Frequently asked questions about the financial rescue proposal.

SUMMARY

Financial markets continue to experience significant turmoil and the banking sector remains fragile. Efforts to restore confidence have been met with mixed results. After attempting to deal with troubled institutions on a case-by-case basis, Treasury has proposed a plan to purchase mortgage-related assets to alleviate stress in financial markets and in the banking system.

This report uses Congressional Research Service reports, committee reports and news sources to provide answers to some frequently asked questions concerning the Troubled Asset Relief Program (TARP), enacted by Congress in the Emergency Economic Stabilization Act of 2008 (EESA, H.R. 1424/P.L 110-343).[1]

WHAT IS WRONG WITH THE FINANCIAL SYSTEM?

Banks and other financial institutions have been reluctant to lend or otherwise engage with other institutions for fear of exposure to the bad assets – largely defaulted mortgage-backed securities or related instruments. That is, a relatively healthy bank is afraid to sign a contract with other institutions because of the fear that the other institution will not be able to fulfill its obligations.

For similar reasons banks and companies of all types that need to raise capital have had trouble doing so because potential investors are either hoarding cash or afraid to enter credit markets. This affects everyone who gets a paycheck or runs a business as it affects customers, suppliers and the ability to make payroll. [2]

WHAT CAUSED FINANCIAL MARKET TURMOIL?

Although there are several contributing elements, most observers agree that rising defaults among residential mortgage borrowers sparked the initial loss in financial market confidence.3 Various observers place different emphasis on low interest rates that caused a housing bubble that in this view was bound to eventually burst, insufficient regulation of subprime mortgage lending practices, and insufficient monitoring of complex financial products and services, especially rating agencies and derivatives markets.[3]

WHAT WAS THE URGENCY?

During the week of September 15 to September 19, the financial markets – those that lend and borrow money to banks and companies to lend and borrow – in many respects ceased to function. This was a critical sign to the Federal Reserve Chairman and Treasury Secretary that the system had "frozen up" and was in danger of collapse.

The events leading up to the credit crises have been compared to a Category 4 financial storm. Unlike a stock market crisis, this was not visible to most people as frightened investors and fund managers, began to lose confidence in banks and the banking system and began pulling out cash and refusing to lend. It was an electronic run on the financial system. If not dealt with correctly, the same circumstances that resulted in the financial collapse that contributed to the Great Depression could result.

Between the morning of Wednesday, Sept. 17, to the afternoon of Thursday, Sept. 18, policy makers decided to use an emergency rescue plan they had been developing to inject needed cash into the system and buoy confidence by buying troubled securities from troubled banks.

Speed was essential in the minds of policy makers to avoid a continuing run on bank deposits and "flight to cash", so Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson proposed their

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[1] Webel, Baird, Murphy, Edward Vincent, Congressional Research Service, "Financial Market Intervention," October 7, 2008, Updated.
[2] Ibid.
[3] Ibid.

$700 billion rescue plan, and briefed Congressional leaders during the Thursday evening of Sept. 18 and Friday, Sept 19. The briefing was in the starkest of terms about how confidence needed to be restored in the financial system quickly. [4]

Though the rescue plan became named by the media as a “Wall Street bailout” it was not about Wall Street or bailing out particular troubled firms. The Federal Reserve had already been forced to take responsibility for the investment bank Bear Stearns, mortgage giants Freddie Mac and Fannie Mae and the insurance giant AIG. Despite these actions, the crisis in confidence threatened the financial soundness of all banking institutions.

It was a plan to restore financial system operation by buying the “toxic securities” from institutions so that financial institutions could have needed cash, and confidence could be restored.

Over the long term, Treasury officials said they hope that they can recover taxpayer funds or even make a profit by selling the assets it has acquired once the market is stabilized. The final plan also gives taxpayers warrants – or a share of the participating companies – so that once they become profitable, the government too can profit.

What about alternative proposals?

Many of the proposed alternatives to the Treasury plan are being used or still available to be used as tools in dealing with the current crisis.

WHY NOT MERELY INSURE THE ASSETS TO RESTORE CONFIDENCE?

The Emergency Economic Stabilization Act does allow insurance to be issued to help restore confidence in financial institutions.

Proponents say this would minimize government investment while providing confidence to the market so buyers could come in.

While this provides restored confidence, it does not provide the needed cash. It also might allow only the worst assets to be insured, so that essentially the government would assume ownership of those and the losses would be larger than the price of insurance. The government would still have to assess a price for the securities to issue insurance – the most difficult aspect of an outright purchase plan.

