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Time to End the TARP Bailout Program

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Last week the Bush Administration tried to find ways to use the funds available in the Troubled Assets Relief Program (TARP) to bail out the Detroit automobile companies. That decision is just the latest of weekly, and sometimes daily, Administration reinterpretations of the TARP program's purposes. And no doubt the incoming Administration will continue this creativity and TARP will increasingly become a White House fund for politically sensitive companies.

With $15 billion of TARP funds still immediately available, and another $350 billion available if congressional action does not block access to the money, it is time to end this program by canceling further Treasury authority to allocate funds. To the extent that new financial crises materialize, recent experience suggests that the Federal Reserve Board is best able to handle them and would do so while resisting political pressure. If additional steps are needed in the future, the White House should request new congressional programs or authority with far greater clarity and restrictions on the uses of money. It is time to end the continued use and abuse of TARP funds.

Why TARP Should Be Ended. The original TARP program could be justified as appropriate action by government to avoid a catastrophic failure of financial markets.[1] As a cardinal principle, the federal government should not intervene to save firms from the consequences of bad business decisions, which is why the proposed congressional Detroit bailout was so unwise.

But in rare cases a second principle comes into play: When the basic functioning of a market is breaking down, with potentially disastrous consequences for the entire economy, there can be a case for government to act to help restore a functioning market.[2] The accelerating turmoil in the financial markets in the early fall, with the prospect of the entire credit system seizing up and a spiraling economic collapse, provided an urgent case of the need to apply the second principle.

At that time, it appeared that the critical step was for the Treasury to purchase "toxic assets" (consisting of mortgage-backed securities of uncertain value) so that credit markets could function smoothly again. TARP was created to address this necessity. While Congress explicitly limited Treasury action to assisting financial institutions to remain functional, the legislative language apparently gave the Treasury too many ways of using funds for additional purposes.

The problem now is that the Treasury has concluded that the purchase of toxic assets is no longer practical and has embarked on a troubling pattern of potentially harmful ad hoc policymaking and mission creep. A major example of this was Treasury Secretary Henry Paulson's announcement on

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November 12 to suspend the original purpose of TARP and to use flexibility granted under the law to explore a wide range of alternative uses of the funds, from guaranteeing securities backed by student loans and credit card debt to using TARP to refinance problem mortgages. This step confused markets, reintroduced uncertainty into the pricing of mortgage-backed securities, and triggered a lobbying frenzy for ever-more "flexible" uses of the TARP funds.[3]

The Bush Administration's decision to consider responding with TARP funds to Congress's refusal to bail out the Detroit automobile companies underscores how far the Treasury has reinterpreted the mission of TARP. The only way to prevent further misuse of the program is to end it.

Huge Dangers Remain in Financial Markets. The financial market dangers that led to the TARP program, however, are far from over and may yet require additional governmental action. U.S. and international credit markets are undergoing a wrenching restructuring and repricing of financial assets as markets adapt to the ending of excessive and risky borrowing. The worry is that another short-term crisis could destabilize that restructuring and once again cause financial markets to seize up.

One especially worrying trend is the widening gap between highly rated instruments (such as Treasury bonds and AAA commercial paper) and financial instruments of quite modest underlying risk. The one-month Treasury rate is now negative—meaning savers and investors are paying the government to keep their money. Meanwhile, borrowers with moderate business risk are facing historically high rates—which have increased quite sharply since late September. Moreover, banks and other financial institutions will have to restate the value of their assets as of December 31. While the Securities and Exchange Commission and the Financial Accounting Standards Board have made improvements in the use of "mark-to-market" accounting rules, the rules are still imperfect. The shock of a large restatement of the balance sheets of major financial institutions at the beginning of the year could trigger yet another run on banks and a financial crisis that could gravely disrupt normal business activity throughout the economy.

TARP Is Not the Cure for Future Problems. The first institutional line of defense against these dangers, however, should be the Federal Reserve Board under its wide, existing powers, not the Treasury using TARP funds in ways not intended by Congress. While many of the Fed's actions in recent weeks have been disconcerting, the Fed is still the appropriate institution to address short-term dislocation in the financial system. Moreover, it is insulated from the political and lobbying pressures that necessarily ensnare the Treasury and the White House. If steps turn out to be needed beyond appropriate action by the Fed, Congress should rapidly consider what action is needed—as it did with TARP. And if in the future Congress needs to give the Treasury new powers to deal with another potentially catastrophic breakdown in financial markets, it should include much tighter limits on Treasury's discretionary authority than it did when it created TARP.

What to Do Next. Congress should:

- Say no to any request to use the second half of TARP funds. Only $15 billion of the first half of the TARP funds ($350 billion) remain uncommitted. If Secretary Paulson or the incoming Treasury secretary wishes to use the second $350 billion, the Administration must give notice to Congress, which then has 15 calendar days to pass a joint resolution of disapproval to deny use

1. See Stuart M. Butler, Ph.D., and Edwin Meese III, "The Bailout Package: Vital and Acceptable," Heritage Foundation *WebMemo* No. 2091, September 29, 2008, at *http://www.heritage.org/Research/Economy/wm2091.cfm.*
2. See Stuart M. Butler, Ph.D., Alison Acosta Fraser, and James L. Gattuso, "What Should Be Done About the Financial Markets?" Heritage Foundation *WebMemo* No. 2070, September 19, 2008, at *http://www.heritage.org/Research/Economy/wm2070.cfm.*
3. James L. Gattuso, David C. John, and J.D. Foster, Ph.D., "TARP and the Treasury: Time to Allow Markets to Work," Heritage Foundation *WebMemo* No. 2131, November 14, 2008, at *http://www.heritage.org/Research/Economy/wm2131.cfm.*

of the money. If such a request is presented, it should be denied.

- Repeal the TARP program. If this Congress reconvenes, and certainly when the next Congress begins its work, it should end the TARP program. Specifically, the authority to spend the second $350 billion of TARP funds, and any remaining uncommitted funds from the program's first $350 billion, should be revoked.
- Get to the bottom of the financial crisis. There is still no consensus on the essential causes of the financial crisis or the strategic actions needed to prevent similar crises in the future. It is time for an independent commission to investigate the matter and propose structural reforms in the nation's financial regulatory system, including the laws governing mortgage lending and other requirements on financial institutions that appear to have exacerbated today's problems. The incoming Congress should establish such a commission consisting of respected independent experts, and Congress should agree to conduct hearings and take action on its recommendations.[4]

The commission should:

- Explore the origins of the crisis and the activities of such private entities as credit rating agencies, the drop in underwriting standards by private housing lenders, and the role of unregulated mortgage originators.
- Examine the operations of the major government institutions involved and make recommendations for changes in their roles. These should include the Federal Reserve Board, the Treasury, and the Securities and Exchange Commission. The commission should also review the charter and operations of the private-public government-sponsored housing enterprises such as Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.
- Review specific statutes and programs that might have contributed to the crisis (such as the Community Reinvestment Act and low-income housing programs) and examine both the apparent breakdown of congressional oversight and the links between campaign contributions and the actions of key lawmakers.

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4. Dave Mason, "Why an Independent Financial Markets Commission Is Needed Now," Heritage Foundation *WebMemo* No. 2112, October 23, 2008, at *http://www.heritage.org/Research/Economy/wm2112.cfm.*