

ISSUE BRIEF

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GLOBAL BUSINESS & ECONOMICS PROGRAM

US Lessons for the Eurozone: Restoring Confidence through Transparency

Resolving the Euro Crisis: Size Matters, but So Does Transparency

When it comes to resolving financial crises, size matters, but so does transparency. In both the US and European crises, the drive for size—firing off enough public funds to plug the hole in the financial system—has proven to be self-defeating as markets raise ever higher, unrealistic, and inappropriate expectations for government policy. This strategy addresses some of the economics and none of the politics of crisis management. The race to meet the size test distracts policymakers from addressing the real impediment to restoring investor and public confidence: the inherent uncertainty and lack of transparency associated with extraordinary government actions in times of crisis. The absence of transparent decision-making inflicts a costly blow to the credibility of policymakers because markets and citizens cannot see or believe what leaders are doing to stabilize the financial system.

In the United States, we learned this lesson the hard way, and Europe is repeating our early mistakes.

The European Council's October 26 agreement to recapitalize European banks, leverage the European "bazooka" (European Financial Stability Facility, or EFSF), and restructure Greek debt continues a failed strategy that focuses on size without addressing fundamental transparency concerns that are preventing markets and the public from supporting European policy. As Europe continues to improve its crisis response measures, it should build four TARP-like safety valves into existing and future bazookas to protect markets and the public against policy misfires: management transparency, market transparency, performance transparency, and oversight transparency.

These four safety valves not only helped to restore confidence in the US financial system, they made the crisis

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less expensive by ending the obsession with the size of the rescue and focusing policymakers on clear, accountable decision-making. The most valuable TARP lesson is found not in making splashy announcements about ever larger bazookas and shady leverage vehicles, but in the transparent structure Congress created to make policy intervention as clear, effective, and efficient as possible. Big bazookas need safety valves in order to function properly; otherwise, policy intervention can be confidence-killing rather than confidence-boosting.

What Worked in the United States: A TARP Bazooka with Safety Valves

Although markets have reacted with skepticism to the two options for leveraging the EFSF—credit enhancement for sovereign bond issuance and public-private funds to purchase sovereign bonds—there is still time to build an overarching policy structure that will invite more support for these and other European stabilization initiatives. A clear decision-making and implementation structure will provide jittery investors better guidance about the direction of future government intervention, and the public with assurances about how and why taxpayer money is being committed to the financial system.

The four safety valves from the US TARP experience can offer Europeans building blocks for creating a more enduring

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and reliable crisis management structure. In the near-term, they represent vital steps to make crisis response policies more transparent and will go a long way in turning the corner in the European crisis, as they did in the US crisis. These mechanisms can also be built into proposals for achieving longer-term fiscal and political union in Europe.

1. Management Transparency

The EFSF is organized as a private corporation in Luxembourg. Disbursing EFSF funds to member countries currently depends on a complicated process involving the European Commission, European Council, Eurogroup Working Group, European Central Bank, board of directors of the EFSF, and the beneficiary member country. This decision-making structure can be streamlined in order to achieve efficiency, but also made more transparent in order to hold decisions accountable to public policy objectives.

On a day-to-day operational level, the EFSF is supported by minimal staff and advice from national-level financial authorities and private institutions that are seeking to do business with the EFSF. This is the same type of tight-knit, opaque management structure that then-US Treasury Secretary Paulson originally envisioned when he submitted a three-page proposal to Congress for the TARP on September 19, 2008. He explained to Congress that only about a dozen Treasury staff would be hired and they would work with a handful of mandated private asset managers to invest public funds. The idea was to disburse the funds as expeditiously as possible to calm markets. Congress sympathized with the argument for streamlined management and speedy release of funds, but also feared the lack of accountability and clarity in such an untransparent management structure. Therefore, one of the primary tasks in writing the law establishing the TARP—the Emergency Economic Stabilization Act (EESA)—was to require a robust, yet efficient, predictable, and accountable management framework for the TARP.

First, Congress established a formal office within Treasury through which the secretary could disburse TARP funds. The Office of Financial Stability was headed by a presidentially-appointed, Senate-confirmed head that was subject to regular public hearings, reporting, and oversight. To provide checks and balances for the Treasury Secretary's actions without compromising timely government intervention, Congress required consultation with the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the comptroller of the

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Currency, the director of the Office of Thrift Supervision, and the secretary of Housing and Urban Development.

