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TARP: A NEW SLUSH FUND FOR WASHINGTON

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SUMMARY

- The President today announced his intention to tap billions of dollars in Troubled Asset Relief Program [TARP] funds to justify additional economic "stimulus" spending.
- This is the latest version of the administration's exploitation of TARP for purposes other than stabilizing financial markets; and it ignores taxpayer protections built into the law that ensured TARP funds would be repaid to the Treasury and not used to increase spending, deficits, and debt.
- Earlier this year, the administration used TARP to purchase two auto companies and to subsidize over-extended mortgage holders who failed to meet their payments, at an estimated cost to taxpayers of $109 billion.
- Thus, after the intense opposition to TARP as a "Wall Street" bailout, two great ironies are now emerging: 1) the cost for meeting TARP's original purpose has declined dramatically; and 2) the administration now seeks to exploit this reduction *to further increase spending, deficits, and debt* – all under the false claim of "fiscal responsibility."

THE TRANSFORMATION OF TARP

From the outset, one of the major controversies surrounding TARP was its cost to the taxpayer and the risk of its becoming a source of constant and uncontrolled spending – and Congress took steps to prevent this. Yet in the past year, the TARP authority has been employed well past its original intent, even as its goal of stabilizing financial markets has largely been reached; and now Congress and the administration are ginning up new excuses for exploiting the program's flow of cash even further – including another "jobs" bill to make up for the failure of the earlier $787-billion "stimulus."

These efforts would shatter the original justification for TARP. As Senate Budget Committee Ranking Member Gregg has put it: "The idea that this money is some sort of kitty, a slush fund that can be used for the appropriators around here for the purposes of whatever the next stimulus exercise is going to be . . . is totally a violation of not only the literal law, but the spirit of the intent of what we were doing when we created TARP to begin with."[1]

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[1] Statement of Senator Gregg, 7 December 2009.

THE PROGRAM'S UNEASY BEGINNINGS

In the midst of the financial crisis in late 2008, TARP was originally sold to and by Congress as a temporary and targeted program that would purchase "toxic" assets from financial institutions and temporarily hold these assets to help stabilize markets, whose troubles were spreading collateral damage into broader sectors of the economy. Although the initial, three-page legislation proposed by the administration gave the Treasury broad discretion in applying its $700 billion in spending authority, then-Treasury Secretary Paulson intended to keep its use focused. As he later testified to the House Financial Services Committee: "The rescue package was not intended to be an economic stimulus or an economic recovery package; it was intended to shore up the foundation of our economy by stabilizing the financial system . . . ."[2]

Congress too sought to circumscribe the legislation, with the aim of protecting taxpayers and limiting the administration's spending authority in multiple places in the law:

- Section 113(a)(1) of the Emergency Economic Stabilization Act [EESA] reads: "The Secretary [of the Treasury] shall use the authority under this Act in a manner that will minimize any potential long-term negative impact on the taxpayer, taking into account the direct outlays, potential long-term returns on assets purchased, and the overall economic benefits of the program, including economic benefits due to improvements in economic activity and the availability of credit, the impact on the savings and pensions of individuals, and reductions in losses to the Federal Government."

- Section 106(d) of the EESA was designed to keep funds from being "recycled," and to ensure that any TARP repayments would be returned to the Treasury to keep the debt from growing: "Revenues of, and proceeds from the sale of troubled assets purchased under this Act, or from the sale, exercise, or surrender of warrants or senior debt instruments acquired under section 113 shall be paid into the general fund of the Treasury for reduction of the public debt."

- Finally, congressional rules generally require new spending to be offset unless designated as an "emergency." To prevent "emergency" funds from being diverted to non-emergency purposes, the House and Senate Budget Committees usually prohibit the use of emergency funds to offset non-emergency spending. Congress designated TARP funding as an emergency and added a further condition that TARP funds could not be used ("rescinded") for the purposes of offsetting the cost of other programs as part of budget enforcement. Section 204 reads: "All provisions of this Act are designated as an emergency requirement and necessary to meet emergency needs pursuant to section 204(a) of S. Con. Res. 21 (110th Congress), the concurrent resolution on the budget for fiscal year 2008 and rescissions of any amounts provided in this Act shall not be counted for purposes of budget enforcement."

