Testimony of Dean Baker
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of the Financial Services Committee
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Thank you, Chairman Gutierrez for inviting me to share my views on the success of the TARP to date and its impact on the broader economy. My name is Dean Baker, and I am the co-director of the Center for Economic and Policy Research (CEPR). I am an economist, and I have been writing about issues related to finance since 1992.

I will make three main points in my testimony:

1) There are two separate issues ostensibly addressed by the TARP and subsequent measures by Treasury and Federal Reserve Board. First, government involvement is needed to arrange an orderly reorganization of insolvent institutions; and second, actions are necessary to maintain the flow of credit.
2) The primary cause of the downturn is the loss of wealth as a result of the collapse of the housing bubble and the subsequent loss of value in the stock market. Credit is a secondary issue.
3) The government can help to promote a better flow of credit in this downturn by ensuring that smaller financial institutions that are in reasonably good financial health have fuller access to funds.

I'll address each of these in turn.

The Insolvency of the Major Banks

The immediate cause of the financial crisis that prompted the drive for the TARP in mid-September was the concern that several of the major money center banks were insolvent. As a result of these concerns, the major banks had largely stopped lending to each other. This was demonstrated most clearly by the "TED Spread," the gap between the interest rate charged on interbank dollar loans in the London market and Treasury notes of the same maturity. This spread increased to almost 5.0 percentage points on 90-day loans at its peak in early October. In more normal times, it hovers in the range of 0.15 to 0.3 percentage points. This extraordinary gap implied that banks were seriously concerned that the failure of other major banks was imminent, otherwise there would be no reason not to take advantage of the much higher interest rates available on interbank loans than on Treasury bills.

The banks had good reason for this concern. The major money center banks have massive quantities of bad assets on their books. Several of them would undoubtedly already be insolvent if they were forced to write down bad assets. There have been several credible estimates that place the losses of the banks at more than $2 trillion.[1] The FDIC put the capital of the commercial banking system at less than $1.2 trillion at the end of 2008. Of this, $400 billion was goodwill, the value of which would largely disappear as banks become insolvent. In short, it is very plausible that the liabilities of the banking system as a whole considerably exceed its assets. And, many of the largest banks are among those in the worst position.

The TARP effectively tossed these banks a lifeline, providing capital at below market rates to banks that were essentially insolvent. The additional capital provided by the TARP, along with the more generous guarantees of deposits, eased the immediate stress on the banking system. Interbank lending resumed and the TED spread fell back closer to its normal range. (It is currently near 1 percentage point.)

However, these banks still must deal with the basic problem that they are insolvent. When their assets are properly valued, many of the largest banks in the country will not be able to meet all of their liabilities. At some point this situation will have to be resolved with the government determining which of the banks' liabilities it will cover.

The TARP was successful in putting off a day of reckoning for the insolvent banks. Without the TARP, several major banks likely would have failed last fall. This would have led to some sort of receivership arrangement comparable to the situation of Fannie Mae, Freddie Mac, and AIG. Many of the major banks will likely still end up in a receivership type arrangement, but the TARP did buy the government time so that in principle it can carry through a bankruptcy-like procedure in an orderly manner.

It was unrealistic to expect that TARP would have led to a surge of new lending by the banks that received TARP money. In fact, the FDIC reported that the volume of outstanding loans at the 84 institutions with assets of more than $10 billion fell at an 8.8 percent annual rate between the end of the third quarter and the end of the fourth quarter of last year. While most of this decline was associated with real estate loans, loans to businesses fell at a 3.4 percent annual rate over this period.

These large banks desperately need to shore up their capital position to protect against further write-downs that they know are coming. In fact, it would be irresponsible for the management of banks that are at the edge of insolvency to making large volumes of new loans, which will inevitably carry considerable risk in the current environment. In short, it was unreasonable to believe that the TARP would lead to a large volume of new lending from the recipients of TARP funds.

Even if banks could not easily lend much of the money they received under the TARP, they could have taken other measures to better husband their capital, most obviously by slashing dividends and cutting executive pay. While such conditions could have been imposed as a requirement for receiving TARP funds, in the rush to pass legislation,

[1] New York University professor Nouriel Roubini and Goldman Sachs have both estimated likely bank loan losses at more than $2 trillion.

Congress did not take the time to insert language that effectively imposed these sorts of restrictions.[2]

As a result, in the months immediately following the TARP, the banks receiving money continued to act largely as they had previously, paying out executive bonuses and meeting their regular dividend schedule. In response to public pressure and pressure from Congress, and more recently pressure from the Obama administration, banks have begun to curtail executive compensation. Many have also reduced or eliminated dividends. The restrictions on executive compensation that were included in the American Recovery and Reinvestment Act of 2009 will also help to restrain pay at the banks receiving TARP money.

Restrictions on pay and dividends at these banks are important for two reasons. First, excessive executive pay and dividends are pulling money away from the purpose of the TARP, which is to restore the banks' capital. Every dollar that is paid out as excessive compensation or to shareholders as dividends is a dollar that could have bolstered the banks' capital.

The second reason why Congress should be concerned about excessive executive pay and shareholder dividends is a simple question of fairness. The TARP money is coming from taxpayers as a group. It can be justified by the public interest in keeping the financial system operating. If several major banks were to fail, it would severely damage the normal flow of credit in the economy. Also, the creditors of these banks (many of whom are public and private insurance funds, as well as mutual funds in individual retirement accounts) would find themselves in an uncertain situation until a bankruptcy could determine the portion of the assets that can be recovered. This would further depress economic activity.

