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The Emergency Economic Stabilization Act of 2008

<u>Summary</u>: The Emergency Economic Stabilization Act (H.R.__) provides the Treasury Department with the authority to purchase illiquid, troubled assets on the books of private financial institutions, in an effort to resolve the current financial crisis. The *highlights* include the following:

- **Purchase Authority**: Provides $700 billion in purchase authority *at any one time* to Treasury to purchase "troubled assets from any financial institutions," of which $250 billion would be made immediately available and another $100 billion once the President certifies that Treasury needs the authority. The final $350 billion is authorized, but Congress could halt the authority by passing a joint resolution *disapproving* the action (under fast-track procedures). However, such joint resolutions require the signature of the President to take effect. While provided in installments or "tranches," the bill provides the full $700 billion, as initially requested by the Administration to calm the financial markets.

- **Troubled Assets:** Broadens the Treasury Department's original request for mortgage-related assets to a larger class of "troubled" assets." Such assets are defined as "any residential or commercial mortgages any securities, obligations, or other instruments that are based on or related to such mortgages" and "*any other financial instrument* that the Secretary…determines the purchase of which is necessary to promote financial market stability" (emphasis added). This definition significantly expands the scope of the purchasing program to potentially many more classes of securities (e.g.., those backed by car loans, credit-card debt, etc.).

- **Insurance Component:** Requires the Treasury Department to establish a federally-backed insurance program, similar to the Federal Deposit Insurance Corporation (FDIC), for holders of troubled assets, *if* it utilizes its purchase authority (which it is expected to do). Treasury would guarantee up to 100% of the timely payment of principal and interest on certain classes of troubled assets, presumably those worth more than the ones which will be immediately purchased. A risk-adjusted premium would be assessed to holders of these assets to self-finance the program through the participants. The total amount of assets insured by the program, minus the premiums, would offset the purchase

authority available to Treasury. However, it is unclear whether the insurance program would be set up quickly or effectively (with a large enough class of assets) to ensure that it can be used to substantially offset Treasury's purchase authority.

- **Private Firms as Financial Agents:** Authorizes Treasury to designate private financial institutions as its agents to carry out such duties as may be required in exercising its new authority. The bill directs Treasury to solicit bids from a broad range of qualified firms and to "take appropriate steps to manage conflicts of interest, including requiring potential firms to indentify and disclose… potential conflicts." The FDIC would be among the candidates chosen to manage the purchased assets.

- **Priorities:** Requires the Treasury Secretary to exercise its authority in a manner that will protect the taxpayer, provide stability and prevent disruption to the financial market system, the need to help families keep their homes and to stabilize their communities, etc. (in that order).

- **Executive Compensation:** Sets executive compensation limits on two classes of firms, 1) those which the federal government directly takes over "AIG-style" and 2) those who sell $300 million or more in assets to the federal government, so-called "high-volume sellers." For those firms directly taken over, the Secretary would establish limits on compensation for taking unnecessary and excessive risk, a prohibition on "golden parachute" payments, and a process for recouping any incentive payments made to "senior executives" (top 5 executives of a public company) based on earning statements later proven to be materially inaccurate. For high-volume sellers, the legislation would also ban golden parachute payments and lower the current deduction for executive compensation from $1 million to $500,000. Many conservatives may be concerned that, while aimed only at participating firms, this change to tax law sets a dangerous precedent since liberals have pushed for years to lower this deduction. It should be noted that the limit on the deduction itself is one of the main reasons for corporations to structure incentives-based compensation that may cause corporate actors to take excessive risks to boost share prices.

- **Reverse Auctions:** Requires the Secretary to use methods, such as auctions or "reverse" auctions, in purchasing firms' troubled assets, in order to minimize the cost to taxpayers. Treasury intends to use a process whereby it indicates its intent to buy a certain class of troubled assets and competing firms provide the terms for which they would sell. If the process works, Treasury would choose the seller with the lowest sticker price. When these assets are later sold, the proceeds would flow into general revenues. However, some conservatives may be concerned that this process may not work in practice because: 1) all sellers have an incentive to hold onto to their assets until the government offers an inflated price over what the market would currently bear (since firms are undercapitalized and there is a limit to the losses that they can sustain by selling their assets at market or below-market rates), and 2) the classes of assets are not particularly large or homogenized, since many of these securities are so complex and unique, perhaps making it difficult to attract a large pool of willing sellers to drive down prices.

