



## **Tarp: A Flawed Acronym, Not a Flawed Mission**

By Robert Pardes\*

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The Treasury has been heavily criticized for its recent decision to abandon using Troubled Asset Relief Program (TARP) funds to acquire illiquid assets from banks and other financial institutions. But, while the patchwork of actions taken by the Treasury and the Fed over the past year provides ample fuel for criticism, that decision by Treasury Secretary Paulson was dead-on correct.

The TARP program has instead focused on injecting capital directly into institutions to stimulate lending, but this goal is not being met. Without abandoning the original goal of cleansing troubled financial institutions' balance sheets, TARP funds can and should be used in a far more expedient and transparent way, and the program should incorporate new goals like stemming foreclosures and stimulating economic activity.

### **The Failure of the Original TARP Strategy**

The original asset repurchase program was doomed because it was inherently impractical. Trying to devise a methodology to appropriately price, transfer and manage assets too complex even for their creators to value properly would be akin to shuffling deck chairs on the Titanic. It might produce a flurry of activity, but little improvement in the underlying crisis could be expected. Inevitably, there would be another round of accusations and finger pointing for delays and squandered resources.

The real failure in abandoning the asset purchase program lies in the glaring absence of a viable alternative plan to promptly employ TARP's funds. The recent increase in market volatility reflects frustration on both Wall Street and Main Street that the economy's downward spiral has continued even after taxpayers granted Treasury astonishing resources and unprecedented authority to play a calming role in the market. There is a general feeling that the only evidence of post-election bi-partisanship is a perceived lack of urgency from both parties. Despite the "dead cat bounce" that seems to accompany each bailout or political appointment, the financial markets have been burdened with added government-induced uncertainty at a time when investors are starving for leadership and a promising, cohesive strategy.

The good news is that this bout of inertia preserves at least \$350 billion of TARP funds that can now be deployed more purposefully. Decisively committing the



remaining resources in a manner that paves the way to economic stability will restore government credibility and boost capital markets.

### **TARP with a Renewed Mission**

With Treasury's pockets still stuffed with TARP funds, it can facilitate the following worthwhile objectives:

- Cleanse the balance sheets of the institutions that present material systemic risk;
- Free up capital to promote lending at the consumer and business level; and
- Address the proliferation of foreclosures afflicting housing markets across the nation.

The TARP was never going to be a panacea for restoring lost value experienced by investors at large, which have been estimated at more than \$ 9 trillion in the equity securities market alone. Any expectations along these lines were never more than wishful thinking. The TARP is a vehicle to support a return to market stability and economic growth and rising asset values.

Moving forward, TARP spending should have the following objectives:

**Capital Investment:** The Treasury should stick with its plan to inject liquidity into financial institutions, but it should do so with the additional goal of cleansing toxic assets from these institutions' balance sheets. Institutions should be allowed and encouraged to sell such assets on the open market, and then "compensated" by adjusting the formula for determining the amount of capital support required once assets have been purged. Presently, the range of capital support an institution can receive is a percentage of its total risk-based assets (1%-3%). Since most TARP beneficiaries are "well capitalized" under regulatory standards (at least until their next round of write-offs), a more productive formula would consider the additional impairment suffered when institutions auction these illiquid assets to the private sector. TARP funds should reimburse the institution for the additional loss, if any, associated with such a sale. TARP funds could purchase additional equity, if warranted, to increase capital levels. The propriety of this approach is that the same dollar is spent toward two objectives: cleansing balance sheets and restoring capital. Renegotiation of the original investments to incorporate a revised formula may be necessary and appears to be realistic at this time.

The Treasury's initial rationale for directly acquiring illiquid assets was that the government would ultimately realize an upside, because unusually stressed market conditions meant the assets were underpriced. Realizing an economic



upside from direct investments in leading financial institutions with proven franchise value may be reasonable, but the prospects of profiting from hard-to-price securities, especially if they are to be managed by cumbersome government bureaucracy and third-party contractors, is far more remote. That challenge, then, should more appropriately be relegated to the private sector. Direct investment in financial institutions also means more accountability and transparency, as taxpayers can understand and follow the value of the government's equity stakes in these institutions. By contrast, taxpayers cannot monitor the value of the government's derivative securities portfolio.

**Increased Lending:** While their intent is commendable, direct investments in financial institutions are unlikely to drive any meaningful increase in lending activity. First, with quarterly increases in non-performing loans expected to increase, "double D" (decimated and diluted) institutions need to preserve capital to absorb likely increases to loss reserves. Second, wide spreads between highly rated securities and readily available funding sources (e.g. Federal Home Loan Bank Advances) encourages a strategy of growing investment portfolios, rather than the riskier and more capital intensive strategy of growing loan portfolios.

Additionally, the regulatory environment has fostered a climate where bankers would prefer to evade the scrutiny of examiners by avoiding even modestly aggressive efforts to expand lending activities and balance sheet growth. Field examiners today scrutinize all lending activities and second-guess each lending decision.

## **Housing Crisis**

At the very heart of the economic crisis lies the glut of foreclosures and anticipated defaults that triggered the rapidly declining financial health of Main Street. But Federal resource allocation (Bear Stearns, the GSEs, AIG, GE, etc.) makes it appear that the housing crisis is a sideshow to the economic collapse rather than a major contributing factor.