Congress also created a Financial Stability Oversight Board (comprising the major financial agencies) to review, report, and make recommendations regarding the exercise of authority under the Act and to ensure that powers would be exercised in a manner consistent with specific criteria established by Congress. The Board was responsible for supporting TARP's mission transparency—ensuring that the policies implemented by the secretary protect taxpayers, are in the economic interests of the United States, and are in accordance with the Act. Congress also included provisions to prevent unjust enrichment by participants of the program and to prevent conflicts of interest arising from market participants advising on TARP. The demand for managing conflicts of interest actually came from market participants themselves, who feared unfair or improper behavior in the competition to manage TARP assets.

Under the existing EFSF management system of complicated, yet unaccountable decision-making, the bazooka benefits from neither efficiency nor transparency. This leads to higher risk premia demanded by EFSF bond investors and less political support for EFSF expansion from member country constituencies. Just days after the October 26 announcement, the *Financial Times* reported that the lack of detail about the EFSF's plans was making bond issuance more expensive. A banker was quoted as saying, “[T]here is so much uncertainty over the EFSF that it will be much harder to sell [EFSF bonds] than it was earlier in the year.” The article went on to explain, “The focus has shifted to the structure of the EFSF, which is still unclear and may mean those bonds could be difficult to sell back to the market.”¹ More than one month following the October 26 announcement, the EFSF leverage plans remain unclear. It is no surprise then that the cost of government funding in Europe continues to soar. Unclear, unpredictable decision-making makes crises more expensive.

¹ “EFSF Bond May See Weak Demand,” *Financial Times*, October 31, 2011

2. Market Transparency

In the United States, market participants lauded the creation of TARP, but many acknowledged that it could only be effective if the government provided “granular, tangible information” on TARP implementation, particularly around price transparency.² At the time, there was a lot of uncertainty about whether the government would buy assets at mark to market or values higher or lower than the mark to market level. To provide a clear account of participants, potential beneficiaries, and the degree of public subsidy provided in individual TARP transactions, Congress created a market transparency provision requiring the Treasury Secretary to publicly disclose within two business days specific market information related to every TARP transaction.

As Europeans continue to develop the insurance and leverage options for the EFSF, requiring the timely release of specific market data, premium pricing, and risk assessments will help inform investors and bring accountability to the general public. Pricing insurance premiums (or credit enhancements), in particular, should maximize protection of public funds, as the government’s ability to appropriately assess and calculate risk is typically inferior to that of the market. Under-pricing premiums could risk significant taxpayer losses, while over-pricing premiums could discourage market participation.

One successful TARP insurance program—the Asset Guarantee Program (AGP), established to insure a pool of Bank of America and Citigroup assets—generated a substantial return to taxpayers while also restoring investor confidence in those two institutions and making them less dependent on government capital. Its success was based not so much on the size of the program, but on the details the Treasury released when the program was announced in January 2009. Information provided about the assets to be insured, timetable for implementation, and pricing/fees offered investors a clear picture of how their investments in Bank of America and Citigroup would be affected by government policy. Such transparency and disclosure is vital to attracting investor interest to market segments that are suffering from skepticism and confusion.

3. Performance Transparency

Europe can also consider building in a safety valve to track the performance of the EFSF programs. In the United States,

² <http://www.sifma.org/news/news.aspx?id=8834>

Congress authorized \$700 billion for TARP, but only made \$350 billion initially available to the Treasury Secretary. This allowed the Treasury Secretary to move forward with his plan, but also provided Congress the ability to prevent the release of the second tranche if accountability mechanisms built into TARP revealed mismanagement, incompetence, or ineffectiveness. As one market participant put it at the time, “If the first \$350 billion is not effective, then Congress should be allowed to stop the program. Markets want to see if the bazooka will work, not just a big \$700 billion size.”

Similar to the German Bundestag’s debate earlier this year about providing parliamentary approval for every EFSF loan, the US Congress considered different thresholds at which it would be appropriate to intervene in the release of TARP funds. In the end, Congress struck the right balance in EESA Section 115, Graduated Authorization to Purchase. The provision allowed the secretary to access the second tranche, unless within fifteen days Congress passed a joint resolution of disapproval considered through expedited Congressional procedure. The threat of Congressional interference with TARP kept pressure on the Treasury to make the first tranche as effective as possible.

4. Oversight Transparency

The EFSF has an internal audit function, but it is only expected to issue periodic and annual reports. The over-€440 billion bazooka is subject to an astonishingly low degree of independent review and currently, very little information is available to markets and the public about the fund’s status. It’s no surprise, then, that countries would feel insecure about extending more capital to the EFSF. Without robust, independently-supplied records, data, and analysis, it is difficult to assess the EFSF’s strengths and weaknesses.