WHAT ABOUT JUST GIVING LOANS?

Proponents say giving loans would provide needed cash without the taxpayer obligation of assuming ownership of the assets. On the negative side, loans would not be the kind of capital needed by banks because a loan is an additional liability, and for taxpayers, a loan remains a contingent liability if the institution fails.

WHAT ABOUT BUYING STOCK OF THE FINANCIAL COMPANIES?

The Treasury and bank regulators do have the power to seize ownership of failing institutions and under the Emergency Economic Stabilization Act they have announced they will buy stock in financial institutions to boost cash availability. Once stability returns, that stock could be sold and the taxpayer funds recovered.

Proponents say this does increase cash available to financial institutions. They say in the savings and loan crisis, the federal government assumed ownership of failed institutions, not just their assets. Opponents of this approach have said this would do little to help in shoring up the confidence in the institutions. It also makes the government a participant in the companies, or shareholder which is a much more big government role than a lender or purchaser of last resort.

The Treasury can buy stock in two ways: it can add capital by buying equity shares; or it can takeover an institution by replacing every other shareholder in buying up to 80 percent of the bank stock for less than a hundredth of a cent a share.

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[4] Nocera, Joe, “The Reckoning: As Credit Crisis Spiraled, Alarm Led to Action,” *The New York Times,* Oct. 2, 2008.

WHY NOT BUY OUT THE MORTGAGES THEMSELVES, HELPING HOMEOWNERS?

Much is already being done to help keep homeowners in their homes, Congress passed a major homeowner relief package with a $300 billion FHA program to help homeowners renegotiate loan terms. Financial institutions want to keep homeowners in their homes, whenever economically feasible. That does help limit the losses on mortgage-backed securities.

But some experts say homeowner help alone would not be fast enough or widespread enough to restore immediate confidence in the financial system. Also, a large government commitment could result in maintaining people in homes they cannot ultimately afford. They would eventually default. Also, when the government is the landlord, it has a conflict of interest between keeping homeowners in the property and maximizing return to taxpayers.

What factors caused this crisis?

MARK-TO-MARKET ACCOUNTING?

Mark to market is a financial accounting rule that requires institutions to report the fair market value of assets and any unrealized gains or losses at the time of the report. The practice gained support in the 1980s as a result of the widespread failure of U.S. savings and loans, because the current value of assets were not reported on the books.

The bankruptcy of Enron in 2001 drew attention to the need for tighter guidelines. The Securities Exchange Commission(SEC) has ultimate authority over application of the standard. In November of 2007, the Financial Accounting Standards Board(FASB) issued its Rule 157 on “Fair Value Measurements” that further tightened requirements for reporting on financial institutions. The rule provided three levels for establishing an asset value.

The rule means if asset values are falling – as in house values – financial institutions have to report a loss and raise more cash, even if the value is artificially depressed.

Supporters say the rule is sensible because it allows a transparent look at the current value of assets. Opponents say the rule forces companies to treat every asset as if it had to be sold immediately whatever the price — that is, right now.

In the case of markets for mortgage-backed securities very few buyers exist and the securities’ prices are well below what their economic value would be if held until maturity. Requiring banks to use artificially depressed values is making a bad situation even worse, opponents say.

Long-term, most economists agree that mark-to-market rules are valuable for increasing transparency.

For the short term, suspension of the mark-to-market rule would stop the cycle that requires institutions to raise more and more cash as values fall.

The FASB 157 rule already accounts for temporary suspension of mark-to-market accounting when the market does not exist for a certain asset.

On September 30, 2008, SEC & FASB issued guidance that allowed factoring in expectations of future cash flows in fair value measurements when no material market exists. The concept of fair value measurement assumes an orderly transaction between market participants. “Distressed or forced liquidation sales are not orderly transactions…”

FANNIE MAE AND FREDDIE MAC?

Fannie Mae was founded as a government agency in 1938 as part of Franklin Delano Roosevelt's New Deal to provide liquidity to the mortgage market. In 1968, Fannie Mae was converted into a private corporation.

The Federal Home Loan Mortgage Corporation (FHLMC), commonly known as Freddie Mac, was created in 1970 as a government sponsored enterprise to expand the secondary market for mortgages. Freddie Mac

bought mortgages on the secondary market, pooled them, and sold them as mortgage-backed securities to investors on the open market. In 1989 it was rechartered as a privately-owned corporation.

