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Q&A: Bailout of financial sector during Great Recession was a bad deal for taxpayers

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U.S. taxpayers did not earn a fair return on the 2008 government bailout of financial institutions, according to new research from the University of Michigan's Ross School of Business.

When the government completed its Troubled Asset Relief Program in 2014, the results were widely described as taxpayers getting back their full investment, plus interest.

"This is a misleading claim. Unfortunately, this narrative has found a large audience and it misses the point," said Amiyatosh Purnanandam, professor and chair of finance. "The real question is whether the return was good enough for the risk, not whether it was positive."

Purnanandam and Ross doctoral student Thomas Flanagan recently published a paper examining the issue, and Purnanandam discussed their research:

What's the problem with the way the TARP returns are often described?

Taxpayers poured hundreds of billions of dollars into the financial system in 2008 to assist financial firms that were struggling from the collapse of the mortgage market. On an aggregate basis, these investments were returned back to the taxpayers with some positive return. A common refrain used by a number of bankers is that we returned every penny of TARP money back to the shareholders, with interest.

But such a narrative misses the most basic point of finance theory: Was the return on TARP sufficient to compensate the taxpayers for the risk that they took? In a private market transaction, investors demand higher returns for high-risk investments. The return is "fair" only if it is commensurate with the risk it imposes on the investors.

The title of your paper asks,"Did banks pay a 'fair' return to taxpayers on TARP?" How did you go about

answering that question?

Bailouts, by definition, occur in bad states of the world, that is, when risk is high. The "fair" market-based return on such investments must earn sufficiently high returns. To evaluate whether banks paid a fair return on TARP investments or not, we compared returns on TARP with returns earned on securities of similar risk in private markets. Specifically, we compared TARP's return with return in preferred equity issued by banks over exactly the same investment horizon as TARP.

The market dramatically improved between the time of the TARP bailouts and the time they were repaid. How were the bailouts affected by this turnaround?

There is no doubt that TARP helped both the financial and the real sectors of our economy. As a result of this intervention, our financial markets recovered and private market securities earned positive returns.

Unfortunately, the return paid on TARP did not keep pace with these private returns. Thus, taxpayers ended up subsidizing banks, and hence the narrative that "banks paid every penny of TARP with interest" is a bit misleading and certainly incomplete.

What's the ultimate answer to the question the paper poses—were the TARP returns fair?

From a purely risk-return perspective, the return on TARP securities was not fair. Of course, the bailout helped the economy by stabilizing the financial sector. So in a broader sense, it did help the taxpayers.

But the gains from the recovery were captured disproportionately by the recipient banks. Hence a nuanced interpretation of our results is that the TARP return was less-than-fair for the risk it imposed on the taxpayers, and the banks ended up getting a subsidy to the tunes of billions of dollars in the process.

What can we learn from these results for any future bailouts?

For future bailouts, we need a better design. Specifically, we need to ensure that once the economy recovers, banks are required to share their gains with the taxpayer. That will be a fair system; otherwise, we end up propagating a system that encourages socialism in bad times and capitalism in good. Such a system can easily end up with a devastating consequence: People will lose trust in our financial system and economic policy.

More information: Thomas Flanagan et al. Did Banks Pay 'Fair' Return to Taxpayers on TARP?, *SSRN Electronic Journal* (2020). [DOI: 10.2139/ssrn.3595763](https://dx.doi.org/10.2139/ssrn.3595763)

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