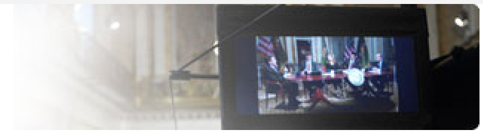
U.S. DEPARTMENT OF THE TREASURY

Press Center



Remarks by Acting Assistant Secretary Timothy G. Massad at Harvard University's John F. Kennedy School of Government

3/29/2011
Notes from the Eye of the Storm: The Financial Crisis and TARP
Mossavar-Rahmani Center for Business and Government
Cambridge, Massachusetts

As Prepared for Delivery

Introduction
Good afternoon, and thank you for the kind introduction. It's great to be back at Harvard, where I spent seven years as an undergraduate and law student. And it's particularly a pleasure to be at the Mossavar-Rahmani Center for Business and Government under the directorship of Larry Summers, who is a friend of mine from college.

I have been working on TARP since December 2008—first, briefly, as a special advisor to the Congressional Oversight Panel, and then at the Department of the Treasury since the spring of 2009. I joined Treasury as the Chief Counsel for the program and later became the Acting Assistant Secretary for Financial Stability, which means I oversee the program.

Today I intend to discuss three things. First, why was TARP necessary? In answering this I will be brief, because we do not have time to discuss in detail the causes of the crisis or the reasons why the additional resources and tools provided by TARP were necessary, but I do want to give you an overview of those issues.

Second, what exactly were the actions taken under TARP? Here I will go into a bit more detail.

And third, how do we evaluate whether TARP worked? I will give you a preview to this answer now, by posing four more questions for you to think about as I discuss what we did. In evaluating whether TARP, or any other response to a financial crisis, was successful, one might ask:

- First, has financial stability been restored so that the financial system is able to support rather than impede economic growth?
- Second, how quickly is the financial system able to replace government investments with private capital?
- Third, what was the direct financial cost of the interventions to taxpayers?
- And fourth, is the financial system stronger today than it was immediately prior to the crisis?

Financial System in Crisis
But before we answer those questions, we need a little background.

In September 2008, the nation was in the midst of one of the worst financial crises in our history. The financial institutions and markets that Americans rely upon to protect their savings, help finance their children's education, and help pay their bills, and that businesses rely upon to make payroll, build inventories, fund new investments, and create new jobs, were threatened unlike at any time since the Great Depression. Across the country, people were rapidly losing confidence in our financial system and in the government's ability to safeguard their economic future.

The causes of the crisis will be studied for years, and we do not have enough time to explore them in detail. But some reasons are clear. Over the two decades preceding the crisis, the financial system had grown rapidly in an environment of economic expansion and stability. Risks also grew in the system, without adequate transparency. Lax regulations and loopholes in supervision let firms become highly leveraged and take on too much risk. Ample credit around the world fueled an unsustainable housing boom in the first half of the last decade. When the housing market inevitably turned down, starting in 2006, the pace of mortgage defaults accelerated at an unprecedented rate. By mid-2007, rising mortgage defaults were undermining the performance of many investments held by major financial institutions.

The crisis began in the summer of 2007 and gradually increased in intensity and momentum over the course of the following year. A series of major financial institutions, including Countrywide Financial, Bear Stearns, and IndyMac, failed; and Fannie Mae and Freddie Mac, the largest purchasers and guarantors of home loans in the mortgage market, came under severe stress.

By September 2008, for the first time in 80 years, the U.S. financial system was at risk of collapse. A growing sense of panic was producing the classic signs of a generalized run on not just banks but the system as a whole. Trust and confidence in the stability of major institutions, and the capacity of the government to contain the damage, were vanishing.

Our system of regulation had not only failed to identify or mitigate the factors that led to the crisis, but we also entered this crisis without adequate tools to manage it. In particular, we did not have tools to deal with the failures of systemically important non-bank financial institutions.

Responding to the Crisis: The Troubled Asset Relief Program
The Department of the Treasury, the Federal Reserve, the FDIC, and other government bodies undertook an array of emergency actions to prevent a total collapse, but the severe conditions our nation faced required additional, unprecedented resources and authorities. That is why the Bush Administration – that's right, most people forget that TARP was passed under President Bush – proposed the Emergency Economic Stabilization Act, or EESA, in late September, and with the support of Democrats and Republicans in Congress, it was enacted into law on October 3, 2008.