In 1992, Congress created the Office of Federal Housing Enterprise Oversight as an independent body within the Department of Housing and Urban Development to oversee the soundness of GSE operations. Congress also directed the GSEs to seek to increase mortgage lending among low and moderate income borrowers as part of an affordable housing policy. It also could meet the affordable housing goals by loaning to rental and multifamily development.

The two government-sponsored enterprises together could borrow at rates almost as low as the federal interest rate, significantly lower than non-governmental institutions.

From 1990 to 2005, Fannie Mae and Freddie Mac grew 944% to $1.64 trillion with outstanding liabilities of $1.51 trillion. [5]

By the time of their government takeover in September the two agencies held $5 trillion of the nation's $11.3 trillion in mortgage debt. [6]

Experts have said Fannie Mae and Freddie Mac, as the largest purchasers of mortgages and mortgage-backed securities in the world, encouraged mortgage lenders to lower their lending standards, because the two GSEs would ultimately buy them. A government guarantee was implicit in all Fannie Mae and Freddie Mac investments.

According to a Congressional Research Service report: In broad terms, the GSEs purchased slightly more than $169 billion of private label subprime mortgage backed securities in 2006 and 2007; they purchased slightly less than $58 billion of Alt-A mortgage-backed securities in the same time period out of combined total mortgage purchases of $1.677 trillion. At the end of 2007, the subprime and Alt-A mortgage-backed securities represented 13.5% of the GSEs' total assets.[7]

But at least one analysis by researchers at the American Enterprise Institute indicates that the two agencies together may have used redefinitions and changes in rules to obscure the extent of their subprime lending. The agencies may have held or guaranteed more than $1 trillion in unpaid subprime loans. [8]

Fannie and Freddie, became overextended – or held too much debt and not enough capital. When their assets' value declined, they rapidly went underwater.

The agencies were troubled by accounting scandals in 2003 and 2005, and numerous questions were raised over the last five years about the extent of the agencies' loan activities, but efforts to increase regulation or moderate their activities did not pass. News reports also shined a light on the GSEs' relationships to other subprime lenders and their extensive lobbying activities to avoid further regulation.

The two agencies were acquired by the federal government on September 7, 2008, for $1 billion in preferred stock in what may be as much as a $200 billion obligation.

FEDERAL RESERVE MONETARY POLICY?

The Federal Reserve does not supervise most of the mortgage lenders. But outside of monetary policy, the Fed can set underwriting standards for regulated institutions through Regulation Z of the Truth in Lending Act. New mortgage underwriting guidelines might have prevented some problems, but the Federal Reserve chose not to do so until July 2008, after the severity of problems became apparent.

The new rule stops some of the most egregious practices of unethical lenders. It prohibits making a home loan without assessing the borrowers' ability to repay and requires verifying borrowers' income and assets.

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[5] Weiss, N. Eric and Michael Seitzinger, "Fannie Mae and Freddie Mac: A Legal and Policy Overview," Congressional Research Service, Feb. 28, 2008

[6] Solomon, Deborah, "Mortgage bailout is greeted with relief," Wall Street Journal, Sept. 9, 2008

[7] Weiss, N. Eric, "Fannie Mae's and Freddie Mac's Financial Problems,", Congressional Research Service, Sept. 12, 2008.

[8] Wallison, Peter J. and Charles W. Calomiris, "The Last Trillion-Dollar Commitment," American Enterprise Institute, Sept. 30, 2008.

It bans heavy prepayment penalties and requires creditors to establish escrow accounts. It also halts abusive practices by predatory sales agents, and requires fuller disclosure of loan costs.

The Federal Reserve has a dual responsibility of maintaining price stability and economic growth. Warning signals of imbalance toward too much cheap money was evident as the stock market took off after 1995. The behavior of house prices in and after the 2001 recession was another.[9]

The Fed could have chosen to target asset inflation before the bubble burst, rather than cutting interest rates afterwards, but it allowed Chinese investment to inflate domestic asset prices rather than proactively draining the bubble.[10] Former Federal Reserve Board Chairman Alan Greenspan warned about "irrational exuberance" before the dot-com bust.

In 2003, the federal-funds rate reached 40-year-lows. That in turn lowered the rates on adjustable loans to historic lows. The low rates combined with new appetites for mortgages for subprime borrowers to help fuel the housing boom.[11]

The Federal Reserve job has been compared to balancing the size of a fire (economic growth) with the amount of oxygen (money supply). A person can stop all fires if he eliminates oxygen, but he will not be able to breathe. Likewise, significantly tighter monetary policy would have dampened economic growth, possibly outweighing the benefit of stable prices.[12]

COMMUNITY REINVESTMENT ACT (CRA) PRESSURE?