TARP'S 'EVOLUTION'

Since those troubled times, two things happened: 1) The financial sector has been stabilizing, lowering the cost of TARP's original intent; and 2) the administration and Congress have exploited that very cost reduction to justify more spending in more places from the TARP.

[2] Testimony of Secretary Paulson before the Financial Services Committee, 18 November 2008.

Financial Markets

During his recent Senate confirmation hearing, Federal Reserve Chairman Bernanke remarked: "I certainly think that the TARP has mostly served its purpose and that it's time to start thinking about how we are going to unwind that program."[3]

While the TARP provided a maximum of $700 billion in spending authority, and this was the perceived price tag of the bill, the peak estimate of TARP costs by the Congressional Budget Office [CBO] was half that amount – partly because the authority was limited to financial assistance that had to be paid back. In addition, Congress provided that the Federal Credit Reform Act be used to estimate the cost of TARP, with an adjustment for market risk.

Under Credit Reform, CBO and the Office of Management and Budget [OMB] estimate the cost of programs taking into account interest rates and the risk of default, and provide an estimate of the program in today's dollars. Due to the uncertainty of market conditions and how the TARP would be used, CBO estimated the peak cost of TARP at $356 billion. Since March, CBO has revised its estimate of TARP down to $241 billion. Since August, financial conditions have improved further, banks that received TARP funds have announced they are going to make repayments with interest, and the projected cost of TARP has declined even more. *Analyzing solely the efforts to stabilize financial markets, it appears TARP will end up costing slightly more than $100 billion – still a staggering sum, but far less than expected.*

Some in Congress had expected an upside from the TARP. Among them was Senate Budget Committee Chairman Conrad, who said: "Taxpayers will now receive an equity stake, so they have a potential profit when markets recover."[4] Senator Gregg echoed the belief that TARP was a taxpayer investment, saying: "We may actually break even. We may lose some money. It is more likely that we will come close to breaking even. We may even, some are telling us, make money for the taxpayer."[5]

New Spending

But these very benefits are now being exploited to justify a range of new spending. In a speech today citing $200 billion in TARP "savings," the President said: "These savings will allow us to pay down the deficit faster than was anticipated while also investing funds that would have gone to banks in job creating efforts instead." This piggy backs on recent remarks by House Speaker Pelosi, who advocated similar steps. The problem is that while TARP spending is real, these "savings" are not.

CBO locks in its baseline projections for scoring subsequent legislation, and since it did so in March, estimated TARP costs have declined as indicated above. Congress and the President are simply taking advantage of this estimate to claim savings relative to CBO's March baseline –

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[3] *Reuters*, "Bernanke testimony at Senate confirmation hearing," 3 December 2009.

[4] Floor statement on EESA, 1 October 2008.

[5] Floor statement on EESA, 1 October 2008.

turning TARP into a kind of "slush fund" for whatever wish-list spending items emerge. This would expand on the precedents that unfolded throughout the year, in which TARP funds have been tapped to take over auto companies and subsidize over-extended mortgage holders, among other things.

Using authority that has not materialized to take credit for deficit offsets is a technique the administration used earlier this year in its *Mid-Session Review*. OMB withdrew a $250-billion placeholder for additional financial stabilization efforts – funding Treasury never requested in the first place.

Instead of following the law's clear intent, the administration is using the TARP to launch a new round of "stimulus" spending while making the false claim of "fiscal responsibility."

CONCLUSION

Many TARP programs already have strayed from their initial purpose of promoting financial stability with taxpayer protections at the forefront.. While the $787-billion economic "stimulus" may have failed in its core mission of creating jobs, TARP must not be used to finance another such package. The unprecedented $700 billion in TARP authority was given to Treasury in exchange for the guarantee that it be used to stabilize the financial system and prevent a meltdown; and it was to be viewed as a narrow and temporary emergency measure that included strong taxpayer protections. It was not intended to mask the cost of new spending programs or a failed "stimulus." Using TARP as a kind of offset for such purposes will only increase Congress's temptation to spend now – while saddling the country with growth-stifling debt for generations to come.

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APPENDIX I
TARP: BORN OF A CRISIS

In 2008, the world watched the chain reaction caused by the implosion of a housing bubble spurred by overly loose monetary policy and a government push to lower mortgage underwriting standards. Investment bank Bear Stearns was an early casualty that served as a signal of things to come. Once-dominant investment bank Lehman Brothers failed later that year, collapsing under the weight of its portfolio of subprime and other mortgage-related assets. It filed for bankruptcy on 15 September 2008. The aftermath of these events were part of the most widespread financial crisis in recent history.

