Congressional Oversight Panel Releases Report on the Use of Government-Backed Guarantees to Promote Financial Stability

November 6, 2009

For Immediate Release

While Taxpayers Will Likely Profit, Guarantees Carry Enormous Risk and Created Significant Moral Hazard

WASHINGTON, D.C. - The Congressional Oversight Panel today released its November oversight report, "Guarantees and Contingent Payments in TARP and Related Programs." The Panel found that the programs' income will likely exceed their direct expenditures, and that guarantees played a major role in calming financial markets. These same programs, however, exposed American taxpayers to trillions of dollars in guarantees and created significant moral hazard that distorts the marketplace.

During the financial crisis, the federal government dramatically expanded its role as a guarantor. Treasury, the FDIC, and the Federal Reserve Board together negotiated to secure hundreds of billions of dollars in assets belonging to Citigroup and Bank of America. In addition to increasing the deposit insurance coverage of bank accounts, the FDIC established the Debt Guarantee Program (DGP) to stimulate the market for banks to issue debt and raise capital, and Treasury acted to reassure anxious investors by guaranteeing that money market funds would not fall below $1.00 per share.

Altogether, the federal government's guarantees have exceeded the total size of TARP, making guarantees the single largest element of the government's response to the financial crisis. At its high point, the federal government was guaranteeing or insuring $4.3 trillion in face value of financial assets under the three guarantee programs discussed in the Panel's report. The enormous scale of these guarantees played a significant role in calming the financial markets last year. Lenders who were unwilling to risk their money in distressed and uncertain markets became much more willing to participate after the U.S. government promised to backstop any losses.

The Panel found that Treasury took an aggressive stance in protecting taxpayer interests, and the Panel did not identify any major flaws with their implementation of the guarantee programs. Even so, these programs carried significant risk. In many cases, the American taxpayer stood behind guarantees of high-risk assets held by potentially insolvent institutions.

These guarantee programs also created significant moral hazard. Guarantees create price distortions and can lead market participants to engage in riskier behavior than they otherwise would. In addition to the explicit guarantees analyzed in the Panel's report, the government's broader economic stabilization effort may have signaled an implicit guarantee to the marketplace: the American taxpayer stands ready to provide a financial backstop for certain markets and large market players to avert possible economic collapse. To the degree that investors, lenders and borrowers believe that such an implicit guarantee remains in effect, moral hazard will continue to distort the market.

The extraordinary scale of these guarantees, the significant risk to taxpayers, and the corresponding moral hazard leads the Panel to conclude that these programs should be subject to extraordinary transparency. The Panel specifically identified the guarantee of Citigroup assets under AGP -- the largest single guarantee offered to date -- and strongly urges Treasury to provide regular, detailed disclosures about the status of the assets backing up this guarantee. Treasury should disclose greater detail about the rationale behind guarantee programs, the alternatives that may have been available and why they were not chosen, and whether these programs have achieved their objectives. This should include an analysis of why Citigroup and Bank of America were selected for AGP and not others.

Recommendations are provided in the full report, which can be found at cop.senate.gov.

The Congressional Oversight Panel was created to oversee the expenditure of the Troubled Asset Relief Program (TARP) funds authorized by Congress in the Emergency Economic Stabilization Act of 2008 (EESA) and to provide recommendations on regulatory reform. The Panel members are: former Securities and Exchange Commissioner Paul S. Atkins, Congressman Jeb Hensarling (R-TX), Richard H. Neiman, Superintendent of Banks for the State of New York, Damon Silvers, Policy Director and Special Counsel for the AFL-CIO and Elizabeth Warren, Leo Gottlieb Professor of Law at Harvard Law School.