The Community Reinvestment Act(CRA) passed in 1977 to encourage private lenders to stimulate economic activity in underdeveloped areas by loaning to businesses, development groups and prospective homebuyers. It requires banks to lend in the low-income areas where they take deposits.[13]

Critics have pointed to the CRA as a case of government launching subprime lending. About 50% of subprime loans today were made by institutions not subject to any kind of federal regulation, much less the depository institutions regulated by the CRA.[14]

Defenders of CRA note statistics that show that those subprime loans done under the CRA regulations did not default at as high a rate as those outside CRA. Most subprime loans were refinancings of first mortgages, and so would not count towards CRA requirements in any case.[15]

The CRA did encourage subprime lending for affordable housing. In 1995, CRA reform increased the number of bank loans to low-and moderate-income families by 80%. In 1997, Bear Stearns made first securitization of CRA loans, $384 million backed by Freddie. Between 2000-2002 Fannie securitized $394 billion in CRA loans, $20 billion of which went to securitized mortgages.[16]

RISK MODELS, CREDIT RATING AGENCIES & DEREGULATION

As the number of mortgage-backed securities grew in number and complexity, their risk and the risk of collateralized debt obligations began to be estimated using computer models.

Lenders and investors rely on econometric models to sift large numbers for variables of related risk. Just as models are used to rate individual's credit worthiness, these models estimated risks on complex securities.

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[9] Hutchinson, Martin "Fed's Misplaced Fulcrum," Asia Times Online, Sept. 9, 2008
[10] Mallaby, Sebastian "Blaming Deregulation" Washington Post, October, 6, 2008
[11] Roberts, Russell, "How Government Stoked the Mania," Walls Street Journal, Oct. 3, 2008
[12] Baily et al, "The Great Credit Squeeze," Economic Studies at Brookings, May 21, 2008
[13] Pressman, Aaron "Community Reinvestment Act had nothing to do with subprime crisis," Business Week Blog, 9.29.08
[14] Kane, Mary "Low-Income Borrowers Blamed in Bailout Crisis," Washington Insider, 9.30.08
[15] Kane, Mary.
[16] Russell, Roberts.

The models were flawed, however, in a number of assumptions, but they gave investors and lenders inordinate confidence in the securities.[17]

Former Federal Reserve Chairman Alan Greenspan has noted that, "Where once more marginal applicants would simply have been denied credit, lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately." Greenspan also noted a concern for transparency and completeness of the data being fed into the computer models. But every institution relied on its own models. Its accuracy often depended on data supplied by the originator of the asset.[18]

The critical agencies that provide ratings for investment products – rating agencies – also became compromised. Moody's, Standard & Poors and Fitch are the "big three" agencies that issue credit ratings that provide signals to investors on the risk and credit-worthiness of an asset. It became commonplace to "rate shop" agencies to find the best credit rating for products. When one of the agencies refused to rate a collateralized debt obligation, the obligation often would be repackaged and represented with the agency agreeing to rate it by lowering its overall rating a few notches. This was called "notching down" a security.[19]

Financial institutions, too, were encouraged to mitigate their exposure to risk by purchasing a type of insurance on risky mortgage bonds called a credit default swap. The credit default swap is a financial derivative that is now an estimated $55 trillion market. Poor records were kept in the rapid trading of CDS and it is unknown how long it will take to unwind the financial liability.[20]

One report describes the Credit Default Swap market like this:

> *So what started out as a vehicle for hedging ended up giving investors a cheap, easy way to wager on almost any event in the credit markets. In effect, credit default swaps became the world's largest casino.*[21]

Deregulation has been blamed for the growth in the abuses, but actually bad law, bad regulations and inattentive oversight are at the heart as the money from domestic and foreign sources grew. In turn, Congress and regulators were susceptible to special interest pressure in regulation of rating agencies, financial institutions, Freddie Mac and other facets of the growth of financial derivatives.[22]

CONCLUSIONS

Between 1997 and 2006, the share of mortgages securitized grew from about 50% to 68%. In dollars, this was an increase from $423 billion to $2 trillion.

Stimulated by the demand of large purchasers like Fannie Mae and Freddie Mac and facilitated by lending institutions not subject to federal regulations, overall underwriting standards fell below acceptable levels.

Once the market was infected with the magical thinking of zero-risk gain, quarterly-earning competitiveness drove the appetite for mortgage-based investments.