Money market funds – liquid investments long considered safe havens – were swept into the turmoil as the Reserve Primary Fund, which held $785 million of Lehman debt,[6] "broke the buck," a term used when the net asset value falls below $1 per share.

Like a game of dominoes, the financial system began to topple, spreading collateral damage into broader sectors. Investors began to withdraw money from money market funds. This devastated the market for commercial paper – debt issued by large banks and corporations in exchange for cash used to finance companies' short-term credit needs – because money market funds are the largest buyers of commercial paper. Firms that relied on commercial paper for critical operating expenses such as payroll were faced with a scenario that would bring business to a screeching halt, putting the country at risk for an economic meltdown.

Then, larger credit markets stopped functioning. The failures of Bear Stearns and Lehman, and the potential collapse of others, had caused the cost of credit default swaps [CDS] – products that effectively insure buyers against defaults for bonds or loans they own – to skyrocket. The world's largest traditional insurer, American International Group [AIG], a leading insurer of CDS, saw its debt downgraded by credit ratings agencies as the financial industry continued to nosedive. As of June 2008, AIG had sold CDS with about $447 billion in exposure.[7] AIG began to face cash collateral calls it could not satisfy from counterparties that were purchasers of CDS. The threat of bankruptcy and liquidity concerns at AIG spread a contagion throughout the markets. Banks refused to lend to one another. Stock markets were thrown into disarray as stockholders dumped shares. One of the more pronounced indicators of the credit freeze, the 3-month "LIBOR-OIS" spread,[8] was widening at a rapid rate. It would eventually reach 364 basis points on 10 October 2008 – about 300 basis points higher than the spread one year earlier.

This unprecedented crisis brought the economy to the brink of disaster and spurred Congress to take swift action to restore a degree of market stability and make credit available again. After failing initially in the House of Representatives, Congress subsequently passed the EESA, and it

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[6] *Bloomberg*, "Reserve Primary Money Fund Falls Below $1 a Share," 16 November 2008.

[7] Government Accountability Office, *Status of Government Assistance Provided to AIG*, September 2009.

[8] This is the difference between LIBOR [London Interbank Offered Rate] rates, which measure the rates at which banks borrow from each other in the London wholesale money market, and OIS [Overnight Index Swap] rates, which measure the overnight average of an interest rate like the federal funds rate. LIBOR-OIS is used as a gauge of banks' willingness to lend.

was signed into law on 3 October 2008. After that, market conditions continued to deteriorate, and Treasury using TARP to remove troubled assets from firms' balance sheets was too complicated and would be difficult to deploy quickly. Within 2 weeks, Treasury chose to inject capital into the financial institutions directly to jolt them back to life.

APPENDIX II
TARP BUDGETARY COSTS AND CURRENT PROGRAMS

BUDGETARY COSTS

While Treasury may give the impression its goal is to wind down TARP, the risk to taxpayers has risen since the administration took office in January. Using the latest data from CBO, the actual cost, or subsidy, has increased from $189 billion in January to $241 billion in August. TARP appears on the Federal budget using a modified credit reform estimate,[9] adjusted for market risk.

Table 1: TARP Costs on Budget, OMB and CBO Projections
(in billions of dollars)

	2009	2010	2011	2012	2013	2014	2015	2016	**Total**
CBO									
January	180	9	–	–	–	–	–	–	**189**
March	332	24	–	–	–	–	–	–	**356**
August	129	84	15	10	3	–	–	–	**241**
OMB									
February	247	–	–	–	–	–	–	–	**247**
May	260	8	10	10	8	6	3	1	**306**
August	235	70	11	9	6	6	3	1	**341**

Table 1 illustrates the point that TARP has so far been projected to cost much less than the full $700 billion in authority granted. Nevertheless, the non-financial-stabilization measures have contributed to rising costs. Much of the enhanced risks are the result of directing more funding to programs such as assistance to the auto industry and mortgage subsidies. In its August report, CBO noted that TARP's auto program is expected to have added $40 billion more to the deficit than it calculated just five months earlier in March. Treasury has committed $50 billion from TARP to the administration's "Making Home Affordable" [MHA] program for mortgage modifications. For MHA the entire $50 billion is an outlay. It is also worth noting that due to MHA, which is a 5-year program, TARP effectively has been extended through 2013.