In the United States, Secretary Paulson also favored minimal disclosure of TARP actions. He included only semi-annual reporting in his draft three-page proposal and expected immunity from judicial review—which earned him a *Newsweek* cover story entitled, “King Henry.”³ Congress subjected the Treasury to a three-fold oversight regime that supplied monthly, quarterly, and annual reports:

1. The Congressional Oversight Panel (COP)—a temporary, bipartisan panel of outside experts to review and report monthly to Congress the effectiveness of TARP.

³ “King Henry,” *Newsweek*, September 29, 2008

- Independent reviews and audits by the Comptroller General of the United States (GAO).
- A Special Inspector General for the Troubled Asset Relief Program (SIGTARP) armed with more than one hundred staff and subpoena authority to audit, investigate, and report quarterly on TARP.

There was no shortage of empowered, well-resourced oversight of TARP. Information about TARP transactions provided to markets and the public was robust, frequent, and readily available, especially beginning in January 2009, when all three oversight mechanisms became fully operational. This access to information provided markets and the public a clearer picture about the direction and effectiveness of the TARP bazooka. At times, these reviews stirred controversy and concern around TARP, but they also chronicled the successes of TARP and benefits to taxpayers and the US economy.

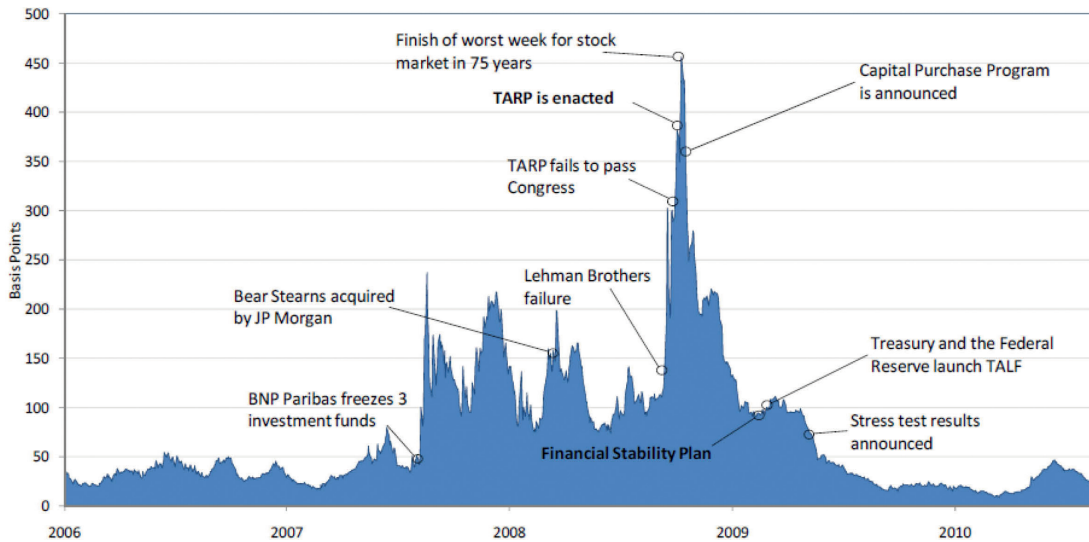
How We Know the Safety Valves Worked

These safety valves, taken together and fully-implemented through the Obama Administration’s Financial Stability Plan in February 2009, created a policy structure in which the US

government could implement individual TARP initiatives in a more transparent, predictable, and confidence-inspiring fashion. It was a noticeable departure from erratic, ad-hoc crisis response policies the US government pursued in 2007 and most of 2008. Markets responded positively to this transparent framework by behaving more rationally: credit spreads dropped, private capital returned to financial institutions, equity markets rallied, and consumer and business lending improved.

In addition, due to the robust taxpayer protection tools Congress built into the program, the net cost of TARP drastically declined. In March 2011, the Congressional Budget Office estimated the cost of the TARP would be \$19 billion, far less than its March 2009 loss estimate of \$356 billion.⁴ Congress insisted on maximizing upside to taxpayers while minimizing risk. One of the key provisions that supported this public policy objective was EESA Section 113. This provision, championed by US Senate Banking Committee Member Jack Reed, required the Treasury to receive non-voting warrants from TARP recipients. This was a hard-won provision that faced opposition from some market participants, yet proved to protect taxpayer. Section 106 required profits from the sale of troubled assets to be used to

Figure 1: Markets Stabilize After Introduction of Transparent Policies



Source: "TARP: Two-Year Retrospective," Treasury Department, October 2010.

