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TARP and the Treasury: Time to Allow Markets to Work

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Treasury Secretary Henry Paulson recently announced yet another change in direction of the "Troubled Asset Relief Program" (TARP), sowing more uncertainty and confusion in the very financial markets the program is supposed to stabilize. Instead of buying mortgage-backed assets as originally intended, Paulson says he is now considering three alternative initiatives:

1. Stock purchases in non-bank financial firms;
2. Federal financing for investors in securities backed by consumer debt such as car loans, student loans, and credit cards; and
3. Subsidies to mitigate mortgage foreclosures.

Rather than moving forward with these new and troubling approaches, Paulson should follow his own advice and let the markets work—including time for them to absorb his earlier initiatives.

TARP: Then and Now. Less than six weeks ago, Congress enacted legislation authorizing a massive $700 billion rescue plan for the nation's financial markets. The goal, as outlined by Paulson, was to prevent a massive, systemic failure of global financial markets. The solution, according to Paulson, was a "Troubled Asset Relief Program" consisting of massive purchases of illiquid "toxic" assets by the federal government from financial firms so that markets could continue to function. The focus was widely expected to be on mortgage-backed securities, whose value was often extraordinarily uncertain, leading to a freezing up of financial markets.

The ink was barely dry on the legislation, however, when Treasury adopted a new—and more problematic—approach: directly infusing selected U.S. banks with capital by purchasing non-voting preferred equity shares. Granted, Treasury's hand in this was in part forced by European governments, which paved the way with massive capital infusions into their own banking systems. However, the original TARP plan, as envisioned when Congress adopted the authorizing legislation, never went forward.

On November 12, Paulson announced that Treasury no longer planned to buy any mortgage-backed securities, except perhaps in certain targeted instances. Instead, he put forth a number of other possible initiatives the Treasury might pursue with the $700 billion that Congress authorized, as well as other authorities such as: purchases of stock in non-bank financial firms; federal financing for investors in securities backed by consumer debt such as car loans, student loans, and credit cards; and subsidies to mitigate mortgage foreclosures.

Paulson's Course Changes Confuse Markets. These possible moves, however, would likely exacerbate rather than ease the current financial prob-

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lem. Not only are there serious questions about the need for these specific actions, but—and perhaps more importantly—the uncertainty created by yet another game plan for the rescue casts doubt on the financial rescue plan as a whole, its administration, and the prospects for its success.

Certainly, the Treasury Department can legally forego the mortgage-backed security purchase program. From the outset, Secretary Paulson emphasized the dynamic and rapidly changing nature of the financial crisis, and the need to be able to adapt. And under the terms of the legislation passed by Congress, although it was clear that the primary intent was to buy toxic mortgage-backed securities, the flexibility to purchase other assets was explicitly provided. Even more clearly, no one would want to require the federal government to intervene in markets where its intervention is no longer necessary, as seems to be the case with the mortgage-backed securities market.

No Bailouts for Non-Banks. Nevertheless, each of the various plans for expanding the program raises serious questions.

Capital purchases—the acquisition of ownership by the government in private-sector firms—presents inherent and inevitable dangers. Already, political pressure is growing for the government to exercise greater control over the activities of banks participating in the capital program. Moreover, as Paulson himself noted, because many such institutions are not regulated and engage in a variety of businesses, protecting taxpayers would be more difficult. The Treasury should not extend the capital purchase program to non-bank firms.[1]

Need for Consumer Credit Bailout Dubious. The second possible new initiative—the purchase of consumer credit securities—raises different concerns. Treasury argues that since the problem has shifted, so should the focus of their attention. But to justify intervention, Treasury needs to show that the problems in these markets present a potentially catastrophic, systemic threat to the ability of the financial system as a whole to function.

In his statement, Paulson argued that "illiquidity in this sector is raising the cost and reducing the availability of car loans, student loans and credit cards." This he said "is creating a heavy burden on the American people and reducing the number of jobs in the economy." Such harms are real and should not be minimized. But they fall short of the sort of systemic threat to the operation of the financial sector as a whole that led Congress to create the TARP program. If such a threat is indeed present, then Treasury should demonstrate this explicitly, and make a clear and compelling case for such purchases.

New Program for Mortgages Unnecessary. The third initiative discussed by Paulson—reducing mortgage foreclosures—is the least well defined. The general goal is to encourage mortgage holders to modify mortgages on a streamlined basis, reducing payments for struggling homeowners. That goal, he said, was to be pursued using leverage gained from mortgage-backed securities purchases. Now that Treasury has decided not to purchase such assets, he explained, other means are needed to pursue it. He did not specify those means, although he said any would require "substantial government spending."

Yet such a separate program would be unnecessary if, as Treasury asserts, other actions succeed in ensuring functioning credit markets. On top of this, there are already many other programs in place to help homeowners. In any case, intervening directly in the mortgage market promises only further market distortions, as well as inequity for hard-working Americans who resisted the urge to take on debts they could not afford.

Single Most Disruptive Force in the Global Economy? The biggest problem with Paulson's announcement yesterday, however, goes deeper than whether this or that new program is justified or

1. Even without formal expansion of the capital purchase program, the initiative has had some troubling consequences for non-bank firms as companies rush to reorganize as bank holding companies in order to qualify for assistance. As a result, otherwise efficient structures are displaced. This process fortunately should end with the November 14 deadline for participation in the bank program. That deadline should not be extended.

acceptable. By once more shuffling the deck of possible interventions, Paulson has jeopardized the very stability of the markets that he was intended to restore.

Markets need to engage the price discovery process and to clear transactions. These functions are being hindered by uncertainty regarding Treasury's next move. In his own statement he acknowledged as much, saying, "We must allow markets and institutions to absorb the extensive array of new policies put in place in a very short period of time."

Unfortunately, Paulson ignored his own advice, sowing the markets with additional confusion. The constant array of new ideas, new strategies, and changed courses mean that the Paulson Treasury has become perhaps the single most disruptive force in the global economy.

It is time for this to end. Henry Paulson should stop tinkering and allow the world's financial markets time—and freedom—to work.

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