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What's Under the TARP?

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The Emergency Economic Stabilization Act was signed into law on October 3, 2008, and granted the U.S. Treasury broad powers to ensure financial market stability through the Troubled Asset Relief Program (TARP). The TARP authorized the purchase and insurance of up to $700 billion of troubled assets from banks and was passed with three goals: to stabilize financial markets, to support housing markets by preventing foreclosures and supporting mortgage finance, and to minimize potential losses to taxpayers.

The TARP was originally conceived to purchase troubled assets directly from banks. However, as quickly became apparent, properly valuing these assets was extremely difficult as a result of ongoing home mortgage foreclosures, defaults, and falling house prices. The financial turmoil intensified in the weeks following the bill's passage, and to move quickly, the U.S. Treasury established the Capital Purchase Program (CPP), which became the centerpiece of TARP. The goal of the CPP was to recapitalize healthy banks by purchasing preferred shares of stock in banks instead of purchasing their troubled assets.[1] The Treasury hoped to stabilize the financial markets and limit downside financial risks to taxpayers via such recapitalization. Later, the TARP included investments in American International Group (under the Systemically Significantly Failing Institutions [SSFIs] provision of TARP), the automotive industry (General Motors, Chrysler, and their respective financing arms), and targeted investments in Citigroup and Bank of America. The left column of the table below summarizes TARP distributions through April 3, 2009.

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The Emergency Economic Stabilization Act also created a Congressional Oversight Panel (COP) to evaluate the effectiveness of the TARP. In their January 9, 2009, report, the COP highlighted four areas that they believe warranted special attention. First, they asked the Treasury to report how banks are using their TARP funds. Second, the panel called for greater transparency and asset evaluation. Third, the panel suggested greater Treasury emphasis on preventing foreclosures, and finally, they asked for better communication of the overall TARP strategy.

On February 10, 2009, Treasury Secretary Geithner released details for the new Financial Stability Plan, which attempts to address some of the COP concerns by reallo-

TARP Allocations and Financial Stability Proposals

Troubled Asset Relief Program (*allocated*)	Amount ($ billion)	Financial Stability Plan (*proposed*)	Amount ($ billion)
Capital Purchase Program	198.8	Capital Assistance Program	Unknown
American International Group	40.0	Homeowner Affordability and Stability Plan	75.0
Citigroup		Public-Private Investment Fund	100.0
Targeted investment	20.0	Term Asset-Backed Securities Lending Facility	100.0
Asset guarantee	5.0		
Bank of America	20.0		
Automotive industry financing*	24.8		
Total	308.6	Total	275.0

NOTE: *Includes General Motors, Chrysler, and their respective financing divisions.

cating the remaining TARP funds and combining the funds with larger, more comprehensive lending facilities. The Financial Stability Plan, initiated under the belief that "[t]here is more risk and greater cost in gradualism than in aggressive action," has several features.[2]

First, the Financial Stability Plan established the Capital Assistance Program (CAP). To be eligible for a CAP investment, banks must first undergo a stress test.[3] This test determines whether a bank has enough money to withstand a severe economic downturn. The stress test is required for all bank holding companies with more than $100 billion in assets, but smaller U.S. banking organizations seeking funds must opt to take a stress test before receiving any funds. The plan then requires participating firms to submit a detailed plan for how the proposed funds will be used. After receiving funds, firms must also provide monthly reports on the number and type of loans issued and securities purchased; these reports will be publicly available at www.financialstability.gov. Any institution that accepts funds must commit to a series of restrictions, such as limits to executive pay, and participate in mortgage foreclosure mitigation programs.

The Financial Stability Plan increases Treasury participation in the Term Asset-Backed Securities Lending Facility (TALF); at the same time, the Federal Reserve Board has expanded the TALF to lend up to $1 trillion.[4] The TALF is designed to lend money and accept assets backed by student loans, small business loans, and credit card payments, thereby increasing the availability of loans to consumers and small businesses.[5] The TALF will use approximately $100 billion of the remaining TARP funds.

A new feature of the Financial Stability Plan is the Public-Private Investment Program, which contains two Public-Private Investment Funds (PPIF) designed to combine government and private equity to purchase troubled or illiquid assets from banks. This should in turn allow banks to then resume normal banking operations. The program contains two components. The Legacy Loans Program will target "legacy loans"[6] currently on banks' balance sheets and the Federal Deposit Insurance Corporation (FDIC) will provide financing through a debt guarantee of up to 85 percent of the PPIF investment; the U.S. Treasury and private investors will split the remaining equity investment dollar for dollar. The second component, the Legacy Securities Program, will provide debt financing through the TALF (instead of the FDIC) and include up to a one-for-one dollar match of private equity by the U.S. Treasury to invest in any legacy security backed by commercial or residential mortgages issued before 2009. Inclusion of the private sector is designed to avoid overpricing assets and creating taxpayer losses. However, initial support and reception for the plan has been mixed.

The Financial Stability Plan also includes language directed solely at stemming home foreclosures. The new Homeowner Affordability and Stability Plan will use up to $75 billion of the $700 billion TARP allocation to refinance or modify qualifying mortgages so that monthly payments are never more than 38 percent of a borrower's gross income. The plan also includes financial incentives for lenders that would lower the borrower's monthly payments to 31 percent of gross income. These modified payments will be in force for a minimum of five years, after which they can gradually be increased to the conforming loan rate.

The Financial Stability Plan is just one piece of a comprehensive government response to the current financial market turmoil. It is meant to complement the fiscal stimulus legislation signed into law in February and build on ongoing actions by the Federal Reserve. The plan also attempts to address some of the concerns of the COP. Time will tell whether these actions will produce their intended effects. ■

[1] Holders of preferred shares are paid before common stockholders. Preferred shares pay a cumulative dividend at a rate of 5 percent per year for 5 years and 9 percent thereafter. These dividends are established by the terms of the CPP and are greater than dividends paid to common shareholders.

[2] Remarks by Treasury Secretary Timothy Geithner on February 10, 2009.

[3] A chart of economic scenarios can be found in the FAQs section of the February 25, 2009, press release by the Federal Deposit Insurance Corporation (FDIC). Under the baseline case, for 2009 the FDIC assumes a decline in gross domestic product (GDP) of 2.0 percent (average annual change), an unemployment rate of 8.4 percent, and a 14 percent decline in the S&P/Case-Shiller 10-City Composite Home Price Index.

[4] See Aubuchon, Craig P. "The Fed's Response to the Credit Crunch," *Economic Synopses* No. 6, 2009.

[5] On March 19, 2009, the Federal Reserve expanded TALF to also include asset-backed securities backed by mortgage servicing advances, loans/leases relating to business equipment, leases of vehicle fleets, and floor plan loans.

[6] Legacy loans are defined as real estate loans still held by banks, which create uncertainty about a bank's balance sheet and thereby compromise their ability to raise additional capital.

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