Mortgage lending ballooned in a system characterized by brokers whose incentives were merely to close deals, securitizers whose financial "innovations" promised zero-risk gains, rating agencies who rated the securities AAA, and political office holders and regulators who did not create effective regulatory and oversight structures.

The whole system began with closing a loan on a house. When a loan begins with a document that even the industry called "liar loans" – in which no documentation was required – the process was bound to collapse. Those people who originated the loans would have known first and best about the loan's likely soundness.

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[17] Minority Staff Analysis, "Examining the Causes of Credit Crisis of 2008," Committee on Oversight and Government Reform, U.S. Rep. Tom Davis, ranking member, Oct. 6, 2008.

[18] Ibid.

[19] Ibid.

[20] Varchaver, Nicholas, "The $55 Trillion Question," *Fortune Magazine Online*, Sept. 30, 2008

[21] Ibid.

[22] Minority Staff Analysis.

Yet, compensation packages across the financial system encouraged short-term risk-taking. Originators got paid on commission, securitizers got paid when the pool is sold: thus the focus was on transactions, not quality of underwriting. Deal flow was the focus, not asset performance.

WHAT DOES TREASURY PROPOSE TO DO?

Treasury proposed a program similar to the Resolution Trust Corporation (RTC) that could acquire $700 billion of mortgage-related assets from the banking system.

The original proposal gave the Secretary of the Treasury broad discretion to determine the terms of asset acquisition and the operations of the program.

WHAT WERE SOME OF THE CHANGES TO THE PROPOSAL IN THE PLAN PASSED BY CONGRESS?

The expressed purpose of the Emergency Economic Stabilization Act of 2008 is to "...provide authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system."

This measure addressed some of the concerns that some policymakers may have had regarding the three-page Treasury plan:

- Excludes foreign central banks from the definition of eligible financial institutions.
- Provides for insurance of some troubled assets as an alternative to, or in addition to, purchasing troubled assets.
- Creates a Financial Stability Oversight Board to review the exercise of authority under the program. The board will be made up of the Chairman of the Federal Reserve, the Secretary of the Treasury, the Secretary of the Department of Housing and Urban Development, the Director of the Federal Housing Finance Agency, and the Chairman of the Securities and Exchange Commission.
- Allows Treasury to manage the acquisition and sale of assets with any proceeds accruing to the general fund for reduction of the public debt.
- Instructs the Secretary of Treasury to implement a plan to maximize assistance for homeowners and to encourage loan servicers to participate in the Hope for Homeowners program. Assistance to homeowners includes consent to reasonable loan modification requests.
- Puts limits on executive compensation of institutions that participate. Under certain circumstances, these limits include limits on incentive compensation for risk-taking during the period that the program has an equity or debt position in the firm, recovery of incentive bonuses paid to senior executives based on financial statements that are later shown to be false, and a prohibition of golden parachutes.
- The Comptroller General has ongoing oversight of TARP management and activities.
- There is to be a study of excessive leverage in financial institutions.
- The President will appoint a special inspector for TARP, with Senate confirmation.
- The debt limit is raised to $11.3 trillion.
- A Congressional Oversight Panel is created in the legislative branch to monitor financial markets and make regular reports to Congress, and to provide a report on financial market regulatory reform by January 20, 2009.
- There is no provision for allowing bankruptcy judges to reduce mortgage debt.
- The SEC is given the authority to suspend mark-to-market accounting rules.
- The limit on FDIC insurance for accounts at depository institutions is raised from $100,000 to $250,000 per individual until the end of TARP (December 31, 2009).

WHAT OTHER PROVISIONS WERE INCLUDED?

Included in the legislation were:

- Energy Improvement and Extension Act of 2008 and
- Tax Extenders and Alternative Minimum Tax Relief Act of 2008.

WHAT IS TREASURY'S NEW PLAN?

After a meeting of the G7 finance ministers on October 14, 2008, President Bush announced a coordinated international effort to rescue credit markets and avoid a global economic crash. Under the new plan, Treasury will:

- Purchase $250 billion worth of equity (nonvoting preferred stock + warrants to purchase common stock) in the nine largest U.S. banks to give them access to capital;
- Temporarily guarantee $1.5 trillion in new senior debt issued by banks; and
- Insure $500 billion in deposits in noninterest-bearing accounts, mainly used by businesses.

The change in strategy was necessary because the financial crisis in the United States had expanded to include the rest of the world. Central banks around the world had to take immediate action to introduce liquidity into credit markets and restore confidence in the global financial system.