Figure 1 demonstrates the market response as the US government developed and rolled out various stabilization programs. This graph tracks the spread between inter-bank deposit rates and yields on short-term Treasury bills—the spread tightened dramatically after more transparent policies were introduced.

⁴ "Report on the Troubled Asset Relief Program," CBO, March 2011 and March 29, 2011

Instead of boosting the bazooka further, the US actually needed less ammunition thanks to more transparency.

pay down the national debt. Other sources of incoming receipts from TARP include:

- Funds from the sale of previously purchased assets;
- Loan principal repayment;
- Premium payments for insured assets; and
- Dividend and interest payments from assets and loans.

To date, the incoming revenue amounts to more than \$300 billion. With robust accounting and auditing, the EFSF will also be able to disclose positive developments in the program over time.

This is not to say that enhanced transparency will appease size-obsessed critics. In the current European crisis, there are economists calling for the EFSF to achieve €2.5-3.0 trillion in firepower through leverage.⁵ In January 2009, economist Nouriel Roubini argued that the US banking system was still “borderline insolvent even after TARP I” and that the “banking system may need another \$1-1.4 trillion of capital injections to return to pre-crisis capital levels.”⁶ Because he and many other analysts were so fixated on size, they were unable to see the confidence-boosting benefits of transparent policy. Clearly communicated policies implemented through more predictable processes, not more firepower, brought confidence and private capital back to the financial system, making government capital less relevant. In addition to the AGP, other TARP initiatives went underutilized because markets returned to normal sooner than expected. For example, Treasury reduced its initial \$30 billion commitment for the Public Private Investment Program to \$22 billion, and of that amount, only \$16.4 billion was disbursed. Instead of boosting the bazooka further, the US actually needed less ammunition thanks to more transparency.

⁵ “EFSF Needs Bigger Bazooka to Maximise its Firepower,” *Financial Times*, October 31, 2011
⁶ <http://media.rgemonitor.com/papers/0/RGECreditLossesEPCNRJan09.pdf>

What Didn't Work in the United States: Big Bazookas with No Safety Valves

Bigger Bazookas, Bigger Market Sell-Offs

Big bazookas with no safety valves are confidence-killing, not confidence-inspiring. The United States learned this lesson through several bazooka blasts in 2008:

Date	US Bazooka	Equity Market Reaction
March 2008	Bear Stearns facilities	8-week rally
September 2008	GSE conservatorship	1-day rally
September 2008	AIG rescue	No rally, 5 percent decline
September 2008	TARP monthly auctions proposal	No rally, 7 percent decline

Each of these policy announcements were eventually followed by market sell-offs because the government's ad-hoc, unpredictable interventions increased investor and public anxiety. Untransparent policy action contributes to chaos, even when the size of government support increases. Investor nerves, public anxiety, and credit spreads are all elevated in financial crises. Essential to restoring normality is for the government itself to behave more rationally and predictably by creating a transparent structure for implementing crisis response policies. In the US, this structure became fully operational starting in January 2009 and it was only then that markets began to stabilize.

Europe is not learning from the US mistakes of bigger bazookas, bigger sell-offs. In Europe, policymakers are still playing the size game without addressing the fundamental transparency issue. Not surprisingly, market reaction has mimicked the early US experience of big bazookas, big sell-offs, and short-lived rallies.

Big bazookas with no safety valves are confidence-killing, not confidence-inspiring.

Date	European Bazooka	Equity Market Reaction
May 2010	€440 billion temporary EFSF	3-day rally
November 2010	€500 billion permanent ESM	1-day rally
July 2011	EFSF firepower boost to €780 billion	1-day rally
October 2011	EFSF firepower boost to €1 trillion	1-day rally

Market pressure to build a big European bazooka first materialized in May 2010 with the creation of the €440 billion EFSF. At the time, the EFSF was focused on providing temporary support to Greece, Ireland, and Portugal. But, as conditions deteriorated for those three countries and investor fears spread to Italy and Spain, Europeans announced on November 28, 2010 the permanent €500 billion European Stability Mechanism (ESM) to succeed the EFSF in 2013. On July 21, 2011, Europeans announced plans to increase EFSF guarantee firepower further to €780 billion.

