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The Beginning of the End of the Financial Crisis

By PHILLIP SWAGEL

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Five years later, it is clear that the decisive actions to stabilize the financial system were those of Oct. 14, 2008, when the United States government put taxpayer money into banks and guaranteed their lending. With American markets closed for the Columbus Day holiday, the chief executives of nine large banks trooped past waiting television cameras into the Treasury to be told — or in a few cases, persuaded — that they would receive $125 billion in taxpayer money from the $700 billion TARP fund and that the Federal Deposit Insurance Corporation would use emergency authority to guarantee bank debt and business checking accounts, neither of which were covered by the F.D.I.C.’s usual deposit insurance. The nine firms together accounted for about half of the assets and deposits in the United States banking system; another $125 billion was to be allocated to the 8,000-plus institutions that made up the rest of the system.

Shoring up banks en masse was meant to assure market participants that the United States government would not allow the banking system to collapse — a serious fear after the failures of Lehman, the American International Group, Washington Mutual and Wachovia over the preceding weeks. There was no promise that every institution would be saved: indeed, some banks were denied access to the two programs and were allowed to fail (and some went bust despite getting taxpayer money). On the whole, however, the Treasury and F.D.I.C. actions arrested the mounting financial market panic in the wake of the Sept. 15 bankruptcy of Lehman Brothers. The Great Recession was not averted, as the economy plunged in late 2008 and early 2009, with consequences still felt in a subpar labor market. But Oct. 14, 2008, was the beginning of the end of the financial crisis.

The causes of the crisis and policy response are the focus of a symposium on the financial crisis being held Tuesday in Chicago, hosted by former Treasury Secretary Henry M. Paulson Jr., whose Paulson Institute is affiliated with the University of Chicago, and by David Axelrod, the former adviser to President Obama who now heads the university’s Institute of Politics. I took part in a session Tuesday morning on the economics of the crisis. The event can be followed using the Twitter hashtag #fiveyearsafter.

Treasury’s capital injections were meant to give banks receiving the funds a buffer against further losses, supporting lending and bolstering confidence in both institutions and the financial system as a whole. Banks accepting TARP money paid a 5 percent dividend on the funds until the Treasury was paid back; this yield rises to 9 percent after five years (meaning
that banks still holding onto their TARP funds will soon pay more). The capital injections included modest restrictions on executive compensation, but the government remained a mostly silent partner, taking a seat on a company’s board only for banks in serious distress.

It is hard to imagine, given the subsequent unpopularity of TARP, but the offer of funding initially was hugely popular, with some banks faxing in applications as soon as Treasury posted the form. TARP’s chief, Assistant Treasury Secretary Neel Kashkari, drew on talented staff from throughout the government to set up a $250 billion investment fund within weeks, evaluating banks and taking the legal and administrative steps to get the money into the financial system. A meeting of the TARP investment committee (on which I served) became a nightly ritual at the Treasury.

While some observers complained that banks were paying less for TARP money than Warren Buffett had wrung out of Goldman Sachs for a September 2008 investment, this was an intentional policy decision to foster broad uptake that would stabilize the banking system as a whole. A further criticism in the fall of 2008 was that banks were sitting on TARP money. This was a puzzling complaint. Banks had every incentive to make loans, since otherwise they would lose money on the 5 percent dividend. And the volume of loans depends not just on banks’ willingness to lend but also on the demand for loans, which was declining given the weak economy. In any case, one could not say that a bank was using its existing resources to make loans but not TARP funds — all dollars inside a bank are green. These facts, however, did not stop this variety of criticism.

While some of the Treasury investments went bad, the TARP bank program on the whole has been a financial success, even returning a profit for taxpayers. As of Sept. 30, 2013, the gain was $28 billion on just over $245 billion invested. The Treasury Department, under Secretary Timothy F. Geithner and now under Secretary Jacob J. Lew, has adeptly handled the process of selling off government stakes in banks to maximize the taxpayer return while avoiding disruptions to financial markets.

The F.D.I.C., through its Temporary Liquidity Guarantee Program, provided a three-year guarantee on bank debt, a program that complemented the TARP capital injections by ensuring that participating banks had not just more capital but also assured access to funding, and could thus avoid the crippling runs that represented the death knell of firms starting with Bear Stearns in March 2008.

Research by two University of Chicago professors indicates that the Columbus Day interventions had a positive return to society of $84 billion to $107 billion, reflecting a balance between the value to firms of the reduced likelihood that they would fail and the increased risk for taxpayers from providing the guarantee. Most of the benefit in this calculation actually arises from the debt guarantees rather than the capital injections, but the TARP capital was essential, since the F.D.I.C. would not have offered the guarantee and put its deposit insurance fund at risk without the extra protection against losses from TARP.

Among individual banks, the biggest winners of the government rescue were the weakest firms, notably Citigroup, Morgan Stanley and Goldman Sachs, which had relatively tenuous funding
bases and thus were aided the most by the government guarantee on their borrowing. Stronger banks like JPMorgan Chase, in contrast, were disadvantaged by having their competitors propped up. In retrospect, JPMorgan’s chief executive, Jamie Dimon, can be seen as an economic patriot for supporting the Columbus Day actions to stabilize the financial system as a whole even though they hurt his company.

The actions taken on Columbus Day 2008 remain contentious, in particular because of concerns about bailouts and of banks that are too big to fail. It is astonishing for the United States government to tell investors, in effect, that it stands behind private firms in any industry. The 2010 Dodd-Frank financial regulatory reform law includes provisions such as increased capital and liquidity requirements that aim to make financial markets more safe, and new authority for government officials to take over failing institutions with the hope of avoiding the panic that developed in the fall of 2008. Until the next crisis, however, it will be difficult to know whether these measures will be effective, either in allowing for a better policy response or in avoiding a crisis in the first place. In the meantime, the Treasury capital injections and F.D.I.C. funding guarantees stand as the most extraordinary measures taken five years ago to deal with the financial crisis — and the most effective.