Testimony of Anthony B. Sanders
Domestic Policy Subcommittee of the Oversight and Government Reform Committee
U.S. House of Representatives
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Mr. Chairman and Members of the Committee:

Thank you for the invitation to testify before you today.

I testified before you on November 14, 2008 on the subject of the Troubled Assets Relief Program (TARP). At that time, we understood that the U.S. Treasury had not purchased loans from financial institutions using TARP funds; instead, the TARP funds were deployed to several financial institutions. The purpose of my testimony today is not to challenge either Secretary Paulson or Secretary Geithner about the deployment of TARP funds; rather, my testimony today focuses on the lack of transparency surrounding the use of TARP funds, as well as related Treasury and Federal Reserve deployment of funds.

Transparency is of critical importance to the stability of financial markets as well as the reputation of the U.S. in the international economy. For example, research has found that the frequency of stock market crashes is higher in countries with companies that are more opaque (less transparent) to outside investors.[1] A recent paper on the asset (mortgage) securitization side has concluded that in order to attract investors, transparency is essential.[2] "The less transparent a market is, the more poorly understood it will be by investors, and the higher will be the yield those investors demand to compensate for the uncertainty." Thus, whether we are talking about the loans that are originated and securitized by banks or how TARP funds are deployed to the banks, transparency is critical to returning trust in our financial system and comforting investors both in the U.S. and globally. When we consider that our own Federal government borrows funds from overseas investors, transparency will a vital tool in restoring confidence in the tarnished U.S. financial system.

Greater transparency of the TARP can alleviate concerns among U.S. taxpayers and the investment community that the funds are being used appropriately and not being wasted. Without transparency, we are no longer "the shining city on the hill." Rather, we are New York City during the Blackout of 1977.

For example, there should be more transparent asset valuation so that we understand how Treasury and the Federal Reserve are valuing the banks relative to the private market valuations (e.g., the stock market). If the Treasury is systematically overvaluing the banks, it is an indication that the danger posed

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[1] Li Jin and Stewart C. Myers, "$R^2$ Around the World: New Theory and New Tests." *Journal of Financial Economics*, Vol. 79, No. 2: (February 2006), pgs. 257-292.

[2] "Key Considerations for the Future of the Secondary Mortgage Market and the Government Sponsored Enterprises (GSEs),"Mortgage Bankers Association, 2009. http://www.mortgagebankers.org/files/ResourceCenter/GSE/KeyConsiderationsfortheFutureoftheSecondaryMortgageMarketandtheGSEs.pdf

by toxic assets (particularly mortgages) has not been dealt with. Until asset valuation is more transparent and the market is confident that banks have written down toxic assets (such as bad mortgage loans) and accurately priced their assets, any effort to restore stability and confidence in our financial system may ultimately fail.

Let us suppose that the fundamental purpose of TARP was to restore bank capital to asset ratios rather than to stimulate lending in the mortgage market and for businesses. Injecting capital does not immediately imply an increase in lending unless the bank has an adequate capital ratio and no expectation of losses that would further undermine its capital. But if the banks that received TARP funds are in jeopardy of further losses that jeopardize their capital position, we should be asking what the recipients of the TARP funding are doing with those funds and would those funds be better used elsewhere? Unfortunately, we still do not have an accurate picture of how those funds are being deployed. The reason why we can't "drill down" on the use is that assets at the banks (and other recipients) are fungible.

**The Problem of Fungible Assets**

One can argue that all assets (including TARP funds) are fungible, meaning it is very difficult to impossible to trace how the TARP funds are spent. For example, Bank A receives $15 billion in TARP funding, but is so large and complex that a paper trail cannot be followed. Despite our accounting and regulatory reporting on these institutions, the TARP funds seemingly sink into an abyss or a "black hole."

Clearly, greater transparency is required so that the TARP funds are spent in a non-wasteful manner. At a minimum, transparency is extremely useful for regulatory purpose and policy. Furthermore, greater transparency is critical to maintain the reputation of the U.S. in capital markets as the country that is transparent and doesn't squander its funds. Clearly, other countries that purchase our U.S. government bonds or invest in our securities would feel more comfortable with our disclosures of government spending and corporate uses of these expenditures if they knew that waste was being monitored and reduced.

**How can we monitor the TARP funds in a fungible world?**

Currently, financial institutions report information that can be found in SEC filings (10Q and 10K reports) and Call Reports[3] that are produced quarterly. However, this information is not "real time" and is highly aggregated. As a consequence, it is difficult to "follow the money" from these filings. Although banks can report on the use of TARP funds on a timelier basis with Treasury (even daily), the quality of these reports may be of dubious substance given the size and complexity of the financial institutions that have received TARP funds.

