch-all category.

I guess I'm old-fashioned, but I still believe in constitutional democracy. I followed the rancorous congressional debate over the TARP closely, and I'm pretty sure that Congress thought it was authorizing $700 billion mainly for the purchase of mortgages and mortgage-related securities. What we have gotten, instead, is zero purchases of either of these two asset classes. Instead, almost all the monies committed to date are for capital injections into banks, justified by the catch-all "any other financial instrument" clause.

Were I a Member of Congress, I'd be pretty unhappy about this turn of events. In fact, as a taxpayer shouldering his share of the $700 billion burden, I am unhappy.

3. The Allocation of TARP Funds

To be sure, I am not suggesting that Secretary Paulson overstepped his legal authority by making capital injections. Section 3.9(B), quoted above, clearly justifies doing so, if he deems that "necessary to promote financial market stability"--as I presume he has done, in writing, to this and other committees. Nor do I question the wisdom of allocating *some* of the TARP funds to recapitalizing banks, although I was always less enthusiastic about this use of the money than many of my colleagues.

But we should pay attention to the scoreboard, which so far reads:

> Mortgages: 0%
> Troubled assets: 0%
> Other: 100% (including a large allocation to an insurance company)

I do not believe that such a lopsided allocation is the optimal use of the public's money. To see why, let's review the arguments supporting these three alternative uses of the $700 billion.

(1) Mortgages: As noted earlier, the financial crisis began with mortgages and fear of foreclosures. FDIC Chairwoman Sheila Bair, among many others, has repeatedly called attention to this as the root cause of the problem; and I agree. Congress apparently agreed, too, because the legislation directs the Secretary to use TARP funds to get mortgages refinanced. Unfortunately for the country, he has not done so. And the mortgage problem festers and worsens.

(2) Mortgage-related securities: Three main arguments were used to sell the idea of buying troubled mortgage-backed securities (MBS) and the like to a very reluctant

Congress. First, panic had virtually shut down the MBS markets, which had to be put back in working order to restore our system of mortgage finance. Second, one of the reasons for panic was that nobody knew what these mortgage-related securities were worth. A functioning market would at least establish objective valuations; creating some buying pressure might even raise their prices. Third, many mortgages are tied up by complicated securitizations and derivatives. Buying up some of these securities would enable the government to acquire and refinance the captive mortgages and refinance them. In fact, this third objective was written explicitly into the law in several places; *cf.* Section 109.

(3) Recapitalizing banks: The catch-all "any other financial instrument" category was a wise addition to the Act. It gives the Secretary much-needed flexibility to respond to unforeseen circumstances. While Section 3.9(B) may get stretched even further, it has thus far mainly been used to inject capital into banks. Given the parlous financial condition of some of our banks, I believe Secretary Paulson was right to decide that bolstering their balance sheets was "necessary to promote financial market stability." But this circumstance was hardly unforeseen. Why wasn't it written into the legislation? I also question whether capital injections are the *most* appropriate, let alone the *only* appropriate, use of the TARP money. And I have serious questions about the details of the Capital Purchase Program, which I'll come to shortly.

Was this a case of bait and switch? Secretary Paulson has appealed to the well-known Keynesian dictum that reasonable people might change their minds when the facts change. I have no doubt that many facts have changed since October 3rd. But he has not explained what new facts invalidate the three arguments that were used only weeks ago to justify the TARP's original design. Foreclosures are still coming *en masse*, and they still destroy value. The MBS markets are still in ruins. Furthermore, a natural symbiosis exists between buying mortgages and buying troubled assets: Purchasing MBS helps the government acquire mortgages to refinance, and refinancing mortgages to avert foreclosures enhances the values of MBS. By the way, each of these policies also can bolster the financial positions of banks—which is the purpose of capital injections.

I conclude that the arguments for TARP buying both mortgages and mortgage-related securities still stand. It is a shame that neither of these is being done today.

4. Some Problems with the Treasury's Capital Purchase Program

Even given the decision to devote virtually all of the first $350 billion of TARP money to capital injections, taxpayers might reasonably have expected a better-designed program. I fault the Treasury on at least six dimensions:

First, while I understand the need to keep proprietary information confidential, the program is enshrouded in too much secrecy. It is, after all, the taxpayers' money being put at risk.