- **Warrants:** Requires the Treasury to receive warrants for non-voting, common or preferred stock in firms that sell more than $100 million in troubled assets to the government. A warrant is a certificate that entitles the holder to purchase securities at a

certain price. Giving the federal government a warrant to shares of participating firms provides a mechanism for taxpayers to recoup a portion of the initial price if share prices increase and the shares can later be bought and sold for a profit. However, it also sets a dangerous precedent in that it allows the federal government to *own* shares in private companies, if the warrant is exercised instead of being sold. While the warrants could only purchase *non-voting* shares, minimizing any authority that comes with such ownership, some conservatives had recommended that the federal government only be able to sell these warrants and never exercise them. This would have allowed for similar levels of taxpayer recoupment without setting a dangerous precedent of the federal government inevitably owning large swaths of the U.S. financial sector.

- **5-Year Recoupment Plan:** Requires the President after five years to determine whether taxpayers have suffered a net loss as a consequence of the purchase program, and if so, to submit a legislative proposal to recoup that amount from participating firms. There is nothing in the bill to ensure that the President's proposal is considered or passed by Congress, casting doubt on the efficacy of this provision—a variation of the Blue Dogs' initial proposal to place an indiscriminate tax on the entire financial sector, regardless of whether a firm's assets where purchased by the Treasury. But to the extent that this provision does lead to legislation, some conservatives may be concerned that it could result in a tax increase.

- **Market and Program Transparency:** Requires the Secretary to make information regarding each purchase available to the public in an electronic form, including a description, amounts, and pricing of such assets. The language also requires the Secretary to make public the mechanisms for purchasing troubled assets, the methods of valuing assets, the process for hiring asset managers, and the criteria for identifying troubled assets for purchase.

- **Debt Limit:** Increases the limit statutory debt limit from $10.615 trillion to $11.315 trillion, an increase of 6.6%. If enacted, the 110th Congress will have presided over three debt limit increases—a total of $2.33 trillion *or 26.2%.*

- **Foreign Banks and Financial Authorities**: Defines a participating financial institution to include foreign banks if "established and regulated under the laws of the U.S. or any State…and having significant operations in the U.S." A central bank or institution owned by foreign government would generally be excluded. However, the Treasury would also be required to coordinate with foreign financial authorities and central banks to establish similar programs in other countries, and to the extent that such foreign institutions lend money to firms with troubled assets that have failed or defaulted, they would be made eligible.

- **Oversight Board:** Establishes a five-person Financial Stability Oversight Board, including the Chairman of the Federal Reserve, the Treasury Secretary, the Director of the Federal Home Finance Agency, the Chairman of the SEC, and the Secretary of Housing and Urban Development, to review the exercise of authority under this legislation and make recommendations to the Treasury.

- **Bank Losses on GSE Stock**: Allows banks to treat losses on shares of preferred stock in Fannie Mae and Freddie Mac as ordinary losses to offset ordinary income, not as capital

losses (which is capped). This provision is targeted at many community banks who hold GSE preferred stock and sustained heavy loss after Treasury placed Fannie and Freddie in conservatorship.

- **Discharge of Mortgage Debt:** Extends for two years the exclusion (set to expire on January 1, 2010) from a taxpayer's gross income any discharge of indebtedness income, as long as the debt is for the acquisition, construction, or substantial improvement of the taxpayer's principal home (in addition to certain refinancing).

- **Affordable Housing Earmark:** Does _not_ include the provision proposed by Democrat negotiators to earmark 20% of any funds recouped from the disposition of the purchased assets for the Affordable Housing Fund, whose funds flow to many non-profit entities such as ACORN or La Raza. It should be noted that this provision was not part of the original Treasury plan.

- **Mortgage "Cram-Down":** Does _not_ authorize bankruptcy judges, as part of creating plans for debtors facing foreclosure to repay their subprime or nontraditional (e.g. interest-only) mortgage debts to reduce or delay adjustments to adjustable-rate subprime or nontraditional mortgages, set a new, fixed interest rate, extend repayment periods, etc.

