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TARP: One Year Later

Hank Paulson's plan was supposed to save the economy. But did it end up merely enriching bankers?

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On Nov. 12, 2008, Treasury Secretary Hank Paulson announced a dramatic shift in the strategy to deal with the rolling financial crisis. Rather than use the $700 billion TARP funds to buy troubled assets from banks, as originally promised, he would dole it out in the form of cash; capital injections in exchange for preferred stock. Kind of like shots of speed. Six weeks before, Paulson had gotten down on one knee to beg House Speaker Nancy Pelosi to support the original plans. But conditions had changed, Paulson argued. The economy was getting worse and he wasn't going to apologize for adapting.

His first few press conferences were awkward, uncomfortable affairs, particularly the one on Sept. 15—the Monday that Lehman Bros failed—when he took a spot behind the White House press podium and, smiling nervously, began, "I hope you've all had a nice weekend ... yeah." The implication was that he, of course, had not, having spent his weekend deciding the fate of Lehman Brothers, and orchestrating the shotgun marriage between Bank of America and Merrill Lynch. In the early going, it seemed Paulson was cracking under the pressure, barely able to conceal the strain of holding the fate of the crumbling economy in his hands. During those first weeks of the financial crisis, the markets usually tumbled after a clunky Paulson press conference. Wall Street's reaction Nov. 12 was no different. The Dow slid 411 points on news that the Treasury was no longer going to buy the toxic assets as it had promised.

To a degree, the announcement was a fait accompli. Paulson had already spent a large chunk of the authorized bailout funds, including $115 billion in strong-armed equity deals forced on the country's nine largest banks and $40 billion to AIG. Populists were already grumbling that TARP was just a handout to the people who'd created the mess. Which is why Paulson sold the switch as one directed at consumers. With the securitization market at a standstill, consumer lending had effectively ceased. No student loans, no lines of credit, no mortgages. By injecting capital straight into banks and other financial institutions, Paulson grabbed hold of the biggest lever he could and gave it a hard tug. In a way, it was the nuclear option.

That was a year ago. And how has it played out? Critics say Paulson's decision to switch up the TARP is at the root of the where we are today, with record Wall Street bonuses, zombie banks, and a festering bipartisan suspicion that nothing's changed. Still, a closer examination shows that Paulson made the right decision. Its original inception was ill-conceived and would have likely led to an even bigger financial catastrophe. The problem isn't that Paulson decided to give the banks the money, it's that he didn't ask for enough in return. Not to mention that TARP has been administered with a transparency that is at best opaque. Tracking the funds over the last year, figuring out who got what from where, has been like following laundered money, leading to a situation rife with conspiracy theories and potential conflicts of interest. "It hasn't done what [Paulson] said it would," says Jerry O'Driscoll, a former vice president of the Dallas Federal Reserve and a senior fellow at the Cato Institute. "Yes, it saved some banks from going under, but did it restore the health of the banking system? Absolutely not."

Here's how TARP was initially designed to work: Treasury was to conduct a reverse auction, buying all those toxic, mortgage-backed securities that were clogging up the financial system. Since the market for them essentially disappeared in 2007, no one was quite sure what they were worth. Sixty cents on the dollar? Twenty cents on the dollar? The point of TARP was to set a price for these assets as banks bid to sell them to the government. In this way, it was supposed to act like Drano: get the nasty junk out of the pipeline and get things moving again.

The original idea was that since things were so devalued, taxpayers would be getting a bargain. And once the market returned to normal, Treasury would make a nice return on them. But if the true market value of these assets was determined to be as low as some thought, anywhere from 20 to 40 cents on the dollar, the effects would have been disastrous. Scores of banks would have been forced to write down the value of their assets, which might have pushed them into insolvency. "It would have been a financial holocaust," says Bill Black, a former 1980s-era financial regulator who worked at the Office of Thrift Supervision. "It was simply not something that Paulson could have done. He realized it would have destroyed the entire financial system."

On the other hand, if Paulson were to overpay, the banks would reap a windfall fleecing the taxpayers. And here's where it gets tricky. In a way, Paulson did overpay. It's just that payments were funneled through AIG, the large insurance company that had built what turned out to be a disastrous business in insuring bonds and other financial products. AIG had sold insurance policies on hundreds of billions of dollars of bonds, subprime mortgages, and other assets by issuing credit default swaps. But it had failed to set aside adequate reserves to pay off claims. Even after the insurance conglomerate negotiated for steeply lower prices, $62 billion of the TARP money that went to AIG ended up going to its counterparties, which were paid 100 cents on the dollar for credit-default swaps they'd bought from AIG. Among the largest counterparties were firms like Goldman Sachs.

The decision to allow AIG to make counterparties whole with government funds continues to draw criticism. In May, Goldman Sachs board member Stephen Friedman resigned as chair of the New York Federal Reserve following reports that he'd purchased 37,000 Goldman shares allegedly with the knowledge that Goldman would be getting paid back at 100 cents on the dollar for its bad bets with AIG. The move netted him $5 million. This week, Congressman Darrell Issa is supposed to hear back on his demands for documents related to AIG's backdoor bailout, including all of Friedman's e-mails, phone logs, and meeting notes.

A big part of Paulson's TARP switch was opening it up to lending businesses that were not regulated banks, like CIT and GMAC, GM's financing arm. After all, these were the companies that most needed to get back to providing crucial lending and financing to parts of the economy outside the financial sector. This has turned out to be a bit of a bum move. Last week, CIT went bankrupt, taking with it every penny of the $2.3 billion of TARP funds it received. GMAC, already the recipient of $8.5 billion of TARP money, now needs another $2.8 billion, and will likely get it.

In his speech last November, Paulson talked about how the new plan would spur lending and help ease the foreclosure crisis. But it hasn't really worked that way. It's taken months of government pressure to get banks to increase lending and modify loans. Treasury had to fund an entirely separate mortgage modification program to the tune of $75 billion. Results have been improving, with some 650,000 homeowners getting their mortgages modified. But foreclosures are still on the rise in many of the hardest hits parts of the country.

"They didn't extract sensible terms," says Simon Johnson, former chief economist at the IMF. Johnson points out that Paulson didn't ask of its own banks what the U.S. regularly asks of developing countries when cleaning up their banking systems. "One of the first things that's done is to fire the managers that oversaw the problems," says Johnson. "Yet shockingly, this hasn't happened in the U.S. These guys are still there for the most part."

And they continue to make good money. Even though executive pay has been capped at seven of the most troubled firms, they are still largely led by the same men, who, while not making what they did a year or two ago, are still bringing home seven-figure paychecks.

At the outset, Paulson argued that taxpayers might ultimately make money from the "investments" the government was making in the financial system. Of the $204.7 billion put into the banking system via the capital-purchase program, the central component of the TARP, $70.9 billion has been paid back, plus dividends of about $10 billion.

Congress is now debating on what to do with the remaining funds authorized for the TARP—more than $200 billion. Pay down the deficit? Keep it as a war chest? Remains to be seen. Did Hank Paulson avert a total collapse of our banking system by his fas action to change TARP with the facts on the ground?

Yes. But a lot of those toxic assets are still sitting on banks' balance sheets. And the same folks who drove the economy into the ditch are still at the wheel. Instead of providing the cash to hire a tow truck, he should have picked new drivers.