TARP Squandering Potential, Redefaults Rising at Alarming Rate According to Watchdog

By: Jann Swanson | Wed, Apr 24 2013, 12:28 PM

In its Quarterly Report submitted to Congress on Wednesday, the Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) looks at the status of "too big to fail" institutions, calling them still a threat and as the progress and problems in those aspects of TARP aimed at small businesses and homeowners.

While great efforts must be taken to avoid a future crisis and bailout the SIGTARP says, we cannot lose sight of the current TARP bailout. **Wall Street may have recovered but Main Street has not**. TARP was always intended as a bailout of the financial system to protect American families. Business and homeowners are still feeling the effect of the crisis and still need help from TARP.

"In its March 2013 TARP report, Treasury writes, 'Thanks to TARP...struggling homeowners have seen relief, and credit is more available to consumers and small businesses. '" SIGTARP says of this, "Lost in this statement is the **unfortunate reality that this improvement is only a fraction of what TARP could and should have done**, and in many ways still can do."

As of March 31, Treasury had spent less than 2 percent ($7.3 billion) of TARP funds on homeowner relief programs including HAMP and the Hardest Hit Funds while spending 75 percent to rescue financial institutions. "Treasury pulled out all the stops for the largest financial institutions, and it must do the same for homeowners."

Treasury also has a responsibility to insure the help it does provide is sustainable. In order to avoid foreclosure through HAMP a homeowner must remain active in a permanent mortgage modification and only 862,279 homeowners are in one, about half of which were funded with TARP money. **Now many homeowners are defaulting on these modifications**, more than 312,000 to date. SIGTARP is concerned that these defaults are **increasing at an alarming rate**. As of March 31 the oldest modifications, done in Q3 and 4 of 2009, are defaulting at respective rates of 46.1 and 39.1 percent.

The report says Treasury should work to curb redefaults, which often inflict great harm on already struggling homeowners when any amounts previously modified suddenly come due. SIGTARP recommended this month that Treasury conduct research to better understand the causes of redefaults and work with servicers to develop an early warning system so they can intervene before problems occur.

As regards Wall Street, the report says **too big to fail is not just about size**, it is about the interconnections the largest financial firms have to each other and to American households. Regulators were shocked, in 2008, to find how these large institutions were tied to each other and to counterparties so that if one went down it pulled other down with it. Even the institutions themselves did not realize the extent to which they were linked. Nor did they realize their exposures to short-term funding counterparties which, as Treasury Secretary Geithner said, "can flee in a heartbeat", bringing the system down. While the financial system is more stable now, ending too big to fail is critical to its safety.

In order to prevent a future crisis and another bailout the Dodd-Frank Wall Street Reform and Consumer Protection Act provided front line measures aimed at keeping the largest financial institutions safe and sound and a last line defense designed to let a company fail without damaging the economy. SIGTARP says some of these front line measures have not yet been determined nor have the determinants of which banks will be subject to them. Without front line measures fully in place, SIGTARP says, "**There does not appear to be enough of an incentive** for institutions to break up or break off dangerous interconnections."

Dodd-Franks' **last line of defense is bankruptcy** or a new FDIC process called orderly liquidation authority. As part of this last line, living wills are envisioned as the way to identify and remove obstacles to an orderly bankruptcy. However the report says, the usefulness of living wills is in question. As in 2008 there may be no time for an orderly bankruptcy or it might not be a viable option for players who dominate the market in providing a critical service. Moreover, most companies operate in different countries with different bankruptcy laws. Because of the interconnections one bankruptcy may drag down others leaving too few healthy companies to buy up assets of the failing ones as envisioned in the living wills.

Under FDIC's process the parent company is placed in receivership, management is fired, and the subsidiaries continue operating and paying counterparties. Losses are expected to be borne by shareholders and debt holders not taxpayers. The key to this working is there being a sufficient amount of debt to absorb the losses, otherwise FDIC must borrow funds from Treasury. Orderly liquidation also has cross-border issues.

The report says that the existence of living wills, bankruptcy, and order liquidation authority have not convinced the market that individuals firms won't get another bailout; thus they have not been willing to disentangle their dangerous connections.

The process of developing **living wills** allows a company to better understand the risk exposures in their interconnections and either break them off or be forced to do so. SIGTARP suggests that regulators think of these as more than part of the last line of defense; they should also be part of the first line of offense. Regulators should use the information to identify and remove obstacles to a firm's orderly resolution but also to inform their broader responsibility to the financial system. The wills give regulators a clearer vantage point into a megabank's inner workings than they had in the crisis. **The company is required to disclose off-balance sheet exposures**, where it has pledged collateral, and **indentify hedging strategies**; "In other words, so much of the information that caught regulators unaware in the last crisis should be contained in the living wills."

Regulators should also use living wills to evaluate the aggregate across institutions of risks, linkages and interdependences. If they expand their use of living wills from a deathbed document to a roadmap of the financial system they can take preemptory supervisory action to force the breakup of interconnections that threaten the system.

SIGTARP also concludes that T**ARP missed an opportunity to increase lending to small businesses**. TARP banks that were allowed to enter the Small Business Lending Fund (SBLF) often did so as a means to exit TARP. They performed more poorly in lending to small businesses than non-TARP banks in the SBLF because the TARP banks used approximately 80 percent of the SBLF funds they received to fund their early exit from TARP. The 24 TARP banks actually decreased their lending to small businesses and 14 of them paid dividends to shareholders despite limits on dividends, executive compensation, and luxury expenditures that were a condition of the program.

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