- **Foreclosure Mitigation:** Directs the Secretary of the Treasury, as an owner of mortgages underlying troubled assets, to implement a plan to maximize assistance to homeowners and to encourage servicers of the underlying mortgages to take advantage of foreclosure prevention programs. In addition, the language requires the Secretary to consent to "reasonable requests" (undefined) from loan servicers for mortgage term extensions, rate reductions, principal write-downs, increases in the proportion of loans within a trust, or the removal of other modification limits.

- **Expiration of Authority:** Terminates the Secretary's authority to purchase and insure troubled assets on December 31, 2009, but allows for extensions until two years after the date of enactment. These sunset dates do not apply to the Secretary's ability to hold purchased assets, since many of these assets may still not be able to be sold by that point.

- **Mark to Market Accounting:** Restates current law that authorizes the SEC to suspend mark-to-market accounting with respect to any class or category of transactions. The bill also requires the SEC to study the impact of mark-to-market regulations on the balance sheets of financial firms and the advisability and feasibility of potential modifications. Some conservatives may be concerned with the lack of stronger language, requiring the SEC to promulgate new rules that allow firms to better reflect the true economic value of the mortgage-related assets on their books.

- **Exchange Stabilization Fund:** Requires the Secretary to replenish the Exchange Stabilization Fund for any funds used to provide a temporary guarantee program for the money market fund industry and bars it from ever being used that way again.

Conservative Concerns: No one would argue that the question before Congress of whether to give Treasury the authority to nationalize mortgage-related and other troubled assets is an easy one. Financial markets are clearly in turmoil, and many large—previously thought to be impregnable—financial firms have and may fail in the weeks to come. Many experts and news

reports also warn that without some federal action to bolster market confidence there will continue to be either stagnation in the capital markets or worse, a run on all depository institutions. No one wants those fears to be realized.

However, many conservatives may be concerned that authorizing the Secretary of Treasury to purchase up to $700 billion amounts to an indirect tax of $6,034 per American household, and it will likely forever change the landscape of the nation's free-market system. Institutions, policies, and precedents—right or wrong— enacted in crisis tend to become permanent fixtures.

As Luigi Zingales, a professor at the University of Chicago, writes:

> The decisions that will be made this weekend matter not just to the prospects of the U.S. economy in the year to come; they will shape the type of capitalism we will live in for the next fifty year. Do we want to live in a system where profits are private, but losses are socialized? Where taxpayer money is used to prop up failed firms? Or do we want to live in a system where people are held responsible for their decisions, where imprudent behavior is penalized and prudent behavior rewarded? For somebody like me who believes strongly in the free market system, the most serious risk of the current situation is that the interest of few financiers will undermine the fundamental workings of the capitalist system. The time has come to save capitalism from the capitalists.

Some conservatives may believe that Treasury is right, and given the present circumstances, the risk of inaction is so grave as to warrant such new authority. Others may indeed wonder whether in this moment of crisis, America is on the brink of something far worse—forfeiting its free-market system by placing an implicit guarantee on all economic failure. The message to rational actors with a bail-out of this magnitude is that your profits will be private but your losses socialized. But the system often does not work that way, at least not for long. If losses are socialized, it is likely that profits will soon be on the way, meaning Americans will no longer be free, not just to fail, but to succeed.

Specifically, many conservatives may have the following concerns with the legislation, because the plan:

- **Fails to adequately penalize the debtholders and shareholders** (including many of the executives themselves), who should bear the risk of any losses, and indirectly infuses capital directly onto the books of these financial institutions.

- **Alters fundamentally the nation's free-market system** in that it broadly socializes firm's money-losing mortgage assets and places the U.S. on a slippery slope whereby profits may also be nationalized.

- **Cedes massive authority to Treasury**. Given the fact that the Presidential election is a mere six weeks away and a new Secretary will take office in January 2009, lawmakers have absolutely no idea what individual will ultimately be exercising this vast new authority over the long-term.

- **Sets up Treasury to pay inflated prices for assets**. Since there is nothing in the proposal that forces the financial institutions to sell their assets at a discount rate or event at all, many of these owners may simply wait on the government to increase their bid,

leading to more inflated prices than the market would currently bear.