The TARP's role in supporting a housing recovery should take three forms:

- Helping modify loans that have been securitized;
- Providing subsidies to new homeowners in connection with the purchase of properties held as a result of foreclosures. These properties are typically referred to as Real Estate Owned (REO) ; and
- Collaborating with the Federal Reserve and Treasury to restore, if not mandate, the availability of historically prudent (pre-2004) credit criteria that support the socioeconomic demographic groups that comprise core housing demand.



The above initiatives address liquidity at the primary market level (whereas the focus to date has been at the capital markets level) and hasten the stabilization of housing values and progress towards economic recovery.

**Loan Modifications:** To meaningfully rein in the flurry of foreclosure activity, loan modifications designed to restructure mortgage payments to an affordable level will be necessary. The problem is that, of the seven million potential foreclosures forecast for the next few years, approximately six million involve loans that have been securitized. These securitized loans are subject to contractual limitations designed to protect various classes of investors and support their investment ratings (e.g. AAA, A, BBB, etc.).

Government action to unilaterally reform these contractual provisions would do more harm than good by destroying any remaining credibility in the US capital markets, a conundrum that has been a major roadblock in addressing the plight of homeowners.

TARP resources can break the stalemate between investor rights and loan modifications by funding the payment shortage on each securitized loan that justifies modification. This approach sidesteps the aforementioned dilemma while implementing the TARP resources on a “pay as you go” basis for those loans that perform following modification. Another alternative is purchasing loans that warrant modification out of securitization at a favorable price, providing complete flexibility in the negotiation of the terms of the loan modification by removing the contractual restraints securitization creates.

**REOs:** Contributing to the supply/demand imbalance and declining values in most major markets is the unprecedented number of foreclosed properties for sale. The speed with which this inventory overhang can be removed is critical to stabilizing housing values. TARP funds can support the rapid turnover of REOs by providing structured subsidies to purchasers of REOs that will occupy the property as a primary residence for a prescribed period — say, three to five years. The subsidies can include discounts from market value, funds for rehabilitation or repairs, and below-market interest rates.

Any program of this nature must be accompanied by regulations to neutralize any adverse effects on non-distressed sales activity. Otherwise, buyers of non-distressed properties would have their borrowing ability impaired, because the assessments of their properties would be reduced through comparisons to comparable sales of distressed properties.

The aggregate costs of these initiatives will not be excessive, and they will be far less than the costs an extended period of inventory overhang would entail. In



fact, if the \$150 billion dedicated to tax rebates over a year and a half ago had instead been used to implement the above strategies, significant indicators of a recovering housing market might already be in place.

**Restoring Core Housing Demand:** Aggressive financing, at least in part, fueled the housing bubble by inflating demand. However, the barn door was left open a long time ago, and the markets accomplished almost immediately what would have taken regulators years to do in terms of curbing the availability of aggressive mortgage products. Recall that sub prime and Alt A loan originations were effectively eliminated by market forces – not by attempts at regulation – once the market dropped to unprofitable levels for newly securitized deals.

Near term relief will not be accomplished by regulatory initiatives and political rhetoric focused on preventing a reoccurrence of the “perfect storm” created by excessive global liquidity accompanied by excessive risk taking, a web of contractual exposures, and weak regulatory oversight. These efforts are better left to a future point in time when the urgent matters now at hand are under control.

While access to homeownership is part of the American Dream, the real estate bubble shows what can go wrong when laudable missions go too far. Still, it’s an oversimplification to blame the crisis on sudden proliferation of new, risky lending practices. Loans with limited documentation as to income, assets or employment were available years before the recent housing boom, and they have in the past proven to be sound in terms of risk-adjusted returns. The problem was never the widespread availability of these features, but the layered risks essentially dumped into securitizations that allowed these features to coexist with little or no equity contribution by the borrower.

Nevertheless, the perception that regulators now frown upon these features — even with equity contributions by the borrower of 20 percent or more — has severely diminished the availability of these products.

TARP funds can ease the regulatory chill depressing demand for financing — a condition as undesirable as the artificially high demand that fueled the bubble in the first place. An endorsed product menu of nonconforming and reduced-documentation loans incorporating many of the more prudent features and standards that prevailed prior to the height of the housing boom in 2003 can be resurrected., Access and demand for homes would be improved, and the excesses that fueled this crisis would be curbed. Distribution of this endorsed menu can become a condition of TARP largesse.



## Reality Check

Over the last few weeks, first-round TARP beneficiaries have come back for a second helping, and new classes of financial and industrial institutions have pleaded their case for financial support to survive the current economic environment. Without getting into the merits of these requests, it has become abundantly clear that the need for resources will exceed the \$700 billion initially earmarked. Adjustments should be made and communicated as soon as possible, along with a clear plan for how the new resources will be used.

Actions, the saying goes, speak louder than words. While the media and political leaders have offered more than enough words to go around, the lack of coherent action in employing TARP funds has been deafening. Whatever the degree of government intervention Washington ultimately signs off on, the market demands the certainty of a deliberate and clearly communicated path.

While the political winds are now blowing in the direction of intervention, it is often the case that the public is better served by the clarity and expediency of market forces. Given that policy makers are already heavily invested in the path of intervention, let's hope that the merits of intervention become apparent in the near future. A key first task of the new administration must be to show us that the road of intervention had its merits, and that it is part of a coherent strategy. If not, perhaps the market should be allowed to take care of itself.

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