

Two Ways to Improve Tarp for Taxpayers

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In Walter Bagehot's famous banking dictum, when faced with a panic, the central bank must "lend freely." The Fed and other central banks are certainly doing so today, with a vengeance.

On top of that, the treasuries of many countries (the United States, Britain, Ireland, Germany, Spain, Belgium, the Netherlands, Iceland, and Switzerland among them) are devoting the public credit to supporting financial companies.

We have moved through the typical stages of governments faced with a financial crisis. First, there is delay in recognizing the extent of the losses while issuing assurances. A notable example, often heard in 2007: "The subprime problems are contained."

Then there is the central bank as liquidity provider or lender of last resort. But lending, however freely done, provides by definition only more debt.

If a company's capital is gone, however much more you may lend it, it is still broke. What was needed was not simply more liquidity but more equity capital. So we have the Troubled Asset Relief Program equity injections.

Of course, what is really happening in such programs is that the taxpayers are being made involuntary equity investors. How should they (we) be given fair treatment as investors?

In the aggregate, the investments the taxpayers are involuntarily making should have an expected positive return, in exchange for the risks being taken. Treasury Secretary Paulson has suggested that the Tarp program might make a profit, and it might.

There is both a yield on the preferred stock investments being made and a potential equity upside on warrants with strike prices reflecting depressed current stock prices. (Recall that the warrants the government got in the Chrysler bailout a generation ago did indeed pay a significant profit.) By one estimate, according to *The Wall Street Journal*, the current bailout program has achieved a gain of \$8 billion in the last three months.

With this potential, we need two fundamental improvements in the Tarp plan to make it reflect the interests of the real investors.

First, all the activities of the Tarp program should be isolated in a separate accounting entity. All investments and other assets, all related debt and other liabilities, all expenses, all income should be clearly measured as if Tarp were a corporation.

An audited balance sheet and income statement should be regularly produced. Then the administration, as operator of the program; the Congress, in its oversight responsibilities; and most importantly, the taxpayers, as investors, could all judge its performance.

Second, 100% of all profit, if achieved, should be earmarked as explicit dividends to the taxpayer-investors. Such dividends might be in the form of cash or specific tax credits.

This would be a well-deserved recompense to the majority of citizens - who bought houses they could afford, paid their mortgages on time, did not engage in leveraged speculation, paid their taxes, and then bore all the risk of the bailout.

Prudence, moderation, and virtue are their own reward, yes, but if the bailout makes money, let's have some dividends for the taxpayers, too!

Thomson Hankey, a mostly unknown intellectual opponent of the celebrated Bagehot, made two basic arguments against the government's helping banks, as restated by James Grant:

"No. 1, moral hazard: Let profit-maximizing people come to believe that the Bank of England will bail them out, and they themselves will assume the leverage that will require them to be bailed out.

No. 2, simple fairness: If Britain's banking interest can claim a right to the accommodation of the Bank of England, why shouldn't the shipping interest, the construction interest, the railroads, the agricultural interest? Shouldn't all actors be equally entitled to benefit by any favors?"

Secretary Paulson's Tarp plan obviously has the problem Hankey foresaw more than a century ago: Lots of people in line with hands out, palms upward. Though Hankey's arguments were insightful, the fear of financial collapse always trumps them.

Financial Times offered this nice summary of our situation:

"The overstuffed, mismanaged banking industry, now contracting as fast as it had expanded, needs to return to fundamental principles and sound underwriting practices. Sobered by the stock market crash of last October, banks should now be ready to provide investors with a more reasonable, competent, and careful industry. ... A huge human price was being paid by the thousands of people now losing their jobs in London and New York."

But this was actually written two decades ago, after the crash of 1987. The problem with thinking of financial market crises as "100-year floods" is that they recur every 10 or 20 years.

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