Testimony of

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TARP Accountability and Oversight

Madam Chairman, Ranking Member Brownback, Vice Chairman Schumer, Senior House Republican Member Brady, and members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI in 2004, I spent 35 years in banking, including 12 years as President and CEO of the Federal Home Loan Bank of Chicago. I am a director of three financial services companies.

My testimony considers the context in which to understand banking bailouts, the clear accounting for them we should demand, and relevant lessons from Jesse Jones and the Reconstruction Finance Corporation.

The Context of Banking Bailouts

The United States and many other countries once again demonstrate the dilemmas of the recurring historical experience of using public money to offset the losses of banks in the name of economic and social stability. Debates about this go back at least to 1802, when Henry Thornton (in The Nature and Effects of the Paper Credit of Great Britain) clearly discussed the "moral hazard" and the "systemic risk," as we now call them, involved in financial rescues.

At the end of the last big U.S. depository institution bust, in 1989-1992, Americans seemed relieved to have the government present the bill for the cost of its deposit guarantees to the taxpayers. As the RTC liquidated the failed thrifts, and helped investors and commercial banks by selling them cheap assets, the thrift depositors were protected with funds from the Resolution Funding Corporation (Refcorp). Refcorp sold 30- and 40-year non-callable bonds on the Treasury's credit, with some coupons of over 9%, to raise money. These borrowings are still outstanding, so we are still paying on the bailout of 20 years ago.

The Japanese in the 1990s, and many other countries before and since, have had similar bailouts. Why should this keep happening?

Because there is an unresolvable conflict in financial systems between the political desire to have deposits for the public which are riskless, combined with a banking business which is inherently risky. Anything levered 12 or 15 or more to 1 is very risky. So we observe that banking is subject to recurring losses of capital which turn out to be much greater than anyone imagined possible—just like now.

The combination of riskless funding with a risky business is in fact impossible: the risk simply moves to the government guarantor. Governments are periodically put in the position of transferring losses from the banks to the public, and money from the public to the banks—as once again today.

Clear Accounting for the Financial Results of Bailout Operations

Government bailout operations make the 60% of households who actually pay federal income taxes into involuntary investors: either investors in bank equity, investors in distressed assets, or both. How can we, the involuntary investors and their Congressional representatives, figure out what is happening with the money?

First, all the activities of the TARP program should be isolated in a separate accounting entity, preferably a Treasury-guaranteed government corporation. This entity should have to borrow on its own balance sheet to finance its investments or expenses in excess of income.

All investments and other assets, all related borrowings and other liabilities, all expenses, and all income should be clearly measured as if TARP were a corporation. This would be most straightforward if it were in fact a corporation—like the Reconstruction Finance Corporation was.

An audited balance sheet and income statement should be regularly produced. This would allow the operators of the bailout program, the administration, the Congress in its oversight responsibilities, and most importantly, the taxpayers as investors, to judge its performance over time. Its retained earnings or accumulated losses would show its results life to date.

In my view, the Congress should require such a regular and disciplined accounting.

Looking forward, as well as measuring backwards, should be businesslike, with regular budgets and forecasts. For as long as TARP represents such large outlays, the Congress should certainly demand a clear forecast of the next year's TARP activity and results before it approves any federal budget.

The investments the taxpayers are involuntarily making might have an overall positive return in the long run, when asset prices recover. With yield on the preferred stock investments being made, and the possible future upside of warrants and common stock, the TARP program might in the end make a profit. Or it might break even, or make a loss, or a big loss—we need to know which one it is.

It is my view that if there is a profit in the end, 100% of any such profit should be earmarked as explicit dividends to the taxpayer-investors. These dividends might be in the form of cash or specific tax credits. This would be a well-deserved recompense to the majority of citizens who bought houses they could afford, paid their mortgage loans on time, did not engage in leveraged speculations, paid their taxes, and then paid for and took all the risk of the bailout efforts.

Prudence, moderation and virtue are their own reward, yes, but if the bailout should make money in the end, let's declare dividends for the investors.

Lessons from the RFC

A fruitful historical comparison might be made between TARP and the Reconstruction Finance Corporation (RFC)—specifically the RFC of the 1930s financial crisis (not the war finance RFC of the 1940s). The RFC was one of the most important and powerful agencies created to cope with the greatest U.S. financial crisis ever; it made investments in more than 6,000 banks in its day.

Set up under President Hoover, and expanded by President Roosevelt, the RFC was run for most of the time by a forceful and very experienced character named Jesse Jones, a successful entrepreneur from Texas (a Democrat by definition in those days), whose formal schooling had ended in the eighth grade.

The basic pattern of RFC bailout equity investing was described by Jones in his instructive memoirs, Fifty Billion Dollars: My Thirteen Years With the RFC. There were, he wrote, four principal steps:

1. Write down the bad assets to realistic economic values, and consequently write off book equity.

2. Make a judgment about the character and capacity of management and make any appropriate management changes.

3. Based on realistic asset values and capable management, have the RFC buy new equity in the bank in the form of redeemable, dividend-paying preferred stock.

4. Receive dividends and ultimately the par value of the preferred stock back, as the bank returns to profitability and recapitalizes in the private market over time.

This summarizes a sensible and tough-minded program, easier said than done well, but a logical crisis model. Note a key difference between the equity investments of TARP and Jones' rule #1: <u>first</u> the write-downs, only then the recapitalization. This strikes me as the right order.

As the President of the Kansas City Federal Reserve Bank, Tom Hoenig, pointed out in a recent speech, "Too Big Has Failed," the RFC at one point held capital in about 40% of all banks, but in the end had no net cost to the taxpayers.

A final thought: organizations are important, but more important is <u>who</u> is running them. In addition to making sure TARP has disciplined accounting, we need to find another Jesse Jones to run the bailout operation.

Thank you again for the opportunity to share these views.