For example, our largest financial institutions have hundreds of divisions and subsidiaries and perform operations in numerous countries (for example, Citigroup has operations in over 100 countries and

[3] See https://cdr.ffiec.gov/public/

includes such banks as Banamex).[4] For a regulatory body, Congress, the Executive Branch or the financial institutions themselves to understand where the TARP funds have gone, there is a need for more aggressive forms of "auditing" that permit better disclosure.

Traditional auditing of the financial institutions is a time consuming and labor intensive process that is clearly valuable but not up to the task of "real time." The Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) produced an initial report to the United States Congress on February 6, 2009 detailing the allocation of TARP funds which is an admirable first step at providing transparency for the TARP program, but it does not address how the recipients of the TARP funds have actually spent (or invested) the funds.[5]

With the rapid weakening of our major financial institutions, it would be extremely helpful to understand the uses of TARP funds in trying to determine if the funds are effective at either increasing loan volumes at the financial institutions, reducing bank losses, or are the TARP funds simply being wasted. Since capital is scarce, the Federal government should be attentive to the effectiveness of the TARP funds.

An approach that can offer "real time" measures of expenditures by TARP recipients (or any other recipient of government funds) is volumetrics. It is possible to obtain vast amounts of reported information on loans, corporate benefits, golf tournaments, concerts, retreats, etc., and aggregate them into a useable form for regulators and other market participants.

**Use of TARP Funds**

Suppose that Bank A has been sued for allegedly engaging in predatory lending. Should taxpayers be responsible for paying for losses associated with a settlement or loss of a predatory lending case? Suppose that Bank B engaged in shoddy underwriting and is being sued to repurchase the badly underwritten loans. Should TARP funds be used to settle these claims? Since TARP funds were injected into the system to preserve the bank's viability, one question would be whether the use of funds in such a case is needed to protect the bank's viability.

On the marketing side, should we the taxpayers be concerned about Bank C using TARP funds for the naming of a sports stadium? While it can be argued that naming of a stadium (or professional golf tournament) is part of their marketing strategy, it can also be argued that the price that Bank B paid for naming rights is far in excess of its advertising value.[6] While it may be a reasonable argument to name sports stadiums, these institutions must be aware of the backlash by taxpayers and regulators against perceived squandering of scarce taxpayer dollars in an economic crisis. The same argument applies to

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[4] See Wall Street Journal, February 26, 2009, "Citi Confronts Global Fallout as U.S. Nears Deal on Stake" for a discussion on how the number and size of Citi's international operations have complicated their business dealings.

[5] www.SIGTARP.gov

[6] See Robert Boland and Lee Igel's article entitled "Don't sell your values for naming rights." http://www.sportsbusinessjournal.com/article/55256

rock concerts, corporate retreats, executive compensation and perquisites (executive jets, lavish office decorations, etc.)

On the investment side, should Bank D be taking TARP funds and then investing in other banks overseas or using these funds to retool an automotive facility overseas? While these investments may represent good project decisions from the corporation's perspective, the question can be asked whether taxpayers in the U.S. should be funding business activities in other countries where the host country and subsidiary is the beneficiary of increased employment, tax revenues or sales. One simple rule to apply to judging the investments and expenditures of institutions receiving TARP funds is rather than ask "Did you do that with TARP money?" ask instead "In this climate, would you have made that investment or expenditure without access to TARP funds?"

**The Best Way to Deploy TARP Funding**

Clearly, simply giving capital to banks makes it difficult to understand its uses. Alternative approaches to the TARP funds could be a loan with a system of verification and draws. Lenders in construction and development lending often use the draw system where the lenders monitor the progress of the borrower; the lenders only give the next allocation of funds upon completion and verification of a task. Alternatively, the government could issues vouchers to the banks requiring the banks to use the funds for targeted purposes only, subject to verification. The problem with simply giving banks capital in exchange for preferred, convertible or common stock is that once the government owns the banks, it may be difficult for the banks to reemerge to private ownership. A draw loan or voucher system would provide greater transparency of the use of the TARP funds since the funds would be more directly monitored.

Another advantage of the draw loan or voucher system is that it allows the government to determine if a particular bank cannot meet the draw loan or voucher conditions on an ongoing basis. Thus, certain banks may be allowed to fail if it is determined that additional funding is equivalent to flushing the funds down the drain.

**Summary**

Transparency for the use of funds by TARP recipients represents a step forward in understanding how taxpayer dollars are employed, particularly in this economic climate. Whether we follow Justice Brandeis' "Sunlight is said to be the best of disinfectants" or President Reagan's "Trust but verify," the path is the same. We should be disclosing the use of TARP and other funding in order to understand how these funds are being used and whether waste is occurring.

In summary, the TARP, TALC and other government programs should be wrapped in Saran Wrap rather than a lead veil that even Superman cannot pierce. Taxpayers have the right to know what is being done with their wealth and transparency helps achieve more economically sound use of the TARP funds.

Thank you for your willingness to let me share my thoughts with you.