Second, Secretary Paulson decided to purchase preferred stock with no voting, or other control, rights. So the government provides money, but acquires virtually no influence over the recipient banks' behavior.

Third, taxpayers will receive only a 5% dividend on their investment (for the first five years). Curiously, just days before the legislation was passed, Warren Buffet concluded a deal with Goldman Sachs (a major recipient of TARP money) that included both preferred stock with a *10%* dividend yield and more attractive warrants. Surely, Goldman Sachs is one of the best credits participating in the Capital Purchase Plan. If so, how can a 5% dividend yield be consistent with the Act's requirements that "prices paid for assets are reasonable and reflect the underlying value of the asset" (Section 113(c)), that purchases are made "at the lowest price that the Secretary determines to be consistent with the purposes of this Act" (Section 113 (b)1), and that he spend the money in ways that "maximize the efficiency of the use of taxpayer resources" (Section 113(b)2)?

Fourth, participating banks are allowed to continue to pay dividends to their shareholders. This raises the spectacle of banks borrowing money (cheaply) from taxpayers in order to maintain their common stock dividends.

Fifth, contrary to many suggestions, Secretary Paulson did not require participating banks to raise private capital *parri passu* with the government's capital injections, which would at least have provided a valuable market test of viability.

Sixth, the capital injections are being made with no public-purpose *quid pro quos* at all—e.g., a minimal lending requirement, or a pledge to refinance more mortgages.

Frankly, I find it all breathtaking.

What can be the rationale behind terms that are so favorable to banks and so unfavorable to taxpayers? Based on what Secretary Paulson has said, I can only presume that his objective was to ensure the widest possible bank participation by avoiding stigma. Indeed, to this end, he even forced money on several unwilling banks at that famous October 13th meeting at Treasury.

To put it mildly, the anti-stigma strategy did not work. Within minutes, the big banks that neither needed nor wanted the Treasury's capital injections made that fact known to the markets. More banks are doing so daily. Nor should the strategy ever have been expected to work. It is in the commercial interests of the healthiest banks to distinguish themselves from the pack by demonstrating their health in every possible way—including turning down government funds. By forcing money on recipients who don't need it, the TARP wastes a precious resource--taxpayer money--that the law requires the Secretary to husband carefully.

5. Where Do We Go from Here?

Congress should now be pondering such questions as these:

First, is there now sufficient oversight over the TARP's choices and operations? My answer is clearly no. The Congressional Oversight Panel called for in Section 125 has yet to be established, though I noted with relief that three of the members were named just a few days ago. But that still leaves two slots open, and the Panel may be a long way from opening for business. When it does, it sure has its work cut out for it.

Second, are zero allocations of funds both to buying and refinancing mortgages and to buying mortgage-related assets really consistent with either the spirit or the letter of the law? My answer is again no.

Third, despite that, have Secretary Paulson's decisions to date advanced the objectives of the law better than the original design? I am far from convinced. According to Section 2 of the Act, these objectives include: to "protect home values" and "preserve homeownership," and to "maximize overall returns to the tax payers." The Secretary's assets allocations do not serve these purposes at all well.

Fourth, and perhaps most basic, can and will the manifold defects in the TARP's design and execution to date be remedied by the current Secretary of the Treasury? That is for you ladies and gentlemen to judge. But I have my doubts.

This thought leads me to my final question for Congress. Section 115 of the Act wisely provided for the $700 billion to be distributed in three tranches. The first two tranches, amounting to $350 billion, have already been authorized. But Congress retains the right to block the final $350 billion via the following mechanism. To gain access to the final $350 billion, "the President transmits to the Congress a written report detailing the plan of the Secretary" to use the remaining funds (Section 115(a)3). Congress then has 15 days in which to pass a "Joint Resolution of Disapproval" (Section 115(c)), which would block the disbursement of the remaining $350 billion. If not, the Secretary gets it.

Based on Secretary Paulson's performance to date, I believe Congress should pass that resolution unless he mends his ways. I say this with great reluctance because the financial system remains in urgent need of repair. But I have concluded that taxpayers will be better served by waiting for the new administration to take office.