Actions Taken by the Bush Administration under TARP
The Bush Administration originally proposed TARP as a mechanism for the government to buy mortgage loans, mortgage-backed securities, and certain other "troubled assets" from banks. But by early October 2008, there was insufficient time to implement such a program, given the challenges of valuing such toxic assets and building the administrative infrastructure to purchase large volumes of assets. So, the Bush Administration determined that immediate capital injections were needed in order to stabilize the banks and to avert a potential catastrophe. And EESA provided this authority because Congress had broadened the statute during the legislative process.

This change in strategy resulted in criticism and distrust of the program. But although I was not involved in that decision, I believe there is no question that this change was correct.

The Bush Administration then used approximately $300 billion of TARP authority as follows:

- $234 billion was invested in banks and thrifts, including $165 billion in eight of the largest financial institutions;
- $40 billion was invested in American International Group, or AIG, along with additional funds from the Federal Reserve; and
- Approximately $20 billion was provided to the auto industry.

The combined effect of the actions taken by the Federal Reserve and the Bush Administration helped stop the panic and slow the financial crisis.

Actions Taken by the Obama Administration under TARP
Despite these efforts, when President Obama took office in early 2009, the financial system remained paralyzed and the economy continued to contract at an accelerating rate. The nation had already lost 3.5 million jobs in 2008, and was losing additional jobs at the rate of approximately 750,000 per month. Home prices were falling and foreclosures were rising. Household wealth had fallen by 20 percent from December 2007 to December 2008, more than five times the decline in 1929. Businesses were cutting back on investments and could not raise capital.

Recognizing the need for additional, quick action, the Obama Administration, working alongside the Federal Reserve, adopted a broad strategy to restore economic growth, free up credit, and return private capital to the financial system.

In addition to the stimulus, the Obama Administration launched a Financial Stability Plan that had three central components:

- Recapitalize and rebuild confidence in the banking system;
- Restart the credit markets that are critical to borrowing for businesses, individuals, and state and local governments; and
- Stabilize the crisis in the housing market.

That three-pronged approach represented an important change in strategy, shifting the focus away from supporting individual institutions and moving the focus toward revitalizing the broad markets for capital and credit.

First, in recapitalizing the system, we recognized that private capital could not be raised until the condition of the major financial institutions was made clear. Treasury worked with the federal banking regulators to develop a comprehensive, forward-looking "stress test" for the nineteen largest bank holding companies to determine which ones would need more capital to remain well-capitalized if economic conditions deteriorated significantly more than expected. The stress test was conducted with unprecedented openness and transparency, which helped restore market confidence in our financial system. Treasury allowed banks needing capital to reapply for further assistance under TARP – that came with tough conditions – but only one did so. Since completion of the stress test, these banks have raised an aggregate of more than $150 billion in private capital, and 13 of the stress-test banks that had TARP investments have repaid the government in full.

Second, in restarting the credit markets for households and businesses, we initiated three new programs.

- Through the Term Asset-Backed Securities Loan Facility ("TALF"), a joint program with the Federal Reserve, we helped restart the asset-backed securitization markets that provide credit to consumers and small businesses. Since TALF was launched in March 2009, new issuances of asset-backed securities have averaged $10.5 billion per month, compared to less than $2 billion per month during the height of the crisis.
- Through the Public-Private Investment Program ("PPIP") for legacy securities, we matched TARP funds with private capital to purchase legacy mortgage-related securities. This program helped return liquidity to key markets for financial assets and clean up the balance sheets of major financial institutions. Since the announcement of PPIP in March 2009, prices for eligible residential and commercial mortgage-backed securities have increased by as much as 75 percent. Moreover, although the funds are still in their early ramp-up phase, they have been successful in earning a positive return for taxpayers.
- Through the SBA 7(a) Securities Purchase Program, we committed to help unlock credit for small business by purchasing securities backed by small business loans. Markets for these securities have since returned to healthy levels.

In addition, helping to stabilize the auto industry was important to aiding consumers and businesses. On top of the actions the Bush Administration took to prevent uncontrolled liquidations of Old GM and Old Chrysler, the Obama Administration provided additional assistance to prevent the further loss of American jobs, but only on the condition that the companies undertake fundamental changes.

