

U.S. DEPARTMENT OF THE TREASURY

Press Center



Interim Assistant Secretary for Financial Stability Neel Kashkari Review of the Financial Market Crisis and the Troubled Assets Relief Program

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Washington - Good morning. Thank you, Dean Daly, for that kind introduction. I would also like to thank the McDonough School of Business at Georgetown for hosting us today.

Today, I will provide a review of the financial market crisis and Treasury's strategy to implement the Troubled Assets Relief Program (TARP) to promote financial stability. First, I will briefly explain why the Administration took the unprecedented action to request Congressional approval for a \$700 billion program to support the financial system. Second, I will explain why- as a first step- we decided to invest in healthy banks through purchases of capital, rather than buying illiquid assets. Third, I will discuss how the capital is being used by recipient banks. Finally, I look forward to answering your questions.

Before I begin, I will give you a brief update on the latest statistics of the Capital Purchase Program, a program to invest in healthy banks of all sizes. On Friday, we executed 43 investments, bringing our total investment to \$192 billion in 257 banks in 42 states and Puerto Rico. The largest investment was \$25 billion and the smallest investment \$1 million. In addition, after extensive preparation, we have also completed a term sheet for S-corps to participate in this program. The S-corp term sheet will be posted on the Treasury website tomorrow. The application period will open at that time and will remain open for 30 days.

The Importance of the Financial System

Let me begin by reviewing how the financial system affects Americans and their families. Banks serve as the primary intermediary between borrowers and savers. Americans save for their futures and their families. These savings of individual Americans are combined and made available to other people and businesses who need to borrow money for their specific needs. The financial system links millions of savers around the country with millions borrowers around the country through billions of individual transactions. This extraordinarily complex, but usually efficient system includes both banks, where people have their savings accounts, and other financial institutions that provide, for example, car loans and student loan financing. This system has developed over our Nation's history and it is built on confidence and on trust. Savers – be they individuals or businesses – must have confidence in the people and institutions they entrust with their money. And because no single bank can touch every family or every business, banks must have confidence to lend to each other for the system to work. If the financial system were to collapse, families might not be able to access the money they have saved. The economic implications of a financial system collapse are profound – for every single American.

Causes of the Credit Crisis

With that background, let me briefly describe the fundamental causes of the credit crisis. The seeds of the credit crisis were planted during a decade of benign economic conditions, including low interest rates and low inflation. Financial innovation, which has served the U.S. economy well over the years, also accelerated. Investors gained increasing confidence in the effectiveness of new financial products to diversify and distribute risks. With this perceived reduction in risk, leverage increased across the financial system. Underwriting standards for mortgages weakened as more and more reliance was placed on the value of the collateral (the home) rather than the willingness and ability of the borrower to repay the loan out of income. Homeowners took out ever larger mortgages with little or no down payment and little or no documentation of income. Regulators, investors and homeowners took comfort from the belief that home prices only go up.

As we have learned, that belief was incorrect. To understand the consequence of that miscalculation, consider that the residential mortgage market in the United States is an \$11 trillion market. With banks' highly leveraged balance sheets and minimal down payments on home loans, even a minor drop in home prices and rise in defaults can result in a large hit to banks' capital. Large losses can threaten the solvency of financial institutions.

Rooted in housing, this credit crisis is complicated by a number of related factors: First, home prices adjust downward slowly, in part due to homeowners' reluctance to realize losses; most people would rather keep their home than sell for a loss if they can avoid it since it usually is their largest financial asset. Next, this necessary housing correction, which is not over, is setting the pace of the credit crisis. Finally, this slow adjustment makes it difficult to value mortgages and mortgage-backed securities, because investors don't know for sure where the bottom of the housing market is and when it will be reached.

But investors are forward looking. With the high leverage in our financial system, the large and necessary housing correction, and credit problems arising in other sectors of the economy, investors quickly realized that the financial system had insufficient capital to withstand the expected losses. But the opacity of mortgage-backed securities and the difficulty in valuing mortgage assets meant it was hard for investors to determine exactly which institutions were at greatest risk.

Not wanting to be exposed to a failing institution, but also not being able to determine for certain which institutions were at risk, investors pulled back wherever they could.

A capital problem for some institutions led to a liquidity problem for all institutions. That liquidity problem created a serious risk that our financial system as a whole, both in the U.S. and abroad, could fail.

Secretary Paulson and Chairman Bernanke recognized early that there might come a time when the private markets would become unwilling to provide the necessary capital to our financial system to deal with the large losses from the housing correction. In such a scenario, only the Federal government would be in a position to support the financial system – to step in to provide the needed capital to prevent a collapse. Government intervention was not our first choice, as it often has unintended, far-reaching consequences. But it was a necessary choice.

Capital is essential for a healthy financial system; it permits banks to take risks and absorb losses while honoring their obligations to depositors and other creditors. During an economic downturn, many businesses and consumers want to see extra capital in their bank in order to have confidence the bank is sound and their money safe. Similarly, in such times, many banks want to see increased capital in other banks in order to have confidence to do business with them.

Although government leaders have numerous tools to combat financial market crises, there was no existing tool to provide capital to the financial system. In early 2008, we evaluated numerous policy alternatives and focused on a program to strengthen banks' balance sheets by purchasing illiquid mortgage assets in very large scale. By ridding their balance sheets of hard to value and troubled assets, banks would be better able to attract the private capital needed to recapitalize our system. We all hoped such government intervention would not become necessary, but recognized the possibility and began contingency planning.

In late summer, after the failure of Bear Stearns, the crisis intensified and our financial institutions came under even more pressure from deteriorating market conditions and the loss of confidence. In a very short period of time, some of our largest financial institutions failed. In July, IndyMac failed. In the month of September alone, we witnessed the conservatorship of Fannie Mae and Freddie Mac, the bankruptcy of Lehman Brothers, the rescue of AIG by the Fed, the distressed sale of Wachovia, and the failure of Washington Mutual. Eight major U.S. financial institutions effectively failed in 6 months – six of them in September alone.

As a result, credit markets froze. The commercial paper market shut down, 3-month Treasuries dipped below zero, and a money market mutual fund "broke the buck" for only the second time in history, precipitating a \$200 billion net outflow of funds from that market. The savings of millions of Americans and the ability of businesses and consumers to access affordable credit were put at serious risk.

The Need for Government Action

Recognizing the threat to our financial system and to every American family, Secretary Paulson and Chairman Bernanke knew the time had come to provide government support for the U.S. financial system. On September 18, they went to the Congress to ask for unprecedented authority to prevent a financial collapse. Congress also recognized this threat and just two weeks later, on October 3, the Congress passed and President Bush signed into law the Emergency Economic Stabilization Act of 2008. We worked hard with the Congress to build tremendous flexibility into the legislation because the one constant throughout the credit crisis has been its unpredictability.

In our discussions with the Congress, we focused on a two part plan: one, our initial, market-based plan to purchase illiquid mortgage assets as a means to attract private capital to the financial system, and two, providing sufficient flexibility to deal with any individual contingencies that arose. In the two weeks between the time we submitted the draft legislation and the time the bill passed, credit markets deteriorated more quickly than we had expected. One key measure we looked at was LIBOR-OIS spread – a measure of perceived credit risk in the financial system. Typically, 5 – 10 basis points, on September 1, the one month spread was 47 basis points. By the 18th, when we first went to Congress, the spread had climbed to 135 basis points. By the time the bill passed, just two week later on October 3, the spread had nearly doubled to 263 basis points.

Why did we switch from illiquid asset purchases to capital investments? Simply put, our Nation was faced with the potential imminent collapse of our banking and financial system and more immediate and powerful actions were needed. It was clear to Secretary Paulson and Chairman Bernanke that we needed to use the authority and flexibility granted under the law as aggressively as possible to quickly stabilize the system. Purchasing equity in healthy banks around the country would be a faster and more direct way to inject much-needed capital into the system and restore confidence compared with asset purchases. We began immediately designing a capital purchase program in addition to continuing work on illiquid asset purchases, which would take longer to implement.

Meanwhile, credit markets continued to deteriorate. On October 10, the LIBOR-OIS spread had risen to 338 basis points. So, four days later, on October 14, when our Capital Purchase Program was ready, we announced a plan to invest \$250 billion in banks and savings

institutions of all sizes, in combination with the FDIC's announcement of its guarantee of senior bank debt. These combined actions were taken to build confidence in the U.S. financial system. We believe these actions were successful.

The Capital Purchase Program was not a bailout of participating banks. Only healthy, viable banks are eligible for the program and it is designed to generate a positive return to the taxpayer.

At the same time, we continued working hard on our illiquid asset purchase programs. We were keenly aware that, while \$700 billion is a large sum of money, it is a finite amount. We needed to use the available funds to provide the maximum benefit to the system, while leaving enough dry powder to deal with contingencies. Throughout the process, we carefully monitored how the markets were responding to our actions and conditions in the broader economy. We asked ourselves: Would banks apply for the capital? Would credit markets respond? What was happening in the economy?

We were pleased that healthy banks of all sizes were signing up for the program and credit markets were showing signs of thawing. But the economic indicators were less positive. On October 31, data on third quarter GDP showed negative 0.3 percent growth. In addition, data released on October 28 showed that through August, home prices in 10 major cities had fallen 18 percent over the previous year.

A large contingency also arose that threatened the financial system and we had to restructure the Federal Reserve's loan to AIG, using \$40 billion of TARP funds. With about half the original \$700 billion available for asset purchases, we asked ourselves: would such a program still be the best approach? For an asset purchase program to be effective, it must be done in very large scale. We concluded that capital would provide the most benefit given available resources.

It is also important to support the non-banking market, which is essential to helping consumers, businesses and our economy get the credit they need. The Federal Reserve is setting-up a \$200 billion program, the Term Asset-Backed Securities Loan Facility (TALF). With \$20 billion from the TARP, we will help make it easier for American families to get affordable auto loans, student loans, and consumer credit, as well as loans for small businesses.

Where We Are Today

As of today, we have fully allocated the first \$350 billion and, at the President-Elect's request, President Bush has asked Congress to make available the remaining \$350 billion for the next Administration. As I mentioned when I opened, we have invested \$189 billion of the \$250 billion Capital Purchase Program in 257 institutions in 42 states across the country, as well as Puerto Rico. There is a huge demand for the program: the number of applications under-review at the regulators is in the thousands, representing every state in the country, and hundreds more have already been pre-approved by Treasury. We are pleased with the large number of banks that have applied. As I also noted above, we have also allocated \$20 billion for the TALF to support consumer and small business lending. Today, the LIBOR-OIS spread has fallen to 19 basis points. We believe the combined actions of Treasury, the Federal Reserve and FDIC have prevented a financial collapse.

We have also had to deal with several contingencies, including a possible loss of confidence in Citigroup, and the impending failures of AIG and the domestic auto companies which have consumed the remaining allocation within the first \$350 billion. We believe that when government intervention is required to prevent the failure of a firm, the firm's shareholders should pay a high price to discourage imprudent risk-taking in the future. Our actions to stabilize Fannie Mae, Freddie Mac and AIG demonstrate this perspective where existing shareholders were severely diluted and the taxpayers received warrants for 80 percent of the companies.

This approach has challenges, however, when the system as a whole comes under pressure and several similarly-situated institutions are at risk. We have worked hard to develop programs to encourage private capital to flow into the banking sector. Whenever possible, we have designed programs that avoid the government controlling private institutions. We have used a combination of tools such as preferred investments and asset guarantees as a means to enhance the confidence of systemically-important institutions on a case-by-case basis.

Update on Lending

People recently have begun to ask what the banks are doing with the money we've invested in them. We designed important features into our investment contracts to limit what banks can do with the money: one, we restricted dividend increases and share repurchases and, two, placed restrictions on executive compensation. By increasing a bank's capital, the bank will have strong economic incentives to deploy the capital profitably. Banks are in the business of lending and they will provide credit to sound borrowers whenever possible. They may also use the capital to absorb losses as part of loan write-downs and restructurings. If a bank doesn't put the new capital to work earning a profit or reducing a loss, its returns for its shareholders will suffer.

What about mergers and acquisitions? Why didn't Treasury prohibit them? We must remember that when a failing bank is acquired by a healthy bank, the community of the failing bank is better off than if the bank had been allowed to fail. Branches and financial services in that community are usually preserved. Costs to the taxpayers via the FDIC deposit fund are also lower than had the bank been allowed to fail. Prudent mergers and acquisitions can strengthen our financial system and our communities, while protecting taxpayers.

People then ask: when will we see banks making new loans? It is important to note that over \$60 of the \$250 billion CPP has yet to be received by the banks. Treasury is executing at a rapid speed, but it will take some time to review and fund all the remaining applications. This capital needs to get into the system before it can have the desired effect. In addition, we are still at a point of low confidence – both due to the financial crisis and the economic downturn. As long as confidence remains low, banks will remain cautious about extending

credit, and consumers and businesses will remain cautious about taking on new loans. As confidence returns, Treasury expects to see more credit extended.

This reduced demand for and provision of credit is common in an economic downturn. During the past nine recessions, inflation-adjusted total private sector lending per quarter has contracted on average 30 percent from peak to trough, while real GDP has contracted 2.0 percent. So we should not be surprised that lending and borrowing will be lower during this current economic downturn. We absolutely need our banks to continue to make credit available – especially given the disruption in the non-banking financial markets. Our banks' role as provider of credit in our economy is even more important now. But we must not attempt to force them to make loans whose risks they are not comfortable with. Bad lending practices were at the root cause of this crisis. Returning to those practices will not help end this financial turmoil.

People have then asked: how will you track lending activity? Treasury has been working with the banking regulators to design a program to measure the activities of banks that have received TARP capital. We plan to use quarterly call report data to study changes in the balance sheets and intermediation activities of institutions we have invested in and compare their activities to a comparable set of institutions that have not received TARP capital investments. Because call report data is infrequent, we also plan to augment that analysis with a selection of data we plan to collect monthly from the largest banks we have invested in for a more frequent snapshot.

The provision of credit that is vital to our economy will not materialize as fast as any of us would like, but it will happen much faster as a result of deploying resources from the TARP to stabilize the system and increase capital in our banks.

Conclusion

The EESA is not an economic stimulus plan, nor is it an economic growth plan. It was one of several initiatives taken by the Federal government to stabilize the financial system – a necessary precondition to any economic recovery. We believe the combined actions of Treasury, the Federal Reserve and FDIC have helped stabilize the financial system and prevent a financial collapse. Nonetheless, the current crisis took years to build up and will take time to work through, and we still face some real economic challenges. As Secretary Paulson has said, there is no single action the Federal government can take to end the financial market turmoil and the economic downturn, but the authorities Congress provided last fall dramatically expanded the tools available to address the needs of our system. Thank you and I would be happy to take your questions.