Understanding TARP

"The wisdom of hindsight, so useful to historians and indeed to authors of memoirs, is sadly denied to practicing politicians" – Margaret Thatcher

Recently, much has been written about the **Troubled Asset Relief Program (TARP)** – a provision of the Emergency Economic Stabilization Act of 2008 signed into law on October 3, 2008 during the last months of the Bush administration. The big public policy questions about what many refer to as the great recession are whether TARP worked and what are the long-term consequences. A long stream of academic, industry and journalistic literature has been produced to address these enduring questions – of course, each has a point of view that either supports or rejects a political ideology. Mindful of such political intensity and diversity, what follows is an assessment of TARP that highlights the **central issues** and a **critical analysis** from the policy response by the federal government to protect and stabilize the backbone of any economy – the banks.

TARP – The Central Issues: Psychology and Public Policy

What stands out from the final months of 2008 is psychological contagion. Indeed, much of the management of risk associated with the equities markets, for example, is strengthened or weakened by the psychology of investors. Perhaps the most memorable psychological blows begin with the U.S. Treasury's conservatorship of Fannie Mae and Freddie Mac on September 6, 2008 followed by the bankruptcy of investment bank Lehmann Brothers on September 15, 2008. The Dow Jones Industrial Average provides perhaps the largest demonstration of contagion as it descends from 12,650 in January 2008 to 7,850 at the end of January 2009. The great challenge in politics is to what end the government should step in to help curb or cure an economic downturn. Studying TARP provides insight not only on the rationale for public policy, but more directly, on the American political, economic and social spirit.

Where psychology influences behavior of investors in markets, the government's role is to set policy that gives markets, firms and investors a framework for which to engage. The on-going political debate remains to what end should government policy influence the supply and demand of a free and competitive market where buyers and sellers trade and bear the consequences of their choices – this is the nature of risk and, in essence, capitalism.

The Policy Response - TARP

On October 3, 2008, TARP authorized $700 billion to purchase or insure **troubled assets** from financial institutions to encourage and enable banks to lend money in order to maintain economic growth through capital demand. The allocation of the funding is as follows:

- $700 billion allocated on Oct 3, 2008 by the Emergency Economic Stabilization Act
- $549.4 billion committed to 640 total firms – banks, autos, insurance

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- Of the non-banks, TARP is projecting a loss

- $245 billion actually distributed to the largest financial institutions
  - Nearly repaid to the U.S. Treasury with a "profit" on the loans due to the required dividend on shares owned by the government – hence, the American taxpayer
- Percentage of total dollars allocated by firm size
  - Greater than $10 billion: 1.6% (the six largest banks 'too big to fail')
  - Less than $1 billion: 95.1% (mostly small banks)
  - Greater than $1 billion: 3.3%

TARP – A Critical Analysis: Bailout or Imminent Fiscal Policy

"Bailout" is a politically charged term that implies an entity is "sinking". As noted above, in the fall of 2008, evidence affirms that the banks throughout the entire capital system – from the colossal banking corporations with global reach to local and regional banks down the street – all had excessive liquidity deficits that were politically and economically unsustainable. So, was the banking sector "sinking" – indeed, it was on the brink.

The Big Questions and Answers

- Was banking and the whole of financial services a market failure – **yes**
- Was government complacent through the years in regulating the industry – **yes**
- Was irrational consumer behavior driving the bubble – **yes**
- Could the policy makers sit back and do nothing – **no**
- Did the government do the right thing with implementing TARP – **yes**
- Was the public policy decision politically and ideologically difficult and unpopular – **yes**
- Did the back bone of the economy – namely banks AND the massive insurance firms that insure risk such as AIG – get a 'bailout' – **no**
- Could the American economy have stabilized itself without TARP and similar fiscal policies by international central banks and treasuries – **no**
- Was TARP a loan – **yes**
- Was TARP a political means of financial last resort – **yes**
- Did TARP solve the systemic problem – **no**
- Did TARP resolve the imminent threat to the banking and financial system – **yes**
- Did the banks – those largest and most at risk – return the money to the government's treasury with a profit to the tax payer – **yes**
- Did the markets create the problem – **no**
- Did the consumers create the problem – **no**
- Did the government create problem – **no**
- HOWEVER, did the **combined dynamic environment** of business, government and society create the problem – **yes**
- Is the nation and the global economy better prepared for the growing complexity of an even more dynamic economy in the decades to follow – **yes**

TARP – Conclusions: Effective and Unpopular

Throughout the economic recovery, we have provided regular analysis of economic behavior and the public policy decisions that ensue. **TARP** remains controversial and intensely political primarily due to the unprecedented reach of the federal government into the private sector. The traditional rationale for public policy is either **market failure** – the over or under production of goods and services from the market system, or **government failure** – the over or under intervention of the public sector to moderate market failure. As the American financial system became more and more stressed in the fall of 2008, the exposure of the complexity of the economic infrastructure became more transparent. Evidence indicates that the market-based economy at that very moment in history required unpopular policy decisions from every spectrum of ideology – in essence, the government had levels of imminent decisions of which it had to contend. The policy response could have been: nothing, measured, or big – in the end, the government legislated **big**.

The Capital Purchase Program of TARP is projected to be entirely refunded by the largest banks with the most 'troubled assets' with a return on the taxpayer's risk. Whether it stabilized the banking system by enhancing liquidity by removing troubled assets (its original intent) remains debatable. What TARP did accomplish, most argue, is that the contagion of rightful fear of a system-wide collapse was eventually averted. The long-term costs include two major precedents now armed in the public policy tool kit: first, a **'too big to fail policy'** with implications of **'moral hazard'** – in essence, enabling further risk-taking by corporations sheltered from consequences; and second, and perhaps most contentious, is the precedent for large-scale government regulation of the economy – this remains the ideological debate of our time.

We hope this critical overview and analysis provides further insight on a policy that impacts all investors. As the dynamic political and economic environments intensify, our assessments will be close at hand.

With continued confidence,

Banta Asset Management