These changes involved sacrifices from all stakeholders—shareholders, unions, auto dealers, and creditors—and they enabled the industry to become more competitive. This assistance also helped the many suppliers and ancillary businesses that depend on the automotive industry. Our actions saved jobs across the country—as many as one million, by one estimate—and created many new ones. Our strategy is helping to restore the domestic auto industry to profitability, and we have already begun to recoup our investments.

Housing Programs Under TARP
Finally, the Administration took aggressive steps to address the worst housing crisis in decades. Our strategy has focused on providing stability to housing markets and giving Americans who are struggling but, with a little help, could afford to stay in their homes, a chance to do so. We provided liquidity for housing purchases through the Federal Housing Administration. We provided strong support to Fannie Mae and Freddie Mac to ensure continued access to affordable mortgage credit across the market. And we launched the Home Affordable Modification Program SM, or HAMP SM, which would permanently reduce mortgage payments to affordable levels for qualifying homeowners.

I want to move away from our discussion of the investment programs under TARP and spend a few minutes on our housing programs. These programs are vital to addressing this crisis, and yet tonight the House of Representatives will vote on whether to terminate HAMP, even though the program continues to provide much needed help to tens of thousands of new families each month.

We strongly oppose these efforts.

Under HAMP, more than 600,000 families across the country have received permanent mortgage modifications, resulting in lower monthly payments. And each month, approximately 25,000 to 30,000 new homeowners receive modifications. For many of these families, a reduced monthly payment is the difference between keeping their homes and foreclosure.

The indirect impact of HAMP has been just as dramatic. Every American home saved from foreclosure benefits the surrounding community, prevents properties from becoming vacant, and helps protect neighborhood home values. Also, HAMP has helped establish important industry-wide standards that have helped push the industry to modify 2 million additional mortgages outside of the program. Today, American families who are seeking assistance from their mortgage company have many more options to avoid foreclosure.

So why would the House terminate the program? The main criticism is we have not helped as many people as we originally estimated. A primary reason for that is we have prudent eligibility criteria. For example, we do not modify mortgages of vacation homes, investors with vacant properties or jumbo loans. And we do not help people who can afford their mortgage without government assistance.

HAMP has been carefully designed to protect limited taxpayer resources. We assist only those homeowners who show that they can meet their obligations under the modified loan. And the program's budgeted funds that are not spent for permanent modifications must be used to pay down the national debt.

A major difficulty in implementation of this program has been poor servicer performance. The servicers were accustomed to collecting payments on performing loans; they did not have the people, the procedures or the systems to deal with this crisis.

From program inception, Treasury has been committed to unprecedented transparency on program performance, including our efforts to make sure servicers comply with program terms. Treasury began by publishing a monthly servicer performance report, one of the only sources of servicer specific information on loan modifications and homeowner experience. Throughout 2010, Treasury expanded reporting to include results of compliance reviews, metrics on homeowner experience, performance of HAMP modifications over time, survey data on homeowners who did not receive permanent modifications, and, most recently, a data file with loan level details on homeowners.

Treasury is moving into our next phase of disclosure on servicer performance. Beginning next month, Treasury's quarterly compliance reporting will include a scorecard for each of the largest HAMP servicers. The scorecard will highlight servicer compliance on a number of key performance metrics, including proper evaluation of homeowners for modifications, staff resources and internal processes dedicated to program implementation and quality control. Mortgage servicers companies will also be rated against their peers.

Under the law, this is a voluntary program, based on a contract. We do not regulate the servicers, and we cannot fine them. To date we have required servicers to take remedial actions to fix inadequacies based on our contractual rights. We will continue to take those actions and we will begin withholding financial incentives for servicers receiving an unsatisfactory grade.

The industry must also move expeditiously to establish a single point of contact for homeowners seeking assistance from their mortgage company. Too often, homeowners receive conflicting information from their servicer and cannot gain access to someone knowledgeable about their case. Ensuring a single point of contact for homeowners moving through the modification process should be key in advancing national servicing standards.

The housing crisis took years to create, and there is no easy or quick way to repair all the damage that it caused. It is going to take hard work, sustained effort, and bipartisan cooperation. Terminating HAMP is certainly not the answer. It would immediately relax the pressure on mortgage companies to offer better assistance to struggling homeowners, creating unnecessary hurdles for those seeking relief. More broadly, it would remove a critical path to recovery for tens of thousands of American families and for our overall economy.

