

Oral Testimony of

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on

"Overall Impact of TARP on Financial Stability"

Before the
Congressional Oversight Panel

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Chairman Kaufman, members of the Congressional Oversight Panel, thank you for inviting me.

In providing an opinion on the impact of the Troubled Asset Relief Program (TARP) on the financial sector and the US economy it is important to establish what is the counterfactual: what would have happened in the absence of TARP. Chairman Bernanke and then Treasury Secretary Paulson repeatedly presented their choice as an alternative between TARP and a collapse of the entire financial system. If the alternative was indeed the abyss, TARP is clearly an unqualified success: we have escaped the abyss. Even if the alternative was between TARP and some chance of falling into the abyss, we have to conclude that TARP was a success. The cost of TARP, however big, is small with comparison to the possibility of a Second Great Depression. Pietro Veronesi and I estimate that the bankruptcy of the ten largest banks would have wiped out 22% of their value, for a total of \$2.4 trillion, a number that does not consider the cost imposed on the rest of the U.S. economy, which could be a multiple of that.

The financial system was at risk and some intervention was needed. Yet, it is both false and misleading to say that there were no other alternatives. False because there were feasible, and in fact superior, alternatives. Misleading because it made TARP appear inevitable, forcing people not to question its costs.

By stating clearly why an intervention was needed (i.e., where the market failed), it would have been possible to design plans more effective and less expensive. This is not just hindsight. On September 19 2008, I wrote a proposal to address the instability of the financial system through an emergency reform of the bankruptcy code that could have transformed the

long-term debt of shaky financial institutions into equity. The feasibility of this idea is proven by the fact that Credit Suisse has now advanced a similar proposal to deal with future bailouts. The same is true for an alternative plan to deal with home foreclosures and with the bankruptcy of GM and Chrysler. I did not write a plan for AIG because I never understood what the real goal of bailing out AIG was: to save European banks, Goldman Sacks, or the policyholders. We have to rely on Wall Street for claims that a failure would have completely roiled markets.

If we agree that other feasible alternatives did exist, then we have to consider the costs and benefits of TARP vis-à-vis these alternatives. Veronesi and I estimated that the Capital Purchase Program increased the value of bank's debt by \$120 billion at the cost of \$32 billion for the taxpayers. Thus, in spite of the enormous value created by the government intervention, taxpayers ended up with a large loss. In the auto companies' case creditors were not the winners: the autoworkers' union was, with a gain of \$16 billion. There is, however, a consistent loser: the taxpayers, who lost \$59 billion in the rescue.

TARP was the largest welfare program for corporations and their investors ever created in the history of humankind. That some of the crumbs have been donated to auto workers unions does not make it any better, it makes it worse. It shows that this redistribution was no accident: it was a premeditated pillage of defenseless taxpayers by powerful lobbies. TARP is not just the triumph of Wall Street over Main Street: it is the triumph of K Street over the rest of America!

Yet, the worst long-term effect of TARP is not the burden it imposed on taxpayers, but the distortions to incentives it generated. First, the

excessively lenient terms of the bailout ensured that legitimate assistance – e.g., recapitalizing smaller banks at market terms --became more difficult.

Second, the way subsidies were distributed under TARP showed the enormous return to lobbying. A member of the Bush Treasury admitted that during the summer of 2008 any phone call from the 212 area code had one message: have the government buy the toxic assets. Eventually, this constant request became government policy.

Third, the way the bailout was conducted destroyed the faith that Americans have in the financial system and in the government. In a survey conducted in December 2008, 80% of the American people stated that government intervention made them less confident to invest in the financial market.

Last but not least, it entrenched the view that large financial institutions cannot fail and their creditors cannot lose. This expectation leads investors, such as a CFO I know, to invest their money in the banks most politically connected, not in the most financially sound. This is the end of credit analysis and the beginning of political analysis!

Table 1
Winners and Losers from TARP

List of the winners and losers of the major programs under TARP on an ex-ante basis (when program announced). The second column is from Treasury.gov. The third and fourth columns are from the SIGTARP Quarterly Report to Congress (January 2011), except for row 5, which comes from CBO (June 2009) for the Treasury and CBO (May 2010) for NYFRB. The fifth column is computed as follows: For 1) it is equal to funds committed, since it is a transfer. For 2) is obtained from Veronesi and Zingales (2010). For 3) it is extrapolated applying to small banks the Veronesi and Zingales (2010) estimates for large banks. For 4) it is taken from CBO (June 2009). For 5) it is taken from CBO (June 2009) for the Treasury and CBO (May 2010) for NYFRB. For 6) it is the CBO “The Troubled Asset Relief Program: Report on Transactions Through June 17, 2009”, applied to the full program. For 7) it is the March 2010 CBO report. The sixth column is based on the author’s judgment. The seventh column is computed as follows: For 1) it is equal to funds committed, since it is a transfer. For 2) is obtained from Veronesi and Zingales (2010). For 6) it is an author’s calculation based on the CBO “The Troubled Asset Relief Program: Report on Transactions Through June 17, 2009” valuations.

			Funds Spent to 12/2010	Ex Ante Cost to Taxpayers	Major beneficiary	Amount Benefit
	Program	Goal	Funds Committed			
1	<i>Making Home Affordable</i>	To promote stability for both the housing market and homeowners.	45.6	1	45.6	Homeowners, servicers
2	<i>Capital Purchase Program Large</i>	To inject much-needed capital into the system in the fastest way.	125	125	32	Debtholders
3	<i>Capital Purchase Program Small</i>		79.9	79.9	20.5	Debtholders
4	<i>Targeted Investment Program</i>	A case-by-case assistance basis to stabilize systemic institutions	40	40	7	Debtholders
5	<i>American International Group</i>	To avoid a catastrophic failure (?)				Debtholders, policyholders ?
		<i>Treasury*</i>	70	48	35	
		<i>NYFRB**</i>	175	175	2	
6	<i>Automotive Industry Financing Program</i>	To prevent a significant disruption of the American automotive industry.	81.8	80.7	58.9	Unions
7	<i>Public-Private Investment Program</i>	To support market functioning and facilitate price discovery in CMBS and non-agency RMBS.	22.4	15.6	1	Investment banks
			639.7	565.2	202.0	
* AIG Treasury investment. Sources: CBO (June 2009). It is comprehensive of SSFI and Equity Capital Commitment Facility.						
** NYFRB investment in AIG consists of revolving credit facility and Maiden Lane II and III						

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