Once again, the focus on firepower without accompanying transparency did nothing to produce confidence. Following the EFSF expansion announcement in July, the crisis worsened for Greece, spread to France, and threatened to spillover into the US financial system. The spread between Greek and German two-year bond yields soared to 246 bps and the cost of insuring against the default of western European sovereign bonds exploded to a record high. CDS spreads on senior debt for French, Italian, and Spanish financial institutions pierced 2008 credit crunch levels. The share price of Société Générale, France's second largest bank, dropped 21 percent in a single trading day in August. Both European and American banks reported a steady climb in the cost of three-month dollar loans in August. Global equity markets lost approximately 20 percent of their value from July to August, led by financials. US money market mutual funds, which held nearly half of their assets in European bank paper, began reducing their exposure to France, Italy, and Spain.

As conditions worsened, Europeans once again began tackling the question of size in preparation for the October summit. This time, the proposals they received were disturbingly focused on leverage to achieve more than €1 trillion firepower. Secretary Geithner traveled to Poland to pitch an idea to leverage ECB funds to support more EFSF lending to sovereigns. Two German financial institutions

proposed turning the EFSF into a credit enhancement fund that would support €5 of lending for €1 of risk. Both proposals have precedent in the US TARP experience, but they only succeeded in the US as part of a structured, transparent program that included strong taxpayer protections and public oversight of implementation. Without a robust program structure, such leverage proposals introduce more uncertainty into the financial system, especially when policymakers make broad announcements with little to no details. Since the October 26 announcement, sovereign funding costs have increased, not decreased. Borrowing spreads for France, a core country that benefited from safe haven status earlier in the European crisis, are now double that of Brazil, a developing country.

Since the October 26 announcement, sovereign funding costs have increased, not decreased.

A Long, Expensive Road to Replacing Ad-hoc Intervention with Coherent Policy

The United States, too, was fixated on meeting size expectations for too long without addressing the transparency issue. And, trying to meet those expectations in an incremental, ad-hoc fashion made crisis resolution more expensive due to the absence of a coherent, decisive policy strategy at the outset. In April 2008, the IMF estimated the size of the US problem (stemming mostly from mortgage-related loan and securities losses) to be \$945 billion, while Goldman Sachs put their estimate at \$1.1 trillion. By the end of the year, the IMF increased its estimate to \$1.4 trillion and Goldman Sachs raised its number to \$2 trillion. As estimates of the size of the problem mounted, so did pressure on US policymakers to increase the government's firepower to stabilize the financial system. Box 1 provides a detailed analysis of US policy action.

Box 1: A Brief History of the US Crisis Response

- **Summer/Fall 2007 Monetary Policy Focus:** US policy intervention initially kicked off with a few tepid moves by the central bank, rather than a blast of any massive bazooka. The Federal Reserve started to ease monetary policy in August 2007 after investment funds at Bear Stearns and BNP Paribas confronted serious liquidity problems and elevated bank funding rates in Europe and the US. What began as monetary policy easing in August 2007 developed into a year-long, multi-prong campaign of unprecedented, ad-hoc stabilization measures in the US.
- **January-February 2008 Fiscal Stimulus:** Despite liquidity support and monetary policy easing provided by the Fed and a \$152 billion fiscal stimulus passed by Congress in February 2008, bank funding problems resurfaced in February and March 2008 as subprime delinquencies worsened and revealed a web of interconnections among highly levered financial institutions around the world.
- **March 2008 Fed Emergency Lending:** In March 2008, the Federal Reserve stepped in with a far more aggressive policy move. As Bear Stearns collapsed under the weight of its funding pressures, the Federal Reserve invoked emergency powers (Section 13-3 of the Federal Reserve Act) to facilitate the acquisition of Bear Stearns by JP Morgan Chase. The bazooka announced for that one failing institution amounted to \$41.9 billion (\$12.9 billion Federal Reserve Bank of New York bridge loan to Bear Stearns plus \$29 billion Federal Reserve Bank of New York loan to Maiden Lane LLC—an SPV established to manage Bear’s risky assets). Yet, the effect of stabilizing the broader financial system was limited because the core of the credit crisis, rising mortgage delinquencies, was not addressed.
- **March 2008-July 2008 Congressional Mortgage Market Support and GSE Bazooka:** To tackle the underlying housing problem, Congress then developed legislation to insure up to \$300 billion in refinanced mortgages for distressed homeowners—considered to be a historic degree of policy support at the time. At the eleventh hour of the legislative process to enact the Housing and Economic Recovery Act, Secretary Paulson requested the inclusion of a GSE bazooka—up to \$200 billion in capital ammunition to support the faltering government-sponsored enterprises, Fannie Mae and Freddie Mac. In his plea for this unprecedented bazooka before the Senate Banking Committee in July 2008,