It would not make things better; it would make them worse.

Evaluating TARP
Let's now come back to the central issue: how do we assess the effectiveness of the response to a financial crisis? And let's repeat the four questions:

- First, has financial stability been restored so that the financial system is able to support rather than impede economic growth?
- Second, how quickly is the financial system able to replace government investments with private capital?
- Third, what was the direct financial cost of the interventions to taxpayers?
- And fourth, is the financial system stronger today than it was immediately prior to the crisis?

We cannot easily separate TARP from the other actions taken by the government in answering some of these questions, particularly the first and the last. But the answers to each of these questions show that TARP, in conjunction with those other actions, was remarkably effective.

Stabilizing the Financial System
Due to the combined actions under TARP and the other government interventions, we no longer face the risk that our financial system will collapse. The cost of credit has fallen dramatically, and the credit markets on which consumers and small businesses depend have reopened. The economy as a whole has made substantial progress since the recession ended in the summer of 2009. Real GDP has risen for six straight quarters, and GDP growth was stronger in the fourth quarter of 2010 than in the fourth quarter of 2007.

American families are spending less on mortgage payments. At the peak of the crisis, a family with an average 30-year, $180,000 mortgage was borrowing at approximately 6.40 percent a year.[1] Today, that family is borrowing at approximately 4.85 percent, saving about $2,100 each year.[2]

And the securitization markets have also restarted. Although volumes have not reached pre-crisis levels, auto lending in particular has recovered, with spreads now below pre-crisis levels.

Although we can never be sure where we would have been today without TARP, one of the most comprehensive independent analyses of the overall impact of our response, by economists Mark Zandi and Alan Blinder, concluded that without the American Recovery and Reinvestment Act, TARP, and other government actions, GDP would have still been contracting in 2010 at the astonishing rate of 3.7 percent, unemployment would have reached 16.5 percent, and we would be experiencing deflation. In short, they say, "this dark scenario constitutes a 1930s-like depression."

We are not in a 1930s-like depression.

But there is more work ahead. Unemployment remains unacceptably high and the housing market remains weak. Still, the worst of the storm has passed and our economy is on the road to recovery. Remember, TARP was not designed to be a solution to all our economic problems; it was designed to keep our entire financial system from collapsing.

Exiting Taxpayers' Investment
Let's turn to the second measure: how quickly will government support be replaced by private capital? The answer in the case of TARP is far faster than anyone ever thought possible. Today, the government's remaining investments in banks represent only about 10 percent of the banking system. Moreover, taxpayers have now recovered more than 99 percent (approximately $244 billion) of the approximately $245 billion in total funds disbursed for TARP investments in banks (inclusive of dividends, interest and other income). In this month alone, taxpayers have recovered $690 million from investments made under the TARP Capital Purchase Program. This means that nearly every additional dollar recovered from banks from now on will constitute a positive return to taxpayers. Indeed, Treasury currently estimates that bank programs within TARP will ultimately provide a lifetime profit of nearly $20 billion.

When President Obama took office, the U.S. government had made investments in financial institutions representing 75 percent of the entire banking system by assets. Today, our remaining investments in banks represent only about 10 percent of the banking system.

Citigroup was one of the largest recipients of TARP assistance; we invested a total of $45 billion. At the time, many doubted whether Citigroup would survive and be able to repay the government. As of last December, we recovered the entire $45 billion, and we realized a positive return in excess of $12 billion on our overall investment. As a recent report by the Special Inspector General for TARP concluded, the government assistance provided to Citigroup was carefully designed and achieved its primary goal of restoring market confidence.

To date, we have recovered a total of almost $30 billion of the $80 billion invested in the domestic auto industry (including the recently sold Ally securities). We completed a highly successful initial public offering of General Motors in November of last year, and the government has recovered almost half of its $50 billion investment and has reduced its stake in GM from 60.8 percent to 33.3 percent. We now have a pathway for exiting the remaining investment. We also are working to exit our investments in Chrysler and Ally Financial.