CURRENT PROGRAMS

Capital Purchase Program [CPP] – Estimated CBO Recovery Rate: 82 Percent.[10] CPP provides banks with capital injections in exchange for, in most cases, preferred stock and warrants so there are shared appreciation rights for the taxpayer. Currently about $134 billion is invested in CPP, down from about a peak of about $205 billion. On 17 June 2009, ten large banks – including JP Morgan Chase, Goldman Sachs and Morgan Stanley – repaid just more than $68 billion in CPP assistance, bringing the total of repaid funds to about $71 billion. While Bank of America is expected to repay the entire $45 billion it borrowed from TARP, CPP recipients still include hundreds of community banks, and large institutions, Citigroup and Wells Fargo.

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[9] Under Federal Credit Reform Act of 1990, direct loans and loan guarantees are scored on a net-present value basis (discounted value of future cash flows). EESA mandates that these estimates be modified for market risk for TARP investments.

[10] Recovery rates are based on CBO subsidy rates by program as listed in its latest report, *The Troubled Asset Relief Program: Report on Transactions Through June 17, 2009*.

Assistance to the Auto Industry – Estimated CBO Recovery Rate: 27 Percent. Approximately $81 billion has been allocated from TARP to help the auto industry, most of it during the spring of 2009. A total of $3.5 billion has gone to auto suppliers; with the rest to Chrysler, GM and GMAC in the form of bridge loans and debtor-in-possession financing during the automakers' bankruptcies. Treasury is considering an additional investment of up to $5.6 billion in GMAC, bringing the finance company's total assistance to over $18 billion. According to the Government Accountability Office [GAO]: "Chrysler and GM would need to have a market capitalization of $54.8 billion and $66.9 billion, respectively, for Treasury to earn enough on the sale of its equity to break even . . . as a point of reference for these values, in 1997, the last year Chrysler was a publicly traded company, its market capitalization value ranged between $23.1 billion and $31.7 billion, and in 1998, when it merged with Daimler, it was valued at an estimated $37 billion. GM, at its peak in 2000, had a market capitalization of $57 billion."[11]

*Cushion for the Federal Reserve's Term Asset-Backed Securities Loan Facility [TALF] – Estimated CBO Recovery Rate: 90 Percent.*Treasury has committed $20 billion to cushion losses for the Federal Reserve's short-term lending facility for asset-backed securities, including those collateralized by auto loans, student loans, credit card loans, Small Business Administration loans, and residential and commercial real estate loans.

Assistance for American International Group [AIG] – Estimated CBO Recovery Rate: 50 Percent. In addition to the Federal Reserve Lending facilities, $70 billion of TARP has gone to AIG in the form of a $40 billion capital infusion in exchange for preferred stock with warrants and a $30 billion line of credit.

Program to Purchase Troubled Legacy Securities – Estimated CBO Recovery Rate: N/A
Even though a plan to purchase troubled assets was the initial idea for the use of TARP funds, Treasury has found this to be a difficult program to implement. Treasury had initially committed $100 billion in TARP funds for this program, but after lackluster support from the private sector, has reduced its commitment amount to $30 billion. Wary of corporate governance restrictions and political risk, private investors such as hedge funds and private equity funds have been reluctant to partner with the government, even with significant leverage, to purchase trouble assets. In addition, if the understanding is that government will not let banks fail, they may have an incentive to "take a pass" on participating in this program in favor of waiting for a better offer.

Home Affordable Modification Program [HAMP] – Estimated CBO Recovery Rate: 0 Percent (no funds recovered). This program carries a 100 percent loss rate for taxpayers for the entire $50 billion committed. HAMP uses TARP funds to either subsidize monthly mortgage payments or to provide incentive payments to servicers or homeowners. The program, aimed at helping 3 million to 4 million homeowners who are close to defaulting or already delinquent, has so far fallen short of this goal. Although 375,000 borrowers have begun trial modifications, a very low percentage of these have become permanent.[12] Any extension of HAMP or similar housing programs would likely be viewed as outlays because the funds will not be recovered.

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[11] Government Accountability Office, *Continued Stewardship Needed as Treasury Develops Strategies for Monitoring and Divesting Financial Interests in Chrysler, GM*, November 2009.

[12] Department of the Treasury, Loan Modification press release, 1 December 2009.