However, there is no public interest in using taxpayer dollars to compensate bank shareholders, who presumably understood the risk in owning stock when they purchased it. There is also no public interest in sustaining the compensation packages of bank executives, who are among the highest paid people in the country. For this reason, Congress is entirely justified in imposing stringent conditions on the recipients of TARP money. After all, the banks don't have to take the money.

The Credit Squeeze and the Economy

While many businesses and individuals are finding it considerably more difficult than usual to get credit, this is not the cause of the recession. The cause was the collapse of an

[2] In this respect, it is worth noting the peculiar decision by Federal Reserve Board Chairman Ben Bernanke to wait until after Congress passed the TARP to announce that the Fed would begin buying the commercial paper of non-financial corporations. Prior to the passage of the TARP, Chairman Bernanke had identified the freezing up of the commercial paper market as one of the main reasons for a quick passage of the TARP. It is likely that many members of Congress did not know that the Fed already had the ability to directly lend in the commercial paper market prior to the vote on the TARP.

$8 trillion dollar housing bubble. The collapse of the bubble has directly harmed the economy most immediately by sending residential construction plummeting. This sector accounted for 6.2 percent of GDP at its peak in 2005. It currently accounts for less than 3 percent of GDP. This implies a loss in annual demand of more than $450 billion.

In addition, the lost wealth in housing has caused consumption to plunge. Homeowners had eagerly spent based on the run-up in wealth in their homes during the boom years. In some cases they borrowed directly against the equity in their homes, in other cases, they opted not to save for retirement because their rising home equity was providing all the saving they felt they needed.

With the decline in house prices to date having destroyed approximately $6 trillion in housing wealth, consumers have radically changed their behavior. By some measures, the saving rate has increased by more than 4 percentage points, implying a further loss in annual demand equal to approximately $400 billion. (The collapse of the stock market, resulting in the loss of approximately $8 trillion in wealth, is also depressing consumption.)

The huge falloff in residential construction coupled with the fall in consumption driven by the collapse of the bubble, are the primary causes of the downturn. The massive loss of wealth in the housing and stock market has made potential borrowers far less creditworthy than they were one or two years ago. Concretely, a homeowner with substantial equity poses much less default risk to a bank when he or she seeks a credit card, car loan, or even small business loan than a homeowner with little or no equity. As a result of the sharp decline in house prices over the last two and half years, tens of millions of homeowners now have little or no equity in their home. These people would find it much more difficult to obtain credit regardless of the finances of the banking system.

Similarly, the sharp decline in consumption has made many formerly creditworthy businesses much greater risks. Businesses of all types have seen declines in demand of 20-30 percent, squeezing profits and jeopardizing their survival. Banks would be far more reluctant to lend to these businesses in current circumstances regardless of the strength of their balance sheets.

One piece of evidence that would seem to refute the claim of a credit squeeze – credit worthy borrowers unable to get loans – is the decline in the Mortgage Bankers Association, mortgage applications index. If the credit squeeze story was accurate, then the mortgage applications index should be rising rapidly, since potential homebuyers might have to make two or three applications to get a mortgage and some would-be buyers might make several applications and still not get a mortgage. In fact, the mortgage applications index has trended downward in step with home sales.[3] This index provides no evidence that homebuyers or potential homebuyers are having any special difficulty getting loans.

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[3] The purchase applications index for the week ending February 21, 2009 was 250. It had often been over 500 during the peak years of the bubble. House sales are still at more than half their peak bubble levels.

There are undoubtedly cases where individuals and businesses who are in fact good credit risks are unable to get loans in the current environment because they have limited collateral and banks are being overly cautious. However, there is little clear evidence that there is a generalized problem of lack of credit beyond what would be expected given the severity of the downturn and the massive loss of wealth over the last two years.

Restructuring the Nation's Banking System

While the lack of credit may not explain the downturn, it will be important to ensure that individuals have access to adequate credit to ensure a sustained recovery. In almost any scenario most of the country's major banks are likely to be seriously impaired for at least the next several years. This provides an opportunity for many smaller banks to fill a void in meeting credit needs.

There is of course a wide range of divergence in the financial condition of smaller banks. As a general rule, they did not engage in the sort of reckless lending that has jeopardized the survival of the largest banks. Nonetheless, few banks could escape the impact of this downturn altogether. In areas where house prices have plummeted with the collapse of the housing bubble, loans that may have seemed very prudent based on bubble-inflated house prices may now be underwater and in danger of default. Lending institutions in these former bubble markets are therefore likely to be seriously stressed even if they had acted cautiously during the bubble years.

However, where these banks have managed to stay relatively sound, the Treasury should seek to ensure that they have adequate access to capital to help rebuild the economy. By bank size, it is worth noting that institutions with between $100 million and $300 million in assets actually increased their lending at a 3.2 percent annual rate from the end of the third quarter to the end of the fourth quarter, according to FDIC data. This was not true for either smaller banks as a group, nor larger banks. These relatively small banks can be expected to have a much larger role in the post-recovery economy than they did prior to the recession, due to the collapse or crippling of the major money center banks.

Therefore, it is entirely appropriate that Congress encourage the Treasury to use TARP funds to ensure that smaller banks have access to capital. There is no way that the country can simply abandon the large banks, because their unchecked collapse would lead to massive losses at pension funds, mutual funds, and insurance companies and likely lead to destruction of our whole financial system. However, there can be no doubt that smaller banks will play an important role in the economy in the future and the Treasury should act to ensure that they are prepared to play this role. The nation's smaller banks should not be penalized for having made the right decisions during the bubble years.