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Treasury Has No Clear Rules for Bailed Out Banks Trying to Buy Their Stock Back from Government, Says GAO

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By Edwin Mora

(CNSNews.com) – More banks that took federal bailout money late last year are beginning to buy back their preferred stock from the federal government, but their ability to do so is hampered by the lack of clear guidelines provided by the Trouble Assets Relief Program (TARP), according to the Government Accountability Office (GAO).

“Unlike the capital purchase process, Treasury, in conjunction with primary federal regulators, has yet to share criteria used to evaluate repurchase requests,” the GAO said in a report first published June 17 and presented to Congress in early July.

As a consequence, the Treasury Department needs to develop “clear and consistent guidelines” to help federal regulators determine when financial institutions are eligible to repurchase their stock, the government watchdog said.

The $700 billion TARP, which was adopted at the end of the Bush administration, was intended to provide the Treasury with the authority to buy and insure troubled mortgages and home loans belonging to financial institutions.

But under TARP’s Capital Purchase Program (CPP), participating banks and financial firms, mainly publicly traded institutions, turned over part of their preferred stock to the federal government in return for an infusion of federal money.

In recent months, the Treasury Department general fund has received billions of dollars courtesy of financial institutions buying back their preferred shares, the GAO noted.

“As of June 30, 2009, 32 institutions, including 10 of the largest bank-holding companies participating in TARP, had repurchased their preferred stock from Treasury for a total of about $70.1 billion,” Gary Engel, director of financial management and assurance for the Government Accountability Office, told the House Committee on Financial Services on July 9.

Public institutions have repurchased $70,092,689 worth of preferred stocks while private institutions have reacquired $31.9 million worth of preferred stock through repurchases from TARP, the GAO said.

However, the process to determine how soon a bank can repurchase its own stock is “opaque” and is subject to criticism, the GAO said.

Engel pointed out that, for the 19 largest banks taking part in the CPP, regulators have relied upon a “stress-test” conducted by the Federal Reserve to determine how “distressed” the banks’ financial conditions really are, Engel pointed out.

“One of the points that were trying to make is for the 19 (largest banks) that had gone through the stress test, the Federal Reserve had come up with specific criteria as to what those 19 would need to demonstrate to basically be able to repurchase their stock,” Engle told CNSNews.com in a recent interview.

But the stress test is not being used consistently and “across the board” by regulators, Engel said. In fact, they have begun to use different standards for deciding when smaller financial institutions may buy back their stock, abandoning the stress-test standard.

“The regulators . . . look at the financial condition of the entities, they look at their standard procedures that they look at when they’re supervising these entities,” Engel said.

“What we were saying (in the report) is -- we were looking for a little more consistent criteria, like the Federal Reserve had done for the 19, so that there will be consistency and (there will) not be a question,” he added.

Engel indicated that without transparent guidelines for how a bank may win approval to repurchase its stock, there may be discrepancies in how individual TARP participants are treated.

“We were just trying to say from a transparency standpoint, that it would be best to have some more defined criteria that all of you are using so that there aren’t questions called in to you (that you) didn’t treat this institution in the same manner you treated this other institution,” Engel told CNSNews.com.

The GAO suggests that Treasury, in consultation with the chairmen of the Federal Deposit Insurance Corporation and the Federal Reserve, the Comptroller of the Currency, and the acting director of the Office of Thrift Supervision, “ensure consideration of generally consistent criteria . . . when considering repurchase decisions under TARP.”

Unless a common repurchasing standard is developed, smaller financial institutions will be at a disadvantage, Engel said.

David Min, a financial policy expert at the Center for American Progress, a liberal think-tank, agreed that if there is no common standard for how financial institutions may purchase their stock back from the government, smaller TARP participants will be burdened.

“I say there are three issues here,” Min told CNSNews.com. “One, there is the fact that no matter what they do with the small banks, unless they do a stress test that is similar in kind and form to the larger institutions, automatically they are going to have a different of treatment of the small banks versus the 19 largest.

“Second, I think that unless they lay out consistent guidelines, there will always be the perception by small banks that they don’t know the rules of the game.

“Third, no matter what happens, the fact is, the 19 largest institutions have a different status just by the fact that they have been . . .deemed systematically important,” he continued.

Min said the 19 have “a bit of an implied government backing there that says, ‘You’re too big too fail.’”

“Under those circumstances, it seems that those folks would be more likely to be able to raise the capital necessary to meet the requirements of the stress test,” he added.

Mark Calabria, a financial regulator expert at libertarian Cato Institute and a former staff member of the U.S. Senate Committee on Banking, Housing and Urban Affairs, echoed Min’s sentiment, saying that smaller institutions would suffer more than larger ones if a common criteria is not implemented.

“The likelihood for the smaller institutions is that they’ll probably be more cookie-cutter decisions made on that (repurchasing),” Calabria told CNSNews.com.

However, Calabria does not fully agree that the Federal Reserve stress test serves as the best model for consistent criteria for banks to buy back their preferred shares.

“If there is a prolong downturn of the economy I think there should sort of what I would call scrubbing to make sure it’s not simply the condition the bank is in today, but what would the condition the bank be in would be six months from now if things are considerably worse,” Calabria told CNSNews.com.

“I think that framework is appropriate, I thought the stress test did not really mention that quite honestly, but I think the framework works, I just think the way it was implemented was poorly done,” he added.

Furthermore, he suggested: “You do want to have it [repurchase criteria in a way that is flexible. I think the bank itself should almost be able to figure out from the rules whether they’re going to be approved or not -- it shouldn’t be a huge mystery.”

Bert Ely, a financial analyst at Ely & Associates, agrees that there the regulators’ are out of tune.

“There are undoubtedly some inconsistencies among the agencies in terms of how they look at these (repurchase) situations,” Ely told CNSNews.com.

The GAO report recommends that financial regulators’ work together to craft common guidelines in regards to how a financial institution is deemed eligible to repurchase its stocks.

According to Engel, the GAO has not made any final determinations in regards to which institutions would be affected more if financial regulators do not implement a consistent approval criteria to repurchase shares.

“We haven’t made any conclusions that these institutions will be affected more than another because the only one that the Federal Reserve came out with some more specific criteria on were those 19 that have gone through the stress test,” Engel told CNSNews.com.

"There are a lot of others besides those 19 that are also decent size. So it wouldn't necessarily be just small ones that could potentially be not done on a consistent basis," he added.

Funds received through repurchases of preferred stock can be used against a bank's outstanding balance under TARP, according to Engel's testimony.

"Treasury may issue new debt to purchase new financial instruments if it so chooses until Dec. 31, 2009, or a later date determined by the Secretary of the Treasury," he added.

Engel revealed that since the inception of TARP last October through June 30, the Treasury had disbursed approximately $339 billion in TARP funds, had approximately $102 billion outstanding in additional obligations to purchase or insure troubled assets, and received approximately $70 billion from preferred stock repurchased by CPP participants.

As a result, Treasury has approximately $328 billion remaining under the almost $700 billion limit on the amount of purchased or insured troubled assets that Treasury may have outstanding at any time -- (the almost $700 billion TARP limit reduced for $339 billion in disbursements and $102 billion in obligations, and increased $70 billion in preferred stock repurchases)," Engel added.

The Treasury's "projected use of TARP funds totaled about $643 billion, without taking into account any repayments," the GAO official stated.

The congressional legislation authorizing TARP requires a GAO report on TARP at least every 60 days.