Over the last two years, Treasury and the Federal Reserve have worked with AIG as it has taken aggressive steps to stabilize its business and sell its non-core assets. As part of this effort, Treasury and the Federal Reserve worked with AIG to recruit an almost entirely new board of directors and several new members of senior management, including the Chief Executive Officer. The management team, in turn, has taken a variety of steps to reduce risk and to focus on AIG's core insurance businesses.

In January, AIG, the Treasury, and the Federal Reserve Bank of New York closed a major restructuring plan, which represented the culmination of two years of efforts to resolve AIG. This plan will accelerate the repayment of U.S. taxpayer funds and puts us in a position to recover our entire investment. AIG has since repaid the Federal Reserve $47 billion, converted Treasury's preferred stock investment into common shares, and repaid Treasury $9.1 billion.

Since market prices will fluctuate, there is no guarantee of what the ultimate returns will be. However, if we are able to sell our investments in AIG at current market values, including the AIG shares that Treasury received from the trust established by the Federal Reserve, taxpayers will get back every dollar put into AIG and will realize a positive return. This is a dramatic turnaround, and a result that stands in sharp contrast to what most observers expected in the fall of 2008.

Reducing the Cost to Taxpayers

Our third measure is the direct cost of the intervention. When first implemented, the Congressional Budget Office, or CBO, predicted that TARP would cost $356 billion. Today's estimates are a mere fraction of that price tag, with the CBO's calculations now at $19 billion. We expect the cost of TARP will be equal to the investment for our programs to help homeowners. The TARP investment programs taken as a whole—including financial support for banks, AIG, the domestic auto industry, and targeted initiatives to restart the credit markets—are expected to result in very little or no cost to the taxpayer.

Furthermore, if one looks at all the actions the government took to stabilize the system, without including broader stimulus measures such as the American Recovery and Reinvestment Act, the cost is quite low when compared to past systemic crises. An International Monetary Fund study found that the average net fiscal cost of resolving roughly 40 banking crises since 1970 was 13 percent of GDP. The Government Accountability Office estimated that the cost of the U.S. Savings and Loan Crisis was 2.4 percent of GDP. We have estimated that the direct cost of TARP, the actions of the Federal Reserve, the Federal Deposit Insurance Corporation, and our efforts to support Fannie Mae and Freddie Mac, would be less than 1% of GDP. We must remember that the financial crisis has resulted in significant costs to our economy that are not included in this estimate. Jobs were lost, businesses failed, wealth was destroyed and tax revenues fell. But that damage would have been far worse without the government's emergency response.

Strengthening the Financial System

As for the fourth question, our financial system is stronger today. The weakest parts no longer exist, the system has substantially higher levels of capital relative to risk than before the crisis, and our financial institutions are better capitalized than their international competitors.

Moreover, Congress has enacted a comprehensive overhaul of financial industry regulation. The Dodd-Frank Act provides the government with critical tools that will help us fix the fundamental failures that led to this crisis. Now, the government will be able to:

- Shut down and break apart large non-bank financial firms whose imminent failure might threaten the broader system – thus giving us the ability to avoid the "Too Big To Fail" problem.
- Promote transparency and consumer choice, and prevent abusive and deceptive practices by creating a new consumer protection agency.
- Monitor and regulate risk in the entire financial system, beyond individual firms and markets; and impose prudential standards that curb reckless risk-taking, to help prevent future crises.
- Make the derivatives market safer and more transparent.

Conclusion

I believe that TARP and the other government actions taken in response to this crisis succeeded on all four of the measures I suggested, in large part because the government acted with overwhelming force and speed, and in a coordinated fashion. In particular, TARP succeeded in what it was designed to do: it helped bring stability to the financial system and helped lay the foundation for economic recovery. It did so at a fraction of the expected cost, and much quicker than anyone ever predicted. There is still a lot of work to be done, but we are in a much stronger position to address remaining economic challenges.

TARP shows how government can work effectively and efficiently to address a national crisis. When TARP was created, when families and businesses were worried like never before about their basic economic security, leaders from both parties stood up, stood together, and as Americans, did what was best for the country. They did something unpopular, but necessary. And we are much better off as a result.

Thank you again for inviting me to speak to you today.

---

[1] The U.S. average mortgage balance was $181,225 in 2007 according to the Federal Reserve Bank of Kansas City.
[2] The U.S. 30-year fixed mortgage average rate was 4.85% as of February 25, 2011, according to BankRate (www.bankrate.com).