Secretary Paulson famously argued, “If you have a bazooka in your pocket and people know it, you probably won’t have to use it.”⁷ But, as Caroline Baum noted in a Bloomberg column, that bazooka ended up acting more like a “beware of dog” sign to GSE investors rather than an Uncle Sam seal of approval.⁸ Within three weeks of the creation of the bazooka, GSE share prices plummeted to historic lows. By the time Congress reconvened for the fall session just after Labor Day, Secretary Paulson did what he said he wouldn’t need to do—he fired off the GSE bazooka. Instead of calming markets however, this bazooka blast pushed the financial system closer to the edge of collapse. Within two weeks, Lehman Brothers fell, AIG neared bankruptcy, and Wall Street powerhouse Merrill Lynch was forced into an arranged marriage with Bank of America. Despite this bazooka backfiring, attention turned to creating yet another bazooka.

- **September 2008 TARP:** On Thursday, September 18, 2008, Secretary Paulson, Federal Reserve Chairman Bernanke and Securities and Exchange Commission (SEC) Chairman Cox made a case to Congressional leadership for authorizing the mother of all US bazookas—a \$700 billion emergency fund to help flush out toxic assets from financial institutions and return the system to normality—to be passed by Congress before Asian markets open on the following Monday. A senior lawmaker incredulously responded that it takes months to pass a bill just to flush the toilet in Congress, much less pass a near-\$1 trillion bill to flush toxic assets out of the financial system. In the rapid-fire days of Congressional deliberation to create what became known as the Troubled Asset Relief Program (TARP), analysts urged the government to go long on size. They pointed to numbers from the IMF, market participants, and economists that placed the size of the problem north of \$1 trillion. They argued that if the bazooka is too small, the US would run the risk of repeating Japan’s mistakes of piecemeal, tepid capitalizations spread out over several years that resulted in a prolonged recession. They also argued that if the size is too small, it would indicate to markets that the government did not have the will to step up and solve the problem and therefore the US would suffer from a loss of credibility—that investors would assume that the US is willing to allow the economy to collapse and compel them to walk away from investing in American markets.

7 <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ayoDeGZ3yYEc>

8 <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ayoDeGZ3yYEc>

Politically speaking, supporting another bazooka of any size invited career suicide. But there were enough bold, determined leaders on both sides of the political aisle in the US Congress who were willing to take that risk if they could secure safety valves that would maximize the effectiveness of the program, minimize risks to taxpayers, and finally replace ineffective, ad-hoc policy with a coherent crisis resolution framework. Over a year into the financial crisis, Congress had learned its lesson—that the decisive factor in financial stabilization is not size alone, but transparency and predictability in government intervention. During the TARP legislative process, Congress proceeded to build in a suite of safety valves. These safety valves put Congress and the US government in a position of helping to shape market expectations rather than being cornered by market expectations. These transparency measures sought to encourage normal market behavior by creating a rational framework for government action. Though each of these safety valves were hotly debated, the United States was rewarded for including them. We learned that there is a multiplier effect on confidence that comes from more transparency, not more money. It was only when the transparency question was addressed that government policy began to produce a more durable, positive impact on the financial system.

Conclusion

The United States spent more than a year pursuing expensive, unsatisfactory, ad-hoc financial stabilization policies. Throughout that period in 2007 through 2008, markets and the public remained on high alert, anxious about the future as the government intervened in markets in unpredictable ways. Nearly two years into the sovereign debt crisis, Europeans are stuck in a similar policymaking rut. Each attempt to add more funds to stabilization measures has fallen short of market expectations while increasing frustration among a weary public. Part of the problem has been the inability to help shape those market expectations through a defined policy framework with clearly communicated objectives, robust management, consistent criteria for intervention, and strong oversight mechanisms for tracking progress and protecting the public interest. Building these safety valves into European financing facilities should be a priority for the European Commission, European Council, EFSF, and the European Parliament. Taking these steps will be essential to pivoting from confidence-killing to confidence-boosting policy.

Adopting some TARP transparency tools will also help overcome persistent roadblocks to financial stabilization in Europe: parliamentary crises, political backlash, bailout fatigue, and market attacks on European bank shares and sovereign bonds. Transparency is something that markets and political constituents alike can agree on—there should be more of it in future European stabilization policies.

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