Journal of Economics and Business 64 (2012) 63–76

Contents lists available at ScienceDirect

Journal of Economics and Business

Anchoring bias in the TARP warrant negotiations

Linus Wilson*

Department of Economics & Finance, University of Louisiana at Lafayette, B. I. Moody III College of Business 214 Hebrard Boulevard, Moody Hall 253, P. O. Box 44570, Lafayette, LA 70504-4570, United States

A R T I C L E   I N F O

Article history:
Received 23 August 2010
Received in revised form 8 March 2011
Accepted 16 March 2011

JEL classification:
D03
C78
G01
G13
G21
G28
G32
G38

Keywords:
Anchoring bias
Behavioral economics
Behavioral finance
Alternating offers
Bailout
Banks
Banking
Bargaining
Bids
Capital Purchase Program (CPP)
Emergency Economic Stabilization Act (EESA)
Heuristics
Negotiations
Offers

A B S T R A C T

This paper finds that banks that offered lower opening bids were rewarded with significantly lower warrant repurchase prices in transactions that raised $2.856 billion in 2009. These results were scaled by third-party consultants' and the Congressional Oversight Panel's estimates of the warrants' value. In contrast to the experimental psychology studies on anchoring bias in negotiations, these are real transactions involving large sums of money. This paper finds that larger banks paid significantly higher prices after controlling for other factors, and the U.S. Treasury obtained better prices over time. The results on anchoring bias are strong even after controlling for bank managers' potential informational advantages over U.S. Treasury negotiators.

* Tel.: +1 337 482 6209; fax: +1 337 482 6675.
E-mail addresses: linuswilson@louisiana.edu, linuswilson@yahoo.com

0148-6195/$ – see front matter
doi:10.1016/j.jeconbus.2011.03.002

Options
Troubled Asset Relief Program (TARP)
Valuation
Warrants:

1. Introduction

The Troubled Asset Relief Program (TARP) left taxpayers holding large stakes of preferred stock, subordinated debt, and warrants in hundreds of banks. This program allowed the U.S. Treasury Secretary to purchase up to $700 billion worth of capital and assets during the financial panic of 2008 and 2009. Blinder and Zandi (2010) argues that the combined financial sector rescue efforts by the Federal Reserve, U.S. Treasury by way of the TARP, and the Federal Deposit Insurance Corporation (FDIC) increased GDP by more than 2.5 percent in both 2009 and 2010. That study also projects that these financial sector rescues have reduced or will reduce unemployment by more than 2.5 percent in 2009, 2010, and 2011. Yet, Wilson and Wu (2011) documents that as soon as the TARP capital infusions were made many of the healthiest TARP recipients clamored to exit government ownership. The present study looks into the negotiation process of banks trying to end the last vestiges of public ownership of their firms.

In the Emergency Economic Stabilization Act (EESA), which was signed into law on October 3, 2009, the U.S. Treasury was required to obtain warrants from banks benefiting from the government's assistance. Warrants are call options that give the owner the right but not the obligation to purchase newly issued shares at a preset price. According to Paulson (2010, p. 305) and Swagel (2009), this was one of the many deals that the U.S. Treasury made to win Congressional approval of the unpopular legislation that has often been referred to as the $700 billion bailout.

The Capital Purchase Program (CPP) announced by Secretary of the U.S. Treasury Henry Paulson on Monday, October 13, 2008, proposed to inject up to $250 billion into U.S. banks. On its first day of the program, it passed out $125 billion in exchange for perpetual preferred stock and warrants that expire in ten years. The U.S. Treasury (2010) reports that the Capital Purchase Program closed for new investments on December 31, 2009, after passing out roughly $205 billion to 707 banks. Of those 707 banks, the author's analysis of transaction reports issued by the Office of Financial Stability of the U.S. Treasury found that 282 banks, insurance companies, and credit card issuers had issued warrants that allow those firms to negotiate with the U.S. Treasury to repurchase them at "fair market value."[1] Banks can only repurchase the warrants after they repaid the taxpayers' investments and any remaining accrued dividends. By the end of 2009, fifty-two banks had repurchased the taxpayers' preferred stock. Yet, through the end of 2009, only thirty-four negotiations had either concluded with banks repurchasing the warrants from the U.S. Treasury or the U.S. Treasury auctioning the warrants to third party investors.

This paper studies the bargaining process of the twenty-eight warrant repurchases which had multiple bids through the end of 2009. It finds that the first bid significantly positively correlated with the subsequent prices paid for the warrants. Thus, banks that made lowball offers appear to have been rewarded with lower sales prices. This lends support to the anchoring bias theory, which says that prices in economic transactions can be affected by irrelevant early signals.[2] The results are robust for controls that measure management's information advantage.

Moreover, this study finds that the U.S. Treasury secured significantly better prices over time and from larger banks. These results provide some support for the hypothesis that the U.S. Treasury learned how to secure better deals over time and responded to political pressure to press for better deals after the early deals were criticized by Wilson (2009b) and then Congressional Oversight Panel (2009b). Nevertheless, the time trend results disappear when the deal prices are scaled by the Congressional Oversight Panel (2010)'s estimates.

---

[1] This is the language of Section 4.9 the securities purchase agreements of the CPP.
[2] Tversky and Kahneman (1974), for example, discuss some examples of this judgment error.