- **Creates the potential for an enormous bureaucracy** that will be needed to administer the purchase and insurance programs.

- **Increases the federal deficit and national debt.** The new mandatory spending, will cause a massive increase in the national debt and an immediate (although smaller) increase in the federal deficit. These annual deficits are funded by selling government bonds purchased by a host of large investors, including foreign countries. However, there is a limit to the amount of bonds that a government can float without adverse financial effects.

- **Aids financial institutions that may not pose a systemic risk.** Some companies, such as AIG, may truly pose a systemic risk to the entire market. However, there is no requirement under the proposal that a company truly be "too big to fail." Instead, *any* financial institutions with mortgage-related assets would be eligible.

Additional Background: On Friday, September 19, 2008, the Treasury Department requested broad new authority to calm U.S. financial markets and purchase illiquid mortgage-related assets from various financial institutions. According to extensive press reporting, the Administration took this action after a series of repeated federal interventions were unsuccessful and a panic began to spread throughout financial markets.

The market for commercial paper, or short-term corporate bonds, tightened as institutional investors increasingly valued ready cash. These investors, namely money-market funds, continued to hoard cash in preparation of an expected run on their funds, which began as investors withdrew roughly $144.5 billion (compared to $7.1 billion the week before). In many cases, these investors fled to short-term government bonds, accepting little-to-no rate of return in exchange for the knowledge that their cash was secured. One money-market fund, Putnam Prime Money Market Fund, shut down because too many investors sought to take their money out at one time, and another, Reserve Primary Fund, announced that it would suspend redemptions temporarily. Administration officials feared that such a lack of confidence would spread.

The case of Reserve Primary Fund is instructive, because it was this money-market fund which seems to have set off the run due to the amount of corporate debt it held in Lehman Brothers. Lehman Brothers had filed for Chapter 11 bankruptcy protection the day before with more than $613 billion in debt. Between 2004 and 2007, this debt had been used in part to purchase almost $300 billion in securities backed by residential and commercial mortgages, otherwise known as mortgage-backed securities or MBS, which have been significantly devalued since the downturn in the housing market.

These "toxic" mortgage-related assets have been virtually unmovable from the portfolios of many financial institutions, such as Lehman Brothers, in part because the market has no idea what they are worth. This underlying predicament led to the Treasury Department's request for blanket authority for the federal government to purchase them—taking them off portfolios, instilling confidence and capital in those firms who had previously held them, in order that lending and borrowing can resume.

Committee Action: The legislation has not been considered by any congressional committee.

Cost to Taxpayers: A CBO score is not yet available. However, the funding authorized is not subject to appropriations and constitutes mandatory spending. The bill treats the cost of purchasing the assets under the provisions Federal Credit Reform Act of 1990, ensuring that the net-present value of the purchased securities will be scored instead of the initial outlays. This treatment recognizes that the securities have some value (even if less than the purchase price), but value which may not realized until they are sold. Under credit-reform scoring, the cost of the initial outlays is offset by an estimation of what the eventual sale of the assets will return in receipts, and it is this figure which will impact the federal deficit. Given the uncertain value of many of these securities, it is unclear whether CBO will have the necessary information to accurately score the legislation's long-term fiscal impact.

Furthermore, Sec. 204 deems all costs arising under the legislation an emergency for purposes of the Congressional budget process.

Does the Bill Expand the Size and Scope of the Federal Government? Yes, substantially as the federal government would now be purchasing billions of dollars worth of troubled securities.

Does the Bill Contain Any New State-Government, Local-Government, or Private-Sector Mandates? A CBO score is not yet available.

Does the Bill Comply with House Rules Regarding Earmarks/Limited Tax Benefits/Limited Tariff Benefits? A Committee report designating compliance with clause 9 of rule XXI is unavailable.

Constitutional Authority: A Committee report citing Constitutional authority is unavailable. House Rule XIII, Section 3(d)(1), requires that all committee reports contain a statement citing the *specific* powers granted to Congress in the Constitution to enact the law proposed by the bill or joint resolution. *[emphasis added]*

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