

Witness Testimony of Joseph E. Stiglitz
Congressional Oversight Panel
Hearing on Impact of the TARP on Financial Stability

March 4, 2011

Thank you for this opportunity to share with you my views about the successes and failures of TARP. We cannot say for sure what would have happened in the absence of strong government action following the bankruptcy of Lehman Brothers. It almost surely played a role in pulling us back from the brink. But this success, as important as it was, should be seen in the light of a broader set of failures. TARP was justified to the American people as necessary to maintain the flow of credit, the lifeblood of an economy. It was hoped that it would play a pivotal role in dealing with the flood of mortgage foreclosures and the collapse of the real estate market that led to the financial crisis.

TARP and the recovery of troubled assets were not ends in themselves, but means to an end, namely the recovery of the economy. In that ultimate objective, TARP has not only been a dismal failure—four years after the bursting of the real estate bubble and three years after the onset of recession, unemployment remains unacceptably high and our economy is running far below its potential, a waste of resources in the trillions of dollars—but the way the program was managed has, I believe, contributed to the economy’s problems. Nor should we underestimate the damage of the (correct) perception that those who were responsible for creating the crisis were the recipients of the government’s munificence; and the lack of transparency that permeated this and other government rescue efforts has only reinforced public perceptions that something untoward has occurred.¹ The normal laws of capitalism, where investors must bear responsibility for their decisions, were abrogated. A system that socializes losses and privatizes gains is neither fair nor efficient. Admittedly, the big banks *were* given many enormous gifts, of which TARP was only one. The United States government provided money to the biggest of the banks in their times of need, in generous amounts and at generous terms²—but have been forcing ordinary Americans to fend for themselves.

That decisions had to be made quickly is no excuse. The problems were anticipated, or at least should have been. Certainly, by the time of the demise of Bear Stearns, markets recognized the high risk that Lehman

¹ I am thus in total agreement with the COP when it claims: “The program is now widely perceived as bailing out Wall Street banks and domestic auto manufacturers while doing little for the 14.9 million workers who are unemployed, the 11 million homeowners who are underwater on their mortgages, or the countless other families struggling to make ends meet. Treasury acknowledges that, as a result of this perception, the TARP and its programs are now burdened by a public “stigma” [...] [the Panel] has called for Treasury to make banks accountable for their use of the funds they received. It has also urged Treasury to be transparent with the public, in particular with respect to the health of the banks receiving the funds. The lack of these data makes it more difficult to measure the TARP’s success and thus contributes to the TARP’s stigmatization.” (COP, September Oversight Report, Sep 16 2010, pp.3-4.)

² Flouting Bagehot’s rule to lend freely, but at a punitive rate. See footnote 4 below for a discussion of the enormous magnitude of these gifts.

would be next.³ The evident lack of contingency plans from both the Fed and the Treasury is inexcusable. But beyond that, there have been more than a hundred crises around the world since the era of deregulation began three decades ago. Economic theory and policy experiences could and should have provided guidance. But those who were wedded to false economic doctrines that claimed the economy was stable and efficient on its own, that self-regulation would suffice, paid little attention to the lessons that might be gleaned from theory and policy. Rather, they turned to the advice of those in the financial market who had wrought the devastation on our economy. Not surprisingly, self-interest, not national interest, was the guiding principle behind the financial markets' advice—and they succeeded in persuading others that what might be good for the big banks would, in the end, prove good for the country. There were alternative approaches, evident at the time of crisis, and even more so as time went on. These approaches, had they been taken, would have led not only to a stronger economy today, but would have led our government to be in a stronger fiscal position.

The failures of TARP are evident in the statistics: lending today is still constrained, especially to small- and medium-sized businesses, and by the best estimates, lending is only now recovering to what it was four years ago. While the big banks were saved, the smaller and regional banks that are responsible for much of the lending to small- and medium-sized enterprises (SMEs) are in trouble. 140 went bankrupt in 2009, 157 in 2010, and 860 are on the watch list—the highest number since March 1993. But this is the tip of the iceberg, evidence of a financial system that is far from repaired. The mortgage market is still on life support; the securitization market that had dominated in the years before the crisis is still dormant; the mortgage bankers still resist assuming even as little as 5% of the risk of the mortgages that they originate. Two million more foreclosures are expected this year—on top of the nearly 7 million since the crisis began. What does it say about an economy and a society in which we have both homeless people and vacant homes?

The bottom line is simple: The financial sector was at the center of the storm that led to the devastation of our economy; but TARP has not succeeded in getting the financial sector to get America back to work. The losses resulting from the gap between our potential and actual output after TARP began dwarf even the waste of resources before the crisis for which the financial sector was responsible.

There were six critical failings of TARP. First, it did not demand *anything* in return for the provision of funds—it neither restrained the unconscionable bonuses or payouts in dividends nor demanded that they lend the money that was given to them. It didn't restrain their predatory practices, whether in credit cards or consumer loans. A system of carrots and sticks, incentives and constraints, might have redirected their attention toward the kind of activities that would have reinvigorated the economy. Instead, they were allowed to continue, much as before, reaping huge profits from speculative and trading activities, and from the monopoly power associated with the control of the payments mechanism.

³ As the FCIC's *Financial Crisis Inquiry Report* (pp. 292-293) noted: "And the word on the street—despite the assurances of Lehman CEO Dick Fuld at an April shareholder meeting that 'the worst is behind us'—was that Bear would not be the only failure."

How could the government say that the problem facing the banks was lack of adequate capital, but allow the money pouring into the banks to pour right out? Such funds were *not* contributing to recapitalization. Any economic analysis would have recognized that the interests and incentives of banks and their managers were not aligned with that of the country.

Secondly, in giving money to the banks, they should have demanded appropriate compensation for the risk borne. It is not good enough to say that we were repaid, or we will be repaid, or we will be almost repaid. If we had demanded arms-length terms—terms such as those that Warren Buffett got when he provided funds to Goldman Sachs—our national debt would be lower, and our capacity to deal with the problems ahead would be stronger. The fairness of the terms is to be judged *ex ante*, not *ex post*, taking into account the risks *at the time*.⁴

Thirdly, there was a lack of transparency. The Treasury through TARP was, perhaps, no worse than the Fed, their partner in many of the bailouts. Lack of transparency—off balance sheet activities deliberately designed to deceive shareholders, regulators, and the government—played a central role in the creation of the crisis and has inhibited its prompt resolution. The lack of transparency in the provision of funds has rightfully caused suspicion of favoritism. The country still has had no adequate justification for why AIG positions were closed out at 100 cents on the dollar—contrary to what happened elsewhere. We now at least know the beneficiaries, both in the United States and abroad. But we have still received no explanation for why American citizens played such a large role in bailing out foreign banks.⁵ Shouldn't that

⁴ As the February, 2009 COP report, "February Oversight Report: Valuing Treasury's Acquisitions," pointed out, "review of the ten largest TARP investments the Treasury made during 2008 raises substantial doubts about whether the government received assets comparable to its expenditures." COP found that, for each \$100 spent in those investments, Treasury received assets worth approximately \$66. Extrapolating to all capital purchases in 2008 made under TARP, COP found that Treasury paid \$254 billion, for which it received assets worth approximately \$176 billion, a shortfall of \$78 billion (p. 4). Some of the later investments—arguably not made in the panic that might have dominated some of the earlier ones—were particularly egregious. For example, in the same report, the COP estimated that the \$40 billion purchase of AIG securities under TARP's Systemically Significant Failing Institutions Program was made at a 63% subsidy to the insurance corporation—the securities were worth only \$14.8 billion, the COP wrote (p.7). While there have been more recent reports that AIG might perform better than originally expected, it should be emphasized that what matters is these *ex ante* evaluations; the COP reiterated the problematic nature of Treasury's assistance to AIG in its September 2010 report, "Assessing the TARP on the Eve of Its Expiration": "[T]he value of Treasury's substantial investment in AIG and the size of any gain or loss are dependent on many external variables, and the protracted investment in AIG continues to create significant risks to taxpayers."

⁵ While noting that it "is not easy to disentangle the cross-border flow of TARP funds," the August 2010 COP report, "The Global Context and International Effects of the TARP," stated that U.S. rescue funds may have had a disproportionate effect on foreign economies (p.76). "While the United States attempted to stabilize the system by flooding money into as many banks as possible – including those that had significant overseas operations – most other nations targeted their efforts more narrowly toward institutions that in many cases had no major U.S. operations. As a result, it appears likely that America's financial rescue had a much greater impact internationally than other nations' programs had on the United States."

be a responsibility of *their* governments? Lack of transparency has fueled suspicions, which are yet to be resolved.

Fourthly, there was a lack of concern for what kind of financial sector *should* emerge after the crisis. There was no vision. The response to any disaster can profoundly shape recovery: done wrong, alleviation of the worst immediate effects can still set the stage for a recurrence. (One should not respond to a tsunami by building new cities on the beach.) Today, we have an even more concentrated banking system, so the problem of too-big-to-fail is even bigger and the risk of anti-competitive behavior is worse. The spread between the discount rate and the prime lending rate is 25 percent higher than it was before the crisis, while lending to small- and medium-sized businesses has shrunk. The too-big-to-fail banks continue to get access to credit at favorable terms—because the market knows that they are almost risk-free.⁶ This sets up an adverse dynamic, in which success is not based on greater efficiency but favored access to government bailouts. Our two-tier strategy—let the small and regional banks responsible for lending go, but save the big international banks—has rightly reinforced these beliefs. Resolution authority has made little difference, because few believe that the government will ever use the authority at its disposal with these too-big-to-fail banks. In short, the deficiencies in lending to SMEs that has emerged should come as no surprise. In spite of what was said in defense of TARP, it was not designed to bring back lending to SMEs quickly.

Fifthly, from the very beginning TARP was based on a false premise—that real estate markets were *temporarily* depressed. The reality was that there had been an enormous bubble, for which the financial sector was largely responsible. The breaking of that bubble — especially given the kinds of mortgages that had been issued — meant that a large fraction of the mortgages were underwater and many would not be repaid.

Many of the false starts, both in asset recovery and in homeowner programs, have been a result of building on this false premise. Particularly flawed was the PPIP, a joint public-private program designed to have the government bear a disproportionate share of the losses; the private sector, while putting up minimal money, would receive a disproportionate share of the gains. It was sold as helping the market “re-price” — but the prices that would emerge would be prices of options, not of the underlying assets. There is only one persuasive explanation for such a fundamental mistake—that in fact it was another program of hidden assistance to the financial sector. The program was a failure—no one has been able to attribute any significant macroeconomic benefit, though I am sure some of the private partners may have done well.

The standard wisdom in such a situation is summarized in a single word, *restructure*. But TARP, combined with accounting changes, *made things worse*. Banks were allowed to avoid recapitalization, if they didn’t restructure. In short, *incentives were put in place to not restructure*. The Administration programs for restructuring mortgages have made only a little dent. Now that the American government has a large stake in the vast majority of mortgages, it is inexcusable that we continue to postpone dealing with the problem.

⁶ In addition, the credit rating agencies now give the largest banks significant increases in their ratings because of the implicit government guarantee.

When bad loans are made, someone has to bear the cost. Part of the problem facing the country today is that no one wants to face up to those costs, which are in the hundreds of billions of dollars. The question from the start was whether it would be the banks, and their shareholders and bondholders, homeowners, or taxpayers. For more than 150 years, a basic democratic principle in America has been that individuals who get into trouble should be given a fresh start. But in America today, it is the banks that have been given a fresh start as a result of the largesse of TARP, while ordinary Americans are being saddled with debts, many of which were foisted on them by predatory actions of the banks.

The sixth critical failure of TARP was that some of the money went to resurrect securitization (under the TALF program)—without an understanding of the deeper reasons for the failure of mortgage securitization. These attempts to revive the market have failed, and, to me, this is not a surprise. Securitization means that risks are spread—no one bears the full consequences of issuing bad mortgages. The rating agencies didn't even attempt to ascertain whether the mortgages being issued were good. Instead, they used flawed statistical models—based on past data collected *before the perverse incentives to which securitization gave rise were so prevalent*—to ascertain the likelihood of adverse outcomes on pools of assets. Correlations induced by common macroeconomic shocks seemed to have been given short shrift. The problem is that even were they to return to their flawed models, using recent data would make these pools of assets highly unattractive—too unattractive to be held by pension funds.

The problems of securitization of mortgages are fundamental, and indeed, I warned about them in the early 1990s, as the securitization movement was just beginning. That the banks are so reluctant to assume even the 5% risk is disquieting; my own view is even that amount does not suffice to resolve the risks.

To be sure, critics of the perspectives that I have put forward will claim that this is Monday morning quarterbacking, that I am just conjecturing about what might have happened if an alternative strategy had been pursued. They will claim that we have been pulled back from the precipice on which we stood, and we have largely been repaid. We should be content, and this speculation of *what might have been* is beside the point. Such a view is, I think, wrong. Indeed, those who give credit to TARP for the economy having been brought back from the precipice are themselves engaged in counterfactual conjectures. They assert that were it not for TARP we would have gone over the precipice. While I agree that there was a substantial risk that that might have occurred—and we will never know for sure—we need to recognize that all such claims are judgmental; and those making these claims have a certain self-interest in attributing the successes to TARP, and ignoring its failures. And TARP's failures to deliver on what its promoters promised is not only evident, but was also predictable, and predicted. The failures are not given with 20/20 hindsight, but were clearly identified even as the program was being formulated. I suspect that it was a fundamental mistake to leave the restoration of the economy and the implementation of TARP to those who were, in a fundamental sense, responsible for its creation, failed to see the crisis coming and/or—even after the breaking of the bubble—failed to see how it would unravel. They had interests in defending past mistakes; and even if that were not the case, they were cognitively captured by perspectives that the crisis had clearly proven wrong, and by interests that were clearly at odds with the broader well-being of our economy.

We can easily describe the elements of an alternative approach that would have left our economy and our public finances in better shape. Some of the actions briefly described below could and should have been

done by TARP authorities; others would have entailed broader actions from the Administration and the Federal Reserve. Money given to the banks would have been accompanied by restrictions on the use of the money and payouts for bonuses and dividends, with oversight on the use of funds for lending, not trading or speculation. Government control would be commensurate with the capital it provided, and used to redirect banks' activities toward SME lending, and away from predatory lending and abusive credit card practices. Both the provision of funds and the use of mergers as resolution devices would have been conducted toward the end of creating a more competitive—not a more concentrated—banking system, focused more on lending, not on trading and speculation. Banks would have been forced to recognize real estate losses—not allowed to assume that the real estate market would be restored—with the government standing ready to provide additional capital, with appropriate terms and control, as needed. Banks would have been forced to restructure mortgages, as a condition of the bailout (I and others have described a variety of ways by which this can and should have been done). Finally, the terms of the deal would have been arm's length—at least comparable to those that Warren Buffett received in his investment in Goldman Sachs, adjusted for the additional risk, say, associated with the more frail financial institutions. The *minimum* terms for the government providing money that no private actor would voluntarily and rationally provide would have given the government substantial more claims on the banks than they received.

We might say all of this is water over the dam. But it's not, for two reasons. First, we have not repaired our banking system. Dodd-Frank did not go far enough; it was riddled with exceptions and exemptions. It did not adequately deal with the too-big-to fail banks and the over-the-counter derivatives. The likelihood is that we will have another crisis.⁷ I hope that in that next crisis—perhaps even more costly than the last—we will have learned the lessons from the failures in this one. But as I wrote at the beginning of the crisis, I fear that we will experience a repeat of what occurred this time, and has occurred in similar crises all over the world. Powerful interest groups, and especially financial institutions, use the turmoil in the midst of the crisis to protect and even enrich themselves at the expense of the rest of society, all in the name of maintaining the economy.

Secondly, our economy is not back to health, and will not be until and unless lending is restored, especially to small and medium enterprises. This means that we need a more competitive financial sector, and one more focused on its core mission of lending. There is a wide array of important activities performed by the financial sector, but not all of them should be undertaken by government-insured banks. Too-big-to-fail

⁷ Even if it is inevitable that there occasionally is a crisis, the rules of the game can affect their depth and frequency. This crisis was, in particular, manmade; it was not like an earthquake, something that “just” happens. JP Morgan Chase CEO Jamie Dimon said in recent testimony: “It's not a surprise that we know we have crises every five or ten years. My daughter came home from school one day and said, 'daddy, what's a financial crisis?' And without trying to be funny, I said, 'it's the type of thing that happens every five, ten, seven, years.'” (First Public Hearing of the FCIC, Panel 1: Financial Institution Representatives, January 13, 2010, viewable online at <http://www.fcic.gov/videos/view/17>). We have crises so frequently because of the lack of adequate regulations, because of the moral hazard that our bailout procedures have created, because of problems in corporate governance, etc.

institutions are a problem, whether they be mortgage companies, insurance houses, commercial or investment banks. They pose an ongoing risk to our economy and the soundness of government finances. Banks won't focus on lending if they can continue to make more money by publicly-underwritten speculation and trading, or by exploiting market power in the credit and debit card markets.

I want to conclude with two more general comments. First, we should not forget the process by which TARP—and this Oversight Panel—was created. That political process does not represent one of the country's finest moments. At first, a short, three-page bill was presented, giving enormous discretion to the Secretary of Treasury, without Congressional oversight and judicial review. Given the lack of transparency and potential abuses to which I have already referred—which occurred even with full knowledge that there was to be oversight—one could only imagine what might have occurred had the original bill been passed. Fortunately, Congress decided that such a delegation of responsibility was incompatible with democratic processes. On the other hand, the political deals required to get TARP passed, with an estimated \$150 billion in largely unjustified and unjustifiable tax breaks, do not speak well for our democracy. When we think of the cost of TARP, surely the price tag associated with the tax breaks should be included in the tally.

Finally, I want to extend a compliment to TARP. In difficult circumstances, as ideas that had seemed so persuasive showed themselves to be so flawed, there was a willingness to try different approaches and to change course. The original idea of buying what were euphemistically called “troubled assets” was fundamentally flawed, for reasons that I loudly articulated at the time. What was needed was more capital. That was necessary, but not sufficient. Capital that comes in and goes out almost simultaneously does not recapitalize banks. *How* capital is provided—preferred shares versus common shares—and with what control and with what constraints makes a great deal of difference. Any economist could have told those running TARP that, and could have told them that the approach taken was deeply flawed. Incentives matter, and incentives were not aligned.

For these, and the other failings of TARP, our economy, and our society, have paid—